Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?

by

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A corporate reorganization has been described as:

> [A] combination of a municipal election, a historical pageant, an anti-vice crusade, a graduate-school seminar, a judicial proceeding, and a series of horse trades, all rolled into one - thoroughly buttered with learning and frosted with distinguished names. Here the union of law and economics is celebrated by one of the wildest orgies in intellectual history. Men work all night preparing endless documents in answer to other endless documents, which other men read in order to make solemn arguments.[1]

Perhaps no process has undergone such a fundamental change over the course of history than the method in which economic failure is addressed by society. From the inception of government, lawmakers charged with fashioning a remedy for insolvency focused on the rights of creditors to realize upon claims without regard to the consequences to the debtor and society.

As a result, over the past three thousand years, the hapless debtor, generally, has been chastised and blamed, beaten and maimed, shunned by society, sold into slavery, and even put to death. Moreover, the concept of credit itself has been targeted and feared, as captured in the public loathe of the wielder of credit himself, the merchant.[2]

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[1] THURMAN ARNOLD, THE FOLKLORE OF CAPITALISM 230 (1937).

[2] See the discussion of The Merchant of Venice by William Shakespeare *available at* http://www.

Only in the past two centuries did the most visionary of political thinkers come to realize the appropriate approach to the insolvency dilemma: acceptance of failure as an inevitable by-product of any economic system based upon credit, and that credit is an integral part of commerce as well as a foundation for the growth and well-being of society.[3] As James Madison pronounced, "establishing uniform laws of bankruptcy legislation is [. . .] intimately connected with the regulation of commerce."[4] At long last, execution came to be directed against the property of the bankrupt, and not his person.[5]

This new line of thought gave birth to the underlying assumption inherent within the railroad equity receivership paradigm for business reorganization: that a troubled firm's business can be reorganized and rehabilitated under the protection of a court and returned to the business world as a viable economic unit. This novel, highly successful concept of reorganization and rehabilitation, grounded in the principles of going concern value and the retention of the debtor as a debtor in possession to operate and manage the assets and business, is unique to American law. It was codified in the bankruptcy laws of the United States during the depression years of the 1930s and reaffirmed in 1978 with the enactment of the Bankruptcy Reform Act.[6]

Twenty-five years have passed since the Bankruptcy Reform Act became law on October 1, 1979. How did the United States come to adopt this innovative approach to business reorganization that has reshaped the way debtors and creditors restructure in today's global economy? And what are the prospects for the continued viability of the Chapter 11 model in the future? To properly address these questions, one must review the history and development of bankruptcy law in America.

The first section of this Article traces the historical roots of bankruptcy law in America, with an emphasis on the genesis of the railroad reorganization paradigm, the evolution of the debtor in possession as the driver of the reorganization process, the protection of the debtor and its estate, and the notion of preservation of going concern value. The second section analyzes today's changing economy and its effect on business reorganizations. The third section examines the vitality of the railroad reorganization paradigm underlying American bankruptcy law. Finally, the Article highlights the cur-

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shakespeare-online.com/plots/merchants.html (The "rich money-lender, named Shylock[, was] despised and disliked . . . very much, and treated . . . with the greatest harshness and scorn.").

[3] *Testimony Advocating the Renewal of the Fair Credit Reporting Act: Hearing on H.R. 2622 Before the Comm. on Banking, Housing and Urban Affairs*, 108th Cong. 30 (2003) [hereinafter *Hearing*] (testimony of John W. Snow, Treasury Secretary).

[4] THE FEDERALIST No. 42, at 271 (James Madison) (Clinton Rossiter ed., 1961).

[5] Louis E. Levinthal, *The Early History of Bankruptcy Law*, 66 U. PA. L. REV. 223, 232 (1918).

[6] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION, A HISTORY OF BANKRUPTCY LAW IN AMERICA 48-70, 131-41 (2001).

rent issues as to the viability of reorganization as contemplated in 1978 in the face of a new economy.

I. THE HISTORICAL ROOTS OF AMERICAN BANKRUPTCY LAW

"Credit is an institution that lives by virtue of man's confidence in his fellow-man's good faith, and good faith and the primitive man are strangers."[7] In the past two hundred years, the concept of credit has shed its historical association with greed, avarice, and skepticism in the eyes of the public. Today, ready access to credit is an integral part of the economic security and well-being of society.[8] Insolvency laws assure the similar treatment of similarly situated creditors, instilling confidence in fair treatment upon default and thereby encouraging the extension of credit in our society.

The earliest known laws regulating the relationship among debtors and creditors prescribed severe criminal punishment for those unable to pay their debts as they came due. In medieval Europe, a merchant who was unable to pay his bills was dealt with harshly: his creditors would come to the market and break his workbench over his head. Accordingly, the broken bench—*banca rota* in Latin—is both the legal and linguistic root of modern bankruptcy. Of course, the result of the broken bench often was the debtor's inability to earn a livelihood with attendant burdens upon society.

To early societies credit was an unfathomable concept, as merchants expected the immediate payment for goods or services. The failure to pay for goods or services was considered a form of theft and was met with swift punishment.[9] The notorious "debtor's prisons" were intended to deter merchants and others from failing to meet their financial obligations. "It is true that the imprisonment of a debtor, who is unwilling or unable to pay his debt, will not necessarily give the creditor his money, but it will tend to stop such abuses of confidence."[10]

The concept of enslaving debtors traces back to the bible.[11] The Code of Hammurabi, circa 1750 B.C., provided that a debtor unable to meet its obligations be sold into slavery.[12] In Hindu law, self-help permitted a creditor to seize the debtor, compel him to labor for him, or, in more extreme circumstances, kill or maim him in his home, or confine his wife, children or cattle.[13]

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[7]*Id.* at 229.

[8]*Hearing, supra* note 3.

[9]*See generally* Levinthal, *supra* note 5, at 228-31.

[10]WILLIAM SEARLE HOLDSWORTH, A HISTORY OF ENGLISH LAW 231 (1925).

[11]*See, e.g.*, *2 Kings* 4:1 ("[A]nd the creditor is come to take to him my two sons to be slaves."); *Isaiah* 50:1 ("Which of my creditors is it to whom I have sold you?"). *See also Exodus* 22:2; *St. Matthew* 18:25.

[12]Levinthal, *supra* note 5, at 230.

[13]*Id.*

In 623 B.C., Draco, ruler of Athens, instituted laws that likened indebtedness to murder and prescribed a punishment of death.[14] The Twelve Tables of Roman law, established *circa* 450 B.C., presented a creditor with a choice of killing the debtor or selling him into foreign slavery.[15]

Other primitive societies provided a religious sanction as an alternative to slavery or execution. In ancient India, this practice was known as "sitting d'harna," while in ancient Ireland a similar practice was known as "fasting on."[16] In each instance, the creditor would sit in the debtor's doorway until such time as the debt was paid. This method proved effective, as a debtor feared a loss in society that would follow the starvation of a creditor in his doorway.[17] In Egypt, it was customary for a debtor to pledge the deceased body of a close relative. This pledge proved effective in light of the moral and spiritual consequences of the opening of a tomb and disturbance of the mummy.[18]

As commerce thrived and transactions spanned geographical areas that required expenditure of time to consummate, societies began to understand the benefits that credit could provide for their economies. As a result, punishments associated with the failure to pay one's debts became less severe. Compensation began to replace retaliation or retribution as the consequence of default. Likewise, execution came to be directed against the property of the debtor, not his person.[19] For example, the Romans under Julius Caesar developed the law of *cessio bonorum*, a progressive concept that permitted an insolvent debtor to forfeit all of his property to his creditors, rather than his life.[20] In feudal times, debtors and creditors would on occasion engage in an actual physical confrontation known as a "wager of battel," wherein a debtor would either lose title to his land to the creditor or earn a discharge of the debt.[21]

American bankruptcy jurisprudence evolved from the English agrarian societies of approximately five centuries ago. Prior to the sixteenth century, there was no need for a specialized body of law that governed relations among debtors and creditors, as the small groups of landed gentry required little more than the most rudimentary forms of credit.[22] English farmers

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[14]F. Regis Noel, A History of the Bankruptcy Law 15 (1919).

[15]Levinthal, *supra* note 5, at 231.

[16]*Id.* at 229.

[17]*Id.*

[18]*Id.*

[19]*Id.* at 232-33.

[20]*See* Harvey R. Miller & Erica M. Ryland, *The Role of Mega Cases in the Development of Bankruptcy Law*, *in* The Development of Bankruptcy & Reorganization Law in the Courts of the Second Circuit of the United States 189, 192 (1995).

[21]Noel, *supra* note 14, at 21.

[22]Miller & Ryland, *supra* note 20, at 192-93.

were skeptical and fearful of extending credit and typically viewed merchants as "cheats" or "evil magicians" who manipulated intangible credit and property.[23]

The first bankruptcy statute, enacted by the English Parliament in 1543 amidst an increase in domestic and international trade credit, provided criminal penalties for defrauding creditors. The law was more a deterrent against fraud by foreign merchants than a provider of rights to an unfortunate debtor.[24] However, as England's colonial expansion grew throughout the sixteenth century, a modern system of mercantile credit, the Law Merchant, and a primitive system of courts were adopted, leading to the passage of England's first non-criminal bankruptcy statute in 1571.

> Where bankruptcy law had once stereotyped the merchant debtor as an elusive social deviant whom the law should criminally punish, it began to develop an opposite image of the merchant debtor - as a noble and venerable statesman of society whom the laws should protect from the cruel contingencies of economic life.[25]

The 1571 Act codified a series of informal legal customs practiced by prominent members of the merchant community. Pursuant to the Act, a bankruptcy proceeding could be commenced by a single creditor and subjected all of a debtor's property to the jurisdiction of the Chancery court, which had the power to stay individual creditor enforcement actions against the debtor until the bankruptcy proceeding was closed.[26]

A major advance in bankruptcy law occurred in 1705 with the adoption of a right of discharge under the Statute of Anne.[27] By issuing a right of discharge to debtors who cooperated in the marshalling of their property for the benefit of creditors, Parliament conceded that a statute which provided penalties but no rewards was self-defeating.[28] However, the infamous "Trader Rule" limited the application of these "decriminalized" bankruptcy laws to large international or domestic traders. Principled on the belief that the benefits of bankruptcy law should be limited to merchants and large traders whose losses were accidental or due to no fault of their own,[29] the Trader Rule relegated individual debtors and small traders to the harsh, punitive

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[23]*See* Robert Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 13 (1986). *See also supra* note 2 and accompanying text.

[24]*See* MILLER & RYLAND, *supra* note 20, at 193.

[25]Weisberg, *supra* note 23, at 6.

[26]Miller & Ryland, *supra* note 20, at 195.

[27]*See* Weisberg, *supra* note 23, at 30-31.

[28]*Id.* at 30.

[29]2 WILLIAM BLACKSTONE, COMMENTARIES 473-74 (4th ed. 1770).

laws of insolvency.[30] The Trader Rule perpetuated a dualism whereby the *bankruptcy laws*, defined by their relative leniency, would protect merchants, while *insolvency laws* would harshly apply to small businesses and individuals.[31]

Consistent with many of the views adopted by colonists fleeing English rule, the first American laws regulating the relationship among debtors and creditors assumed the principles of the progenitor English *bankruptcy laws*, giving merchants broad protections in recognition of the importance of credit and trade to the colonial economy. The early course for the nation's economic policy as to insolvency and commercial failure over the next several hundred years, thus, was established. Significantly, however, the American laws were more progressive in relaxing the nature of the oppressive English *insolvency laws* and their harsh treatment of individual and small business debtors.[32]

A. The First United States Bankruptcy Laws

> *"Capitalism without bankruptcy is like Christianity without hell."*
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> *—Frank Borman, Chairman, Eastern Airlines.*

While the progenitor of modern United States reorganization law is the equity receivership that was fashioned in the late nineteenth century to resolve the financial distress and failures that permeated the railroad industry after the Civil War, the roots of United States bankruptcy law trace back to colonial America and the framers' struggle over federalism.[33]

In yet another example of the framers' prophetic vision of the American political and economic system, the equitable treatment of creditors through the enactment of a uniform bankruptcy law was of manifest importance in the infant stages of American government. Accordingly, Article I, section 8 of the United States Constitution provided Congress with the power to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."[34] In Federalist No. 42, James Madison pronounced that "[t]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different

[30]*See* W. J. Jones, *The Foundations of English Bankruptcy: Statutes and Commissions in the Early Modern Period*, 69 Transactions of Am. Phil. Soc'y pt. 3, at 24-25 (1979).

[31]Miller & Ryland, *supra* note 20, at 196.

[32]*See* Peter J. Coleman, Debtors and Creditors in America: Insolvency, Imprisonment for Debt, and Bankruptcy, 1607-1900, at 11-15 (1974).

[33]Skeel, *supra* note 6, at 48-70 (2001).

[34]U.S. Const. art. I, § 8, cl. 4.

states, that the expediency of it seems not likely to be drawn into question."[35]

Congress rarely reached a consensus throughout the late-eighteenth and nineteenth centuries as to the enactment of a federal bankruptcy law. Southern agricultural states, suspicious of Northern Federalist ideals, were opposed to a national bankruptcy law that would govern the appropriation of real and personal property by operation of law to satisfy creditor claims. Thomas Jefferson, one of the largest landowners and biggest debtors in the Commonwealth of Virginia, was vigorously opposed to a federal bankruptcy law that would have allowed his creditors recourse to his real property to satisfy their claims.[36] In contrast, Northerners supported bankruptcy legislation as necessary to promote commercial enterprise, to encourage the extension of credit, and to protect creditors and personal liberties.[37] An economic panic in the closing years of the eighteenth century reconciled some of the opposing views and resulted in the adoption of the first national bankruptcy law in 1800. Rather than depart from the harsh English insolvency laws and adopt small merchant friendly insolvency legislation, the Bankruptcy Act of 1800 adopted rules then in effect in England, including the Trader Rule, which limited protections to large merchants.[38] As the economy improved and the distrust of federal courts continued, the 1800 Act was repealed in 1803.

No factor had more influence on the adoption of federal bankruptcy legislation than the "boom or bust" nature of the domestic economy. It was only in the face of financial crisis and economic depression that bankruptcy legislation passed. In times of economic turmoil, Congress quickly enacted bankruptcy laws to alleviate the effects of widespread depression and panic.[39] Likewise, when an economic crisis passed, support for the laws dwindled, and they were repealed before their intended expiration date.[40]

Following the repeal of the Bankruptcy Act of 1800, federal bankruptcy legislation was not enacted until 1841, in response to the panic of 1837, attributable by many to land speculation.[41] Though the Act of 1841 broadened the scope of relief to cover small merchants and individuals and introduced the concept of a voluntary bankruptcy, the Act was quickly re-

[35]THE FEDERALIST No. 42, at 271 (James Madison) (Clinton Rossiter ed., 1961).

[36]*See generally* CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 11-12 (1935).

[37]*See* SKEEL, *supra* note 6, at 26.

[38]Charles J. Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 345-46 (1991).

[39]SKEEL, *supra* note 6, at 24.

[40]*Id.* at 24-25 (noting that this traditional account, while inaccurate in some respects, is a convenient framework for describing the first century of bankruptcy debate).

[41]*See* Daniel W. Levy, *A Legal History of Irrational Exuberance*, 48 CASE W. RES. L. REV. 799, 822-26 (1998).

pealed in 1843. Yet another bankruptcy act was enacted in 1867 generated by a post-Civil War currency debacle, but it also was repealed in 1878.

Ultimately, the "manifest destiny" doctrine of the last decade of the nineteenth century spurred a growth of interstate businesses which presented state courts with jurisdictional problems that preceded yet another push for permanent bankruptcy legislation.[42] Proponents of the legislation argued that expansion of the commercial economy by virtue of the railroad and telegraph and the rise of populism made a permanent national bankruptcy law a necessity. Opponents doubted the need for such legislation that would benefit a selfish few.[43] Finally, the Bankruptcy Act of 1898 was passed and became the first enduring federal bankruptcy legislation in the nation's history.

B. Railroad Reorganization as Equity Receiverships

The bankruptcy debates undertaken by Congress in 1800, 1841, 1867, and 1898 did not address corporate reorganization. Although the Bankruptcy Acts of 1867 and 1898 were the first to introduce provisions contemplating corporate bankruptcy, these provisions were intended for small businesses and did not serve as the predecessors for the large corporate reorganizations that have consumed the bankruptcy courts since the commencement of the twenty-first century.[44] Rather, the foundation of United States reorganization law is the equity receivership, also known as the federal consent receivership, that was fashioned in the late nineteenth century to resolve the financial distress and failures that permeated the railroad industry after the Civil War.[45]

Akin to the phenomenon recently experienced in the development of the telecommunications industry, the post-Civil War development of transcontinental railroads captured the imagination of investors. Entrepreneurs competed with each other to attract the capital to acquire the rights of way, construct the railroad, and purchase the equipment to run the railroad. The entrepreneurs and their advisors projected the time to completion, the anticipated revenue and net income to support debt obligations, and, hopefully, a return to stockholders.

Unfortunately, similar to what occurred in the telecommunications industry at the end of the twentieth century, the entrepreneurs and their advisors miscalculated the physical difficulties of building a transcontinental railroad, failed to adequately consider the effects of competition (e.g., Northern Pacific Railroad versus Central Pacific Railroad versus Southern Pacific Railroad) and overestimated revenues and underestimated expenses in the face of

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[42] *See* Miller & Ryland, *supra* note 20, at 200.

[43] *Id.*

[44] *See* Skeel, *supra* note 6, at 48.

[45] *Id.* at 48-70.

highly-leveraged capital structures encompassing institutional debt, public bond debt, trade payables, and public stockholders. Thousands of miles of track were laid at great expense without considering a means for coordination between them. "Between 1873 and the end of the nineteenth century roughly one-third of all the railroads—some seven hundred in all—failed, and in some years nearly 20 percent of the nation's track was in receivership."[46] It was a recipe for disaster!

The problem that arose upon the occurrence of illiquidity and failure of the railroad to meet its obligations was - what to do with the 800-pound gorilla? In some cases, the railroad construction was incomplete. In other cases, projected revenues had been grossly overestimated and the competence of management was questionable. The situation was further complicated because the railroad ran across many state jurisdictions. The absence of a federal bankruptcy statute left the railroads vulnerable to a disruptive seizure of their assets. The exercise of remedial rights by one creditor and the enforcement of those rights in a creditor's home state, say on a portion of track in Connecticut (i.e., foreclosure of a consensual or statutory lien), could have terminated the operations of a railroad that ran from West to East through several states. Concomitant with such termination would be the adverse impact upon the public interest. Citizens and residents of various states and localities would have been deprived of the most efficient and expeditious means of transportation then extant. There was a broad national consensus that the troubled railroad industry must be saved, the absence of which would leave "nothing but a streak of iron-rust on the prairie."[47]

In light of the interstate nature of railroads and absent a uniform federal bankruptcy statute, innovative action was required. Congress' authority to enact comprehensive bankruptcy legislation under the bankruptcy clause of the Constitution was undermined by the recurrent federalism debate incessant in the nineteenth century. The investment in railroads and their subsequent construction, heavily subsidized by the federal government, was very substantial and the railroads were providing a basis for a new economy in moving goods and people over long distances in relatively short time periods. A public need for an efficient railroad system was rising. As a result, legal practitioners, with the substantial and cooperative aid of the federal judiciary, stepped forward to use the equity power of the federal courts to provide a remedy that has become the paradigm for modern business reorganization law.

Drawing upon their equitable authority to appoint receivers to administer properties when appropriate, progressive federal district courts forged the

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[46]*Id.* at 51-52.

[47]Cent. Trust Co. of N.Y. v. Wabash, 29 F. 618, 626 (E.D. Mo. 1886).

concept of using equity receiverships to assume control of the defaulting railroad and its assets. The federal railroad equity receivership negated state borders and provided a single forum to protect and administer the assets of the distressed railroad. Thus, the functional equivalent of a national reorganization statute emerged.[48] The process involved the debtor railroad, the significant creditors, and the federal district court working together to effectuate the continuation of the railroad while the parties in interest, through the use of protective committees and receivers appointed by the federal court, negotiated the recapitalization of the railroad. In time, the use of an equity receivership proceeding spread beyond railroads as a means to resurrect, rehabilitate, and reorganize failing businesses.

As originated, the process began with the filing of a "creditor's bill," which formally asked the court to appoint a receiver, followed by the filing of a "foreclosure bill," which asked the court to schedule a sale of the property. The debtor railroad did not contest the bills and usually consented to the relief requested. Multiple "protective committees" of bondholders and stockholders would be formed to represent respective stakeholders in the bargaining process, and negotiations to restructure the railroad's financial affairs would ensue. The negotiations would culminate in a reorganization plan that would recapitalize the railroad as an essentially new entity and distribute new securities to the stockholders pursuant to the plan.

What began as a prosecution of the creditor's bill in equity, which acted as a modern day "automatic stay," accompanied by the consensual appointment of receiver(s) in one federal district court with *in seriatim* appointments of the same receiver(s) by each federal court in each district through which the railroad ran, soon developed into a more sophisticated process with a single collective forum; the initial federal district court that first appointed the receiver(s) having jurisdiction over the entire railroad and all of its assets. This process became known as the Railroad Equity Receivership and was utilized in, among others, the reorganizations of *Northern Pacific Railway Company*,[49] *Mississippi and Missouri Railroad Company*,[50] and the *Wabash, St. Louis & Pacific Railroad Company*.[51]

> What emerged was one of the most remarkable dances in the history of American common Law. Railroad creditors continued to solemnly incant the magic words of foreclosure law

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[48]*See* SKEEL, *supra* note 6, at 57.

[49]N. Pac. R.R. Co. v. Boyd, 228 U.S. 482 (1913). The Supreme Court's ruling in *Northern Pacific* that unsecured creditors have a higher priority than shareholders, and, therefore, must receive a distribution before shareholders are afforded a participation right, represented the first pronouncement of what would eventually become the Absolute Priority Rule.

[50]R.R. Co. v. Howard, 74 U.S. 392 (1868).

[51]Chicago Deposit Vault Co. v. McNulta, 153 U.S. 554 (1894).

> .... When the smoke had cleared, however, a body of law designed to liquidate the assets of an insolvent debtor had been reconfigured to effect the nation's first corporate reorganizations.[52]

The development of the Railroad Equity Receiverships did not evolve overnight. Receiverships were traditionally viewed as an extreme remedy that contemplated the "absolute wresting away from the hands of its owners of property of such peculiar character, and often of enormous value."[53] Also problematic was the requirement that a neutral party be appointed as receiver, not an insider intimately familiar with the debtor's industry and business affairs. Further, receiverships could not be commenced by debtors; only a creditor could invoke a receivership as ancillary relief to a lawsuit seeking enforcement of a debt. Finally, traditional receiverships had not been used to rehabilitate or reorganize a company's failing business operation, the court's ultimate goal for Railroad Equity Receiverships. The law of receiverships provided no precedent for conveying ownership of a business to creditors in satisfaction of debt obligations, or for binding disapproving creditors to a reorganization plan.[54]

In developing and implementing Railroad Equity Receiverships, courts reacted to the necessity of preserving value and serving the public interest. They instituted radical reform and gave birth to novel ideas that became the genesis of the business reorganization law adopted as part of the Bankruptcy Reform Act of 1978.

The Railroad Equity Receivership, unlike liquidation proceedings of that period under state laws, included the active participation of the railroad's management in the ongoing operation of the railroad and the development of the business plan to support any financial reorganization. Creditors and courts embraced the concept that the debtor's knowledge, expertise, and familiarity with its business were inherently valuable in large, complex, corporate restructurings.[55] The participation of the debtor in the practice of Railroad Equity Receiverships became nearly indispensable.[56]

This debtor in possession concept was memorialized with the first voluntary equity receivership, *Wabash, St. Louis and Pacific Railway* in 1884, the most celebrated case in the evolution of equity receiverships.[57] Until this time, receivership had been purely a creditors' remedy, commenced only after

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[52]SKEEL, *supra* note 6, at 57.

[53]D. H. Chamberlain, *New-Fashioned Receiverships*, 10 HARV. L. REV. 139, 141 (1896).

[54]*See* Miller & Ryland, *supra* note 20, at 203.

[55]*Id.* at 209-10.

[56]*See generally* Chamberlain, *supra* note 53, at 139-42.

[57]*See* Albro Martin, *Railroads and the Equity Receivership: An Essay on Institutional Change*, 34 J. ECON. HIST. 685, 697-701 (1974).

a creditor's request and a foreclosure by one or more classes of creditors.[58] In the case of *Wabash*, representatives of the railroad *themselves* sought and obtained judicial authority to commence a receivership *prior* to missing their first interest payment. "[W]abash was . . . the most vivid illustration of the fact that managers and their Wall Street professionals, not ordinary creditors, were the ones who controlled the reorganization process."[59] The debtor's increased role was necessary in light of the fact that "only a financial wizard, with plenty of time and money at his disposal, could have sorted out the property represented by the mortgages of the numerous railroads which comprised the *Wabash*, property which had been irrevocably commingled throughout the system."[60]

Another novel accomplishment of the equity receivership was the critical concept of "going concern value." Often, the value of assets mortgaged by the railroad was inextricably intertwined with such entity. For example, the foreclosure of a judgment lien against six feet of railroad track or a locomotive would have resulted in probably *de minimus* proceeds absent the continuation of the railroad. Thus evolved the concept of going concern value, i.e., as a part of an ongoing operation, the assets had greater value than what could be realized from the forced sale and liquidation of the track or locomotive.

An 1851 Supreme Court of Georgia case involving the Munroe Railroad and Banking Company employed one of the first known uses of equity receivership and, likewise, provided early support for the proposition that preservation of an enterprise to realize going concern value is paramount to distinct rights of individual creditors. On appeal from the denial of a request that the railroad should be foreclosed and each of its constituent portions sold at a sale in the area through which it passed and to different creditors, the Court prophetically stated:

> [W]hat disastrous consequences would have resulted, if each judgment creditor had been allowed to seize and sell separate portions of the road, at different sales, in the six different Counties through which it passed, and to different purchasers! Would not this valuable property have been utterly sacrificed - the rights and interests of the creditors, as well as the objects and intentions of the Legislature in granting this charter, entirely defeated? I feel warranted in saying, that the whole history of Equity Jurisprudence does not present a case which made the interposition of its powers not only highly expedient, but so indispensably necessary in adjusting

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[58]*See* SKEEL, *supra* note 6, at 64.

[59]*Id.*

[60]Martin, *supra* note 57, at 699.

> the rights of creditors to an insolvent's estate, as this did. The Chancellor, then, in taking this matter in hand and directing a sale of the entire interest for the benefit of all concerned, was but invoking the powers of Equity to aid the defects of the Law, and applying analogous principles to the existing emergency; and so far from transcending his authority, he is entitled to the thanks of the parties and the country, for the correct and enlightened policy which he adopted. Had he faltered or shunned the responsibility thus cast upon him, he would have shown himself unworthy of the high office which he filled. *As it is, this precedent will stand out in bold relief, as a landmark for future adjudication.*[61]

The shared belief among various creditor constituencies in the preservation of an enterprise was instrumental in the success of Railroad Equity Receiverships. Whereas secured creditors tend to be much more skeptical than unsecured creditors regarding financial restructurings (as opposed to liquidations), railroad bondholders secured by discrete sections of track realized that they had as much to gain from keeping the railroad intact as did managers, employees, and shareholders. Accordingly, Railroad Equity Receiverships benefited from the collective interest in preserving the business as a going concern.

The equity receivership courts' innovations transcended problems typically associated with the operation of large corporations that are undergoing restructurings and offered powerful guidance to future courts faced with similar dilemmas. For example, railroads were often mired in the receivership process for numerous months and even years and were routinely troubled by suppliers who had lost incentive to continue to provide goods (i.e., coal, etc.) that were vital to the continuation of the railroad's operations. As a solution, courts authorized railroads to issue "receiver's certificates" that gave special priority to investors who contributed additional equity for specified purposes, such as making payment to suppliers. This special priority encouraged investors to provide additional equity which afforded suppliers with enough confidence to continue providing goods necessary for the continued operation of the railroad.[62]

From the Railroad Equity Receivership cases evolved numerous additional principles of reorganization law, including: (i) liquidation value will be less than going concern value, while reorganization enables preservation of going concern value;[63] (ii) full notice of proceedings and disclosure of the

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[61] Macon & W. R.R. Co. v. Parker, 9 Ga. 377, 394 (Ga. 1851) (emphasis added).

[62] *See* SKEEL, *supra* note 6, at 59-60.

[63] *Id.* at 57.

relevant facts and applicable law (i.e., due process), was necessary to enable creditors to vote to accept a proposed plan of reorganization;[64] (iii) application of the Absolute Priority or Fair and Equitable Rule;[65] (iv) receivers and protective committees are subject to fiduciary duties and obligations;[66] (v) nationwide equity jurisdiction over all of the debtor's assets is necessary to effectuate reorganization;[67] (vi) suspension of the exercise of remedial rights by secured creditors is not violative of the United States Constitution;[68] (vii) all creditors may be enjoined from taking any actions against the debtor or its property without leave of the reorganization court in order to preserve the integrity of the estate to pursue reorganization;[69] (viii) dissenting minority creditors or equity security holders will be bound by a confirmed plan of reorganization;[70] and (ix) confirmation of a plan of reorganization requires compliance with confirmation standards, including, among others, feasibility, the Absolute Priority Rule, good faith, etc.[71]

In what became a precursor for the "pre-packaged" or "pre-negotiated" corporate reorganizations of today, railroad managers inspired by the *Wabash* receivership began to approach "friendly creditors" and encourage them to file receivership papers upon terms that would enable existing management to remain in control of the business. Accordingly, in a study of receiverships between 1870 and 1898, insiders were appointed as receivers in 138 of 150 cases.[72] In addition, a "friendly receivership" enabled a manager to choose a forum of preference by creating diversity jurisdiction in federal courts and provided incentive for bondholders to negotiate with managers in advance of the filing in order to determine the goals of the reorganization prior to the commencement of formal proceedings.[73]

C. THE CHANDLER ACT OF 1938

The evolution of bankruptcy law in the United States has been a product

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[64] *See, e.g.*, Boyd, *supra* note 49, at 490.

[65] John C. McCoid, II, *Discharge: The Most Important Development in Bankruptcy History*, 70 AM. BANKR. L.J. 163, 187-88 (1996).

[66] SKEEL, *supra* note 6, at 58.

[67] Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1213, 1254 (1994).

[68] James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 1003-07 (1983).

[69] SKEEL, *supra* note 6, at 58.

[70] *See* Thomas G. Kelch, *Shareholder Control Rights in Bankruptcy: Disassembling the Withering Mirage of Corporate Democracy*, 52 MD. L. REV. 264, 269-71 (1993).

[71] *See* SKEEL, *supra* note 6, at 58-63.

[72] *Id.* at 65, 253 n.38 (citing Henry Swaine, 3 ECONOMIC STUDIES OF THE AMERICAN ECONOMIC ASSOCIATION 71, 77 (1898)).

[73] *See* SKEEL, *supra* note 6, at 65.

of the "boom or bust" economic mentality of lawmakers. American history generally reflected that periods of economic downturn resulted in calls for bankruptcy legislation and relief, while periods of recovery resulted in repeal prior to the twentieth century. The so-called "Great Depression" of the 1930s was the catalyst for the codification of principles that had evolved in the Railroad Equity Receiverships.

American society in the 1920s was defined by a feeling of general optimism. The rapid pace of technological progress in the "Roaring Twenties" had fostered a belief among businessmen and economists alike that living standards would increase and that markets would continue to expand. Following a boom in the stock market that greatly inflated stock prices, the newly-born U.S. Federal Reserve raised interest rates in 1928 and 1929 in order to discourage stock speculation. Surprised by the initial recession that ensued, companies cut back on plans for further purchase of long-term durable goods. Likewise, producers of goods cut back production and consumers, fearing they might soon be out of work, cut back their purchases of goods. As demand for goods fell, prices decreased and the deflation that ensued triggered further contractions in production and an additional fall in prices.[74]

With prices falling ten percent per annum, investors deferred investment in belief that their dollar would stretch ten percent further by waiting another year. The collapse of the world monetary system and a general panic among bankers cast doubt on the viability of the economy and reinforced the widespread belief that it was a time to watch and wait.[75] On October 29, 1929, the stock market crashed, resulting in the loss of $10 billion to $15 billion of market value in one day.

Declining prices, falling production, and increased unemployment ensued at a drastic rate, and the United States fell deeper and deeper into the Great Depression, the worst and longest economic collapse in the history of the modern industrial world. What ensued was a vicious cycle whereby workers were unemployed because companies would not hire them, and companies would not hire employees because there was no market for goods, as workers had no incomes to spend on goods. In 1933, at the nadir of the depression, over fifteen million Americans—one quarter of the nation's workforce—were unemployed.[76]

The Great Depression stirred populist mistrust and hostility toward Wall Street and led to enormous pressure for reform and government intervention that ultimately resulted in the New Deal. Consistent with the

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[74] J. Bradford DeLong, *Slouching Towards Utopia?: The Economic History of the Twentieth Century* (February 1997) (unpublished M.S. thesis, University of California at Berkeley and National Bureau of Economic Research) *available at* http://econ161.berkeley.edu/TECH/Slouch_Crash14.html.

[75] *Id.*

[76] Great Depression in America, *available at* http://encarta.msn.com.

trends in the development of U.S. bankruptcy legislation, the economic collapse spurred a push for reform. The Bankruptcy Act of 1898 did not contain provisions suitable to assist in relieving the effects of the ever-mounting close-downs and liquidations of industrial and commercial enterprises.

As Congress addressed the nation's problems caused by the Great Depression, it sought a means to preserve the commercial fiber of the country and enable the survival of businesses and the related employment opportunities. During the early 1930s emergency legislation was enacted that enabled the reorganization of business entities under the protection of the district courts sitting as bankruptcy courts (e.g., §§ 77 and 77b of the Act). The emergency legislation was followed by the realization that a more comprehensive statutory scheme was necessary to meet the economic crisis of the Great Depression. Resort was made to the experiences obtained in the prosecution of Railroad Equity Receiverships.

Since the inception of the Railroad Equity Receivership courts had afforded railroad managers, investment bankers, and reorganization lawyers substantial leeway in their prosecution of the cases; managers would oversee the business operations while the bankers and lawyers would negotiate the reorganization with the creditor constituencies. Cognizant of the expanding powers the investment bankers and lawyers were exercising as they became more efficient at the receivership process,[77] courts alluded to the ideological consensus in favor of reorganizing troubled railroads—that railroads served the public interest and should not be allowed to fail—and hinted that such leniency would not be afforded to the reorganization of other types of entities.[78]

As Congress considered legislative action to preserve the nation's industrial and commercial foundation, the newly formed U.S. Securities and Exchange Commission (the "SEC") commissioned a study to review federal consent receivership cases and develop a legislative response.[79] Drawing on the populist mistrust of Wall Street, the radical political atmosphere associated with New Deal reform, and a heavy Democratic majority in the House and Senate, the Chandler Act of 1938 was enacted.[80]

The Chandler Act was added to the Bankruptcy Act of 1898 and provided for several debtor relief "chapters." The most comprehensive was

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[77]Critics complained that bankers would routinely allocate themselves generous underwriting fees upon the issuance of new securities, and lawyers would receive fees before anyone else in the case was paid. Moreover, critics contended that lawyers were often compromised by their relationship with managers prior to the commencement of receiverships. *See* SKEEL, *supra* note 6, at 110-11.

[78]*See* Harkin v. Brundage, 276 U.S. 36, 52 (1928); Shapiro v. Wilgus, 287 U.S. 348, 356 (1932); SKEEL, *supra* note 6, at 105.

[79]*See* Miller & Ryland, *supra* note 20, at 211.

[80]Chandler Act of 1938, Pub. L. No. 75-696, 52 Stat. 840 (1938) (repealed 1978).

Chapter X Corporate Reorganization. Chapter X, largely drafted by the SEC, was available voluntarily or involuntarily and was meant to deal with the reorganization of large publicly owned corporations having complex capital and debt structures. It contained statutory provisions to enable the comprehensive reorganization of a publicly-owned corporation, including: judicial approval of a petition under Chapter X as being filed in good faith; the mandatory appointment of a reorganization trustee(s) if the entity had more than $250,000 in liabilities; an extended process for the development and promulgation of a plan of reorganization; the active participation of the SEC, including the explicit right of the SEC to evaluate any plan proposed for the reorganization of a public corporation with more than $3 million in liabilities; the strict application of the fair and equitable rule; the administration of the case, in large part, under the direct supervision of a United States District Judge rather than a referee in bankruptcy; no statutory appointment of official committees of creditors or stockholders; a disinterestedness requirement for trustees, attorneys, other professionals and bankers employed pursuant to court orders; a broad, comprehensive discharge; permitted impairment of rights of secured and unsecured creditors and stockholders; restricting the proposal or filing of a plan of reorganization until the reorganization trustee(s) had filed a proposed plan of reorganization or a report as to why it could not propose a plan of reorganization; requiring a determination by the reorganization court that a plan was worthy of consideration by stakeholders before solicitation of acceptances of a particular plan would be permitted; the power to "cram down" a plan of reorganization over dissenting classes of creditors or equity security holders; specifying confirmation standards, etc.

The appointment of a disinterested trustee(s) as soon as a Chapter X petition was filed and approved for a large corporation was mandatory. The trustee(s) would supersede the board of directors and executive officers. The requirement of disinterestedness, i.e., complete impartiality and objectivity, would be rigidly enforced. The reorganization was under the extended supervision of the SEC. Routinely, Chapter X cases would take five to ten years to complete. "Out were private negotiation and the wiles of Wall Street, in was pervasive governmental oversight."[81]

Chapter X of the Chandler Act caused the traditional power groups to suffer a significant loss of control. Originally supportive of reform in light of (i) rising costs of appeasing dissenting creditors and (ii) jurisdictional problems which necessitated "ancillary receiverships," the traditional Wall Street reorganization practice became crippled by the implementation of the Chandler Act. The independent trustee(s) requirement strongly discouraged managers from filing bankruptcy cases if there was any possible way to cir-

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[81]SKEEL, *supra* note 6, at 122.

cumvent it. "Whereas more than five hundred corporations filed for Chapter X in 1938, the number dropped to sixty-eight in 1944 and fluctuated around one hundred per year for much of the 1950s and 1960s."[82]

The rigid requirements of Chapter X encouraged certain corporations to consider relief under another chapter of the Chandler Act, Chapter XI, which did not require the appointment of a trustee(s), permitted managers to stay in control and shareholders to retain stock, and provided no statutory role for the SEC.

Chapter XI was designed to provide an efficient, expeditious, economical vehicle for a small, generally privately-owned business enterprise and an individual who desired to modify and discharge unsecured debts. Available only upon a voluntary basis, Chapter XI did not provide any authority to affect the rights of secured creditors. Initially, Chapter XI also required the application of the fair and equitable (absolute priority) rule before stockholders could retain their interests. This latter requirement had the effect of inhibiting the use of Chapter XI. As a result, in 1952 the application of the fair and equitable rule in Chapter XI cases was repealed. Chapter XI also provided for the formation of a statutory or official creditors' committee to negotiate the arrangement of the unsecured debt. An arrangement could be confirmed if accepted by the requisite majority, initially, in number and amount of all creditors. Subsequently, this was changed by rule to required majorities in dollar amounts and number of all creditors actually voting on the arrangement. Chapter XI had no provision for "cram down" of non-accepting creditor classes. However, the debtor had an unlimited exclusive right to file a plan of arrangement. The alternative was conversion of the case to a liquidating bankruptcy case, a result usually not in the best interests of stakeholders.

The Chandler Act also added Chapter XII to deal with specific economic issues raised in connection with real estate trusts that were peculiar to certain jurisdictions, and Chapter XIII to provide an alternative bankruptcy procedure for a wage earner with a regular source of income. Under Chapter XIII, such a wage earner could propose a plan for the satisfaction of its debts and liabilities and avoid sale of its assets in a liquidating bankruptcy case.

D. The Expansion of Chapter XI as the Primary Reorganization Chapter of the Bankruptcy Code

During the 1960s and thereafter, the United States went through a democratization of credit. For example, in 1954 only 41 banks in the U.S. offered customers credit cards, and less than 500,000 consumers used them. In contrast, 30 years later, over half of all families in the country—including 42

[82] *Id.* at 125.

million households—would have at least one credit card, 3000 institutions would offer them, and over 2 million businesses worldwide would accept them.[83] To a large extent, the economic expansion was fueled by the availability of credit and an expanding securities market. The availability of credit on a market-democratized basis carried with it a larger risk of default. A means to deal with credit and business failure needed to be shaped. The experiences incurred in connection with corporate reorganization under Chapter X of the Act discouraged distressed debtors from seeking relief under that Chapter. The mandatory application of the fair and equitable rule, the displacement of management by a court appointed trustee(s), and the laborious and long duration of Chapter X reorganizations all served as deterrents to its use.

In contrast, Chapter XI appeared to provide an expeditious, potentially less expensive, and more debtor-oriented process for achieving a restructuring or reorganization. However, the limitations of Chapter XI in respect to the ability to deal with all types of debt and liabilities as well as stockholder interests presented obstacles to the use of the arrangement process. In addition, the SEC zealously fought the use of Chapter XI, first, to affect public stockholders and thereafter, public bondholders. The controversy with the SEC, as to proper choice of Chapter X versus Chapter XI, persisted almost through the enactment of the Bankruptcy Reform Act. When the parties litigated, in most instances the debtor's choice of Chapter XI was sustained on the basis that it would serve the needs of the debtor.[84] These decisions encouraged further use of Chapter XI to deal with the growing number of increasingly complex and large business failures that often involved publicly owned corporations.

The number of Chapter XI cases filed far exceeded those under Chapter X.[85] The same type of ingenuity and imagination that was applied to Railroad Equity Receiverships was introduced to cases under Chapter XI. They had the effect of transforming Chapter XI from a debtor-relief proceeding intended for small mom and pop businesses with small amounts of unsecured liabilities to a chapter used by Fortune 500 corporations. These Chapter XI cases accomplished comprehensive reorganizations. The bankruptcy court was asked to and did fashion appropriate remedies under its equitable powers

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[83]*See* Comptroller of the Currency Eugene A. Ludwig, *Address before the Organization for a New Equality's 4th National Urban Economic Summit* (Jan. 15, 1996), *available at* http://www.occ.treas.gov/ftp/release/96-4.txt.

[84]*See* Grayson-Robinson Stores, Inc. v. SEC, 320 F.2d 940 (2d Cir. 1963); *cf.* Gen. Stores Corp. v. Shlensky, 350 U.S. 462 (1956).

[85]50,162 cases were commenced under Chapter XI for the period 1973 through 1982, whereas only 850 cases were commenced under Chapter X. *See* NEW GENERATION RESEARCH, INC., THE 2003 BANKRUPTCY YEARBOOK & ALMANAC 8 (2003).

to enable debtors to use Chapter XI as the means for a comprehensive reorganization. Bankruptcy rules of procedure were adopted which allowed for the automatic stay of creditor actions, particularly the exercise of remedial rights by secured creditors; the debtor enjoyed unlimited exclusivity to file a plan of arrangement with court-sanctioned authority to use the secured creditors' collateral security. Landlord rights were severely curtailed by the bankruptcy court in favor of reorganization.[86] In many judicial districts, the debtor remained in possession of the assets and was authorized to operate its business. In other districts, receivers were appointed. As Chapter XI became more expansive, its popularity grew and those judicial districts that favored the retention of the debtor as a debtor in possession became the venues of choice for distressed business entities.

The number of public corporations commencing Chapter XI cases increased.[87] In 1975, the first billion dollar Chapter XI case was filed by W.T. Grant Company, a New York Stock Exchange listed public corporation.[88] The commencement of such a large Chapter XI case concurrent with the commencement of other large cases involving public corporations amidst an environment in which bankruptcy reform was being contemplated emphasized the need for a comprehensive reorganization statute.

E. The Legislative Process to Replace the Bankruptcy Act of 1898

The Bankruptcy Reform Act of 1978 (the "1978 Act") was signed by President Jimmy Carter on November 6, 1978 and took effect on October 1, 1979. The 1978 Act was the first bankruptcy legislation not enacted on the heels of domestic economic turmoil[89] and instituted comprehensive changes to the reorganization process. Notwithstanding the fact that the 1978 Act was considered to be in large part a response to an increase in consumer bankruptcies during the 1960s, the new Act ushered in a new era in corporate restructurings.[90]

The 1978 Act was a decade in the making, and the final version was the

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[86]*See, e.g.*, Queens Boulevard Wine & Liquor Corp. v. Blum, 503 F.2d 202 (2d Cir. 1974).

[87]Firms that had any choice in the matter tended to avoid Chapter X. While there were 577 Chapter X filings in 1939, "in the next five years, the number would drop to less than 100 per year and remain" near or below 100 for most of the remaining life of Chapter X. *See* Skeel, *supra* note 6, at 171.

[88]*Investigating the Collapse of W.T. Grant*, Bus. Week, July 19, 1976, at 60-62.

[89]Charles Jordan Tabb, *The History of Bankruptcy Law in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 32 (1995).

[90]Skeel, *supra* note 6, at 160 (noting that the "legislative activity that led to the Bankruptcy Code of 1978 had been prompted by the astonishing rise in consumer bankruptcies rather than business failures"). There was also clear dissatisfaction with the bankruptcy law as it applied to corporations. Financial institutions such as the American Banking Association, the Robert Morris Associates, and the American Council of Life Insurance "complained loudly about a banking community with hundreds of millions of dollars invested in debtors and no reliable way to deal swiftly with corporate rehabilitations." Bruce G.

culmination of separate drafting efforts by a congressional commission, the House of Representatives, the United States Senate, and a coalition of bankruptcy judges. One catalyst for this flurry of activity to revamp bankruptcy law was a 1971 study conducted by scholars at the Brookings Institution that called upon Congress to "completely rethink the bankruptcy process."[91]

Rethinking the form and substance of bankruptcy law was Congress' ultimate goal when it conducted hearings in 1968 regarding the establishment of a commission to examine the status and efficacy of bankruptcy law.[92] A subcommittee of the Senate Judiciary Committee ultimately concluded that it was necessary to appoint a commission to "study, analyze, evaluate, and recommend changes to the [1898] Act . . . in order for such Act to reflect and adequately meet the demands of present technical, financial, and commercial activities."[93]

Following congressional hearings on the matter, a National Bankruptcy Review Commission was created by Congress in 1970.[94] Notably absent from the Commission were bankruptcy judges. This absence was a symptom of the longstanding tension between bankruptcy judges, who had only recently attained the title of judge and were no longer referees, and federal judges appointed under Article III of the Constitution. Article III judges were appointed by the President with the advice and consent of the Senate and have lifetime tenure absent impeachment. Bankruptcy judges were not appointed pursuant to Article III of the Constitution; they acted as support personnel of the district court and "[o]riginally . . . had been considered to be a kind of clerk or 'adjunct' of the district court."[95] As a consequence, there was substantial opposition to making bankruptcy judges Article III judges because they were not considered to be of the same intellectual or professional caliber.[96]

The Article III Judges perceived the presence of bankruptcy judges on the Commission as a threat to their judicial and intellectual distinction.[97] On

Carruthers & Terence C. Halliday, *Professionals in Systemic Reform of Bankruptcy Law: The 1978 Bankruptcy Code and the English Insolvency Act of 1986*, 74 AM. BANKR. L.J. 35, 43 (2000).

[91]*See* SKEEL, *supra* note 6, at 142.

[92]*Id.* at 138.

[93]Act of July 24, 1970, Pub. L. No. 91-354, § 1(b), 84 Stat. 468, 468 (1970).

[94]Act of July 24, 1970, Pub. L. No. 91-354, 84 Stat. 468 (1970).

[95]Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47, 61-62 (1997).

[96]Former District Judge Simon Rifkind opposed the increase in Article III judges on the basis that an such action "would dilute the significance, and prestige, of district judgeships." *Bankruptcy Court Revision: Hearings Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary on H.R. 8200*, 95th Cong. 9-10 (statement of Simon Rifkind, Past President, American College of Trial Lawyers).

[97]Posner, *supra* note 95, at 75 ("The most likely reason that the federal judiciary opposed the participation of bankruptcy judges on the Commission is that it feared that bankruptcy judges would use their

the other hand, "[b]ankruptcy judges had long made clear to the federal judiciary their dissatisfaction with their subordinate status, lobbying the federal judges for more autonomy, fancier titles, greater privileges, and the right to participate in judicial policymaking and administration."[98] Many Article III judges had previously opposed bestowing the title of judge on bankruptcy judges and now fought just as hard to keep bankruptcy judges off the Commission.[99]

During their campaign to keep bankruptcy judges off the Commission, many federal judges sought to make clear that they possessed the true judicial power and emphasized what they believed to be their superior status in the judicial hierarchy. For example, this sentiment clearly prompted a comment made by District Court Judge Edward Weinfeld, who would eventually be named to the Commission. In explaining his opposition to the placement of bankruptcy judges on the Commission, Judge Weinfeld remarked, "[h]ere the proposal is that referees be included [on the Commission] as well as lawyers, but the fact is that the ultimate judgment with respect to bankruptcy matters is made by judges of the court who review the various actions of referees when petitions for review are presented."[100]

In 1973 the National Bankruptcy Review Commission issued a report and a draft of proposed bankruptcy legislation.[101] On the administrative front, the Commission proposed the creation of the United States Bankruptcy Administration, which would become an arm of the Executive Branch and relieve bankruptcy judges of nearly all administrative duties.[102] The Commission envisioned that the Bankruptcy Administration would attend to tasks such as those associated with "no-asset" personal bankruptcies and the appointment of a trustee and creditors' committees in corporate restructurings.[103] As a consequence, the number of bankruptcy judges required to adjudicate bankruptcy cases would decrease.[104]

The Commission's efforts to overhaul the administrative infrastructure of

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influence on the Commission to press for bankruptcy laws that would transfer power and status from the federal judiciary to the bankruptcy judges."); *see also* SKEEL, *supra* note 6, at 139 (noting that federal judges "objected bitterly to the requirement that two of the commission members be bankruptcy judges").

[98]Posner, *supra* note 95, at 75.

[99]*Id.* at 79 (noting that federal judges had "resisted the bankruptcy judges' efforts to have their title changed from 'referee' to 'bankruptcy judge,' apparently on the grounds that such a change would dilute the prestige of the title 'judge.'").

[100]*Id.* at 74 (quoting hearings on S. J. Res. 100 Before the Subcomm. on Bankruptcy of the Senate Comm. on the Judiciary, 90th Cong. 53 (1968)).

[101]SKEEL, *supra* note 6, at 139.

[102]*See id.* at 143 ("Most dramatically, the commission agreed that much of the bankruptcy process could, and should, be handled by an administrative agency.").

[103]*Id.* at 142.

[104]*See id.* at 144 ("The drafters of the 1973 commission report quite candidly predicted that their proposal would require roughly one-third less judges than were currently in place.").

the bankruptcy process stemmed at least in part from the Brookings Institution report. The Brookings Institution scholars criticized the "fundamental disjunction between the essentially administrative character of the 200,000 or more uncontested cases they studied and the prevailing adversarial system that seemed to add layers of personnel and costs to a process better suited to a rational bureaucracy."[105]

Other administrative changes proposed by the Commission included a limitation of the involvement of the SEC, with most of the agency's former duties transferred to the new Bankruptcy Administration, an extension of the jurisdiction of bankruptcy judges to include all matters pertaining to a bankruptcy, and "consolidation of all the business reorganization chapters into a single chapter."[106]

Substantively, the Commission sought to transform the definition of "property of the estate."[107] Pursuant to the Commission's proposed legislation, property of the estate would no longer be defined as "the property that the debtor could have transferred to a third party outside of bankruptcy," as such concept was defined by the 1898 Act.[108] Instead, the Commission proposed that property of the estate be defined as property in which "the debtor had any legal or equitable interest."[109] The Commission also wanted to broaden the characterization of a "claim," and abandon the existing inflexible definition, which provided that "[t]o be included in the bankruptcy distribution, a claim had to qualify as both 'provable' and 'allowable.'"[110] The Commission believed that such changes would provide the debtor with a better opportunity to resolve all matters that posed a threat to a successful reorganization and a healthy postpetition financial existence.

Angered but not deterred by the exclusion of bankruptcy judges from congressional efforts to study and reform bankruptcy law, the National Conference of Bankruptcy Judges drafted a competing bill. The judges' bill and the bill drafted by the Commission "had many similarities but several important differences."[111] Not surprisingly, unlike the Commission's bill, the judges' bill elevated the status and jurisdiction of bankruptcy judges. The judges' bill provided for different treatment of public and private corporations while the Commission's bill did not.[112] Further, the Judges' bill provided no equivalent to the Bankruptcy Administration as proposed by the Commission

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[105]*See generally* Carruthers & Halliday, *supra* note 90, at 50-52.

[106]Tabb, *supra* note 89, at 33.

[107]SKEEL, *supra* note 6, at 148.

[108]*Id.*

[109]*See id.*

[110]*Id.* at 148.

[111]Posner, *supra* note 95, at 69.

[112]*Id.*

nor did it advocate a merger of the corporate reorganization chapters of the 1898 Act and proposed to keep the trustee and the SEC involved in corporate bankruptcies.

In 1975, the House and the Senate Judiciary Committees convened subcommittees to consider the competing legislation proposed by the Commission and by the National Conference of Bankruptcy Judges. Following subcommittee review, separate bills were proposed by the House and the Senate. Neither bill included the creation of the Bankruptcy Administration envisioned by the Commission. The legislation that was ultimately signed into law by President Carter was an amalgamation of the ideas contained in the House Bill and the Senate Bill.[113]

F. Reorganizations Under Title 11 of the United States Code as Enacted by the Bankruptcy Reform Act of 1978

Congress' ten-year study of the procedure and substance of bankruptcy law produced a change that would eventually lead to a new era for corporate bankruptcies. The 1978 Act codified Chapter 11 of title 11, which remains as the general template for corporate reorganizations. Congress intended that this newly enacted Chapter 11, which represented a merger of existing Chapters X, XI, and XII, would eliminate controversy that often surrounded a debtor's choice of a particular chapter under the old Act. Congress hoped this would respond to the grievance articulated in the Brookings Institution study and held by many others that "existing law did not have adequate mechanisms to facilitate corporate rehabilitation in a straightforward, predictable way."[114]

Certain aspects of the new Chapter 11 made bankruptcy a more appealing option than it had been in the past. Perhaps most significantly, under the new Bankruptcy Code, the debtor's management remained in control during the restructuring process. Trustees and examiners were only to be appointed for cause, and receivers were prohibited.

Other provisions in the Code further enhanced the comfort zone the new Chapter 11 provided to corporations and management, including: the automatic stay of action against the debtor, its properties and properties in the possession of the debtor upon commencement of a Chapter 11 case;[115] the broad financing power available to debtors;[116] the debtor's expanded authorization to reject executory contracts;[117] a more comprehensive definition of

[113]Skeel, *supra* note 6, at 140.
[114]Carruthers & Halliday, *supra* note 90, at 44.
[115]11 U.S.C. § 362 (2000).
[116]*Id.* at § 364.
[117]*Id.* at § 365.

property of the estate;[118] the recovery and return of property of the estate transferred or removed from the debtor's possession prior to the commencement of a Chapter 11 case;[119] the reduced role of the Securities and Exchange Commission;[120] the expansion of the debtors' administrative powers;[121] and the debtor's retention of the exclusive right to file a proposed plan of reorganization and to solicit acceptances of such a plan within 180 days of a case filing (subject to termination, contraction or extension for cause).[122]

In addition, the new legislation also provided safeguards that protect the interests of creditors and public investors. Such provisions demonstrated Congress' intent to balance the interests of all parties involved in the Chapter 11 reorganization process and provided that: the commencement of a Chapter 11 case may be voluntary or involuntary;[123] secured creditors are entitled to adequate protection, if requested, of their interests in property of the estate;[124] the goal of a Chapter 11 restructuring is to achieve a consensual plan of reorganization accepted by certain requisite majorities of various classes of impaired creditors and equity holders;[125] solicitation of acceptances or rejections of a proposed plan may not occur until a disclosure statement has been approved by the bankruptcy court, after notice and a hearing, upon a finding that the statement contains "adequate information" to enable creditors and equity holders the opportunity to cast an educated vote;[126] the discharge provision be broadened, which in most instances supercedes conflicting state and federal laws;[127] the office of the United States trustee will oversee the administration of Chapter 11 cases;[128] the debtor must provide due process to creditors, i.e., notice and hearing, prior to obtaining the entry of orders and judgments;[129] and that confirmation standards be specified to include, *inter alia*, an expanded feasibility requirement and a best interests of creditors test.[130]

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[118]*Id.* at § 541.

[119]*Id.* at §§ 542, 543.

[120]*Id.* at § 1109.

[121]*Id.* at §§ 361-366.

[122]*Id.* at. § 1121.

[123]*Id.* at §§ 301, 303.

[124]*Id.* at §§ 361, 363.

[125]*Id.* at § 1126.

[126]*Id.* at § 1125.

[127]*Id.* at § 1141.

[128]*Id.* at § 307.

[129]FED. R. BANKR. P. 2002. For a definition of "notice and hearing," see 11 U.S.C. § 102 (2000).

[130]11 U.S.C. §§ 1123, 1129 (2000); *see In re* Gen. Teamsters, Warehousemen and Helpers Union, Local 890, 265 F.3d 869, 877 (9th Cir. 2001); Kane v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 843 F.2d 636, 649 (2d Cir. 1988) (best interests test requires "a finding that each holder of a claim or interest either has accepted the plan or has received no less under the plan than what he would have received in a [c]hapter 7 liquidation.").

G. The Claw Back By Special Interests and Creditor Groups

1. *Special Interest Provisions of the Bankruptcy Code*

As early as the codification of the Bankruptcy Reform Act of 1978 and continuing to this day with the recurrent attempts to pass new bankruptcy laws, special interest legislation is surprisingly abundant in the Bankruptcy Code's landscape. Congress has responded to the needs and, at times, wants of certain groups and has passed provisions protecting their interests. Whether such provisions ensure that the bankruptcy process safeguards social welfare is a matter of personal opinion and much debate.

Section 1110 of the Bankruptcy Code protects the interests of aircraft manufacturers, lessors, and financiers. Its purpose is to maintain affordable access for airlines to leases and financing for aircraft by providing lessors and financiers additional protection. Section 1110 and its railroad counterpart, codified in § 1168, have their genesis in § 77(j) of the old Act, which was passed in response to the Supreme Court's ruling in *Cont'l Nat'l Bank v. Chicago, Rock Island & Pac. Ry.*[131] that a creditor's right to foreclose on a particular railroad asset could be enjoined to preserve going concern value. Without protection for the rights of aircraft lessors and financiers to receive payment and assurance, airlines would face untenable increases in the costs of aircraft leases driven by lessors' and financiers' need to account for such risk and the airlines would be unable to readily acquire new aircraft to service additional markets, compete with other airlines, or upgrade aging equipment.

Financial institutions that conduct derivative transactions also receive special protection under the Bankruptcy Code.[132] The Code grants such financial institutions the right to setoff mutual claims despite the automatic stay and permits them to exercise otherwise unenforceable *ipso facto* provisions.[133]

Absent these provisions, financial institutions would have little incentive to enter into transactions with financially troubled corporations. These provisions are meant to preserve the liquidity of the nation's financial markets and remove the uncertainties of bankruptcy as a limiting factor in the formation and execution of such transactions.

Commercial property owners also enjoy special protection under the Bankruptcy Code. While a debtor can delay its decision whether to assume an executory contract until confirmation of its plan of reorganization, § 365(d)(4) limits the time within which a debtor may assume a lease of nonresidential real property to sixty days from the date of commencement of the Chapter 11 case, subject to extension for cause. In addition to the sixty-

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[131] Cont'l Nat'l Bank v. Chicago, Rock Island & Pac. Ry., 294 U.S. 648 (1935).

[132] *See* 11 U.S.C. §§ 362(b)(6), 362(b)(7), 555, 556, 559, 560 (2000).

[133] *Id.*

day limitation of § 365(d)(4), owners of shopping centers lobbied for and received further protections in the form of adequate assurance of performance provisions set forth in § 365(b)(3) as it pertains to the assumption of leases within their shopping centers.

Equipment lessors are also protected by virtue of § 365(d)(10), which obligates a debtor to make all payments required under a lease of personal property arising sixty days after the commencement of the Chapter 11 case, thereby protecting such lessors from a debtor who retains the lessor's property and attempts to limit the lessor's administrative expense claim through § 503(b)(1).

Section 524(g), enacted after the Johns-Manville Corporation Chapter 11 cases,[134] permits a debtor to create a trust which, upon confirmation, will be the only source of recovery for unknown parties with tort claims. A trust developed pursuant to § 524(g) shields the debtor from any postpetition liability with regard to future claimants. While a trust formed pursuant to § 524(g) may not ultimately increase the amount of recovery for claimants, it does provide a procedural mechanism to protect the funds that will be used to compensate future claimants.

Other parties that receive preferential treatment under the Bankruptcy Code are various agencies of the United States,[135] unionized employees,[136] retirees,[137] and parties that produce grain and catch fish and then deposit their product in a storage facility that files for bankruptcy protection.[138] Moreover, legislation currently before Congress would further expand the protections already afforded to commercial landlords, secured creditors, utility companies and others.

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[134]*Kane*, 843 F.2d 636.

[135]The Bankruptcy Code is replete with provisions that provide preferential treatment to agencies of the United States. *See, e.g.*, 11 U.S.C. §§ 362(b)(4), 362(b)(8), 362(b)(12), 362(b)(13), 502(b)(9), 505, 507(a)(8), 507(d), 523(a)(1) (2000). *But see* 11 U.S.C. § 525 (2000) (providing that such agencies cannot discriminate against a debtor).

[136]Section 1113 was enacted in response to the Supreme Court's ruling that the debtor's business judgment, which permits the unilateral and almost unfettered right to reject executory contracts, applies to a rejection of the debtor's collective bargaining agreements. Daniel S. Ehrenberg, *Rejecting Collective Bargaining Agreements Under Section 1113 of Chapter 11 of the 1984 Bankruptcy Code: Resolving the Tension Between Labor Law and Bankruptcy Law*, 2 J.L. & POL'Y 55, 72 (1994) ("The procedural requirements of § 1113 are relatively straightforward and overturn that part of *Bildisco* which allowed a debtor to unilaterally reject a collective bargaining agreement without obtaining bankruptcy court approval.") (referring to NLRB v. Bildisco, 465 U.S. 513 (1984)). Section 1113 contains the exclusive framework by which a debtor may reject a collective bargaining agreement. *See* 11 U.S.C. § 1113 (2000).

[137]As a corollary to § 1113, § 1114 governs the debtor's ability to reject retiree benefits. 11 U.S.C. § 1114 (2000).

[138]Sections 546(d) and 557 of the Bankruptcy Code provide for expedited procedures to determine the parties' rights in the grain or the fish held in the storage facility. 11 U.S.C. §§ 546(d), 557 (2000).

2. *Examiners with Expanded Powers*

Section 1104(c) provides for the appointment of an examiner "to conduct such an investigation of the debtor as is appropriate."[139] The use of an examiner with expanded power to override the prerogatives of the debtor in the administration of a reorganization case has become more prevalent. Recent examples include the Chapter 11 cases of Enron, The Leslie Fay Companies, Big Rivers Electric Company, and Eastern Airlines. In certain instances, the expanded powers of an examiner may extend to the formulation and promulgation of a plan of reorganization. The appointment of an examiner is often more attractive than the appointment of a trustee because the appointment of a trustee would terminate the debtor's exclusivity pursuant to § 1121 of the Bankruptcy Code and enable any party in interest to file a plan of reorganization. Such termination could result in a chaotic administration that might compel a bankruptcy court to process a filed plan through a disclosure statement hearing, even though it is not supported by any major constituency.

3. *The Election of Trustee*

In the subsequent amendments to the Bankruptcy Code, § 1104 was amended to afford creditors the opportunity to elect one disinterested person to serve as a trustee in a Chapter 11 case. Prior to the amendment, creditors were apprehensive about seeking the appointment of a trustee, as the moving creditors could not be certain who might be appointed, or whether the appointed trustee would act adversely to their interests. Trustee elections have been relatively rare, but remain an example of a contraction of debtors' protections in favor of creditors' rights.

II. THE CHANGING ECONOMY AND ITS EFFECT ON BUSINESS REORGANIZATIONS

A. Globalization and Consolidation of Suppliers and Customers

Over the past ten or more years, technological advances, including those in the management and administration of businesses, have led to an enormous consolidation of business entities and their products. This consolidation has been compounded by the globalization of the world's economy. No longer limited to specific geographic regions, a commercial enterprise may produce goods overseas, or outsource the production of goods such that the commercial enterprise becomes an administrative organ that supervises and integrates various types of businesses.

As businesses have consolidated, sources of inventory and customer bases have contracted, and supply options have been limited. Similarly, customers

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[139] 11 U.S.C. § 1104(c) (2000).

of commercial entities have consolidated. In the retail industry in the United States, for example, Wal-Mart, Target, Lowe's, and Home Depot are dominant retailers. The inability of a commercial enterprise to sell to one of those retail giants would have potentially fatal consequences.

Consolidation has complicated the situation where a commercial enterprise becomes financially impaired. The changing global economy has increased the power of consolidated customers and suppliers. Such entities may opt to avoid dealing with a Chapter 11 debtor, or dissuade a debtor from commencing a Chapter 11 case altogether. At a minimum, the supplier or customer may elect to participate as a powerful creditor constituent in the administration of the Chapter 11 case.

B. Distressed Debt Trading

Similarly, distressed debt trading has grown to proportions never contemplated at the time of the enactment of the Bankruptcy Reform Act. In the 1970s and 1980s, a more symbiotic relationship existed between debtors and creditors than exists in today's economy. Chapter 11 debtors had long-standing relationships with their vendors and customers. Prior to globalization and technological advancements such as the facsimile machine and Internet, suppliers, purchasers and customers often shared long-standing commercial and interpersonal relationships and, as a result of geographic limitations, were confined to the same areas and local economies. Fortunes were often tied one to another. The local hardware store relied upon the business generated by the needs of the local restaurant and the restaurant relied upon the hardware store for a quick means of repair. These relationships encouraged support when a local enterprise filed for bankruptcy, as it was in the best interests of suppliers and, indeed, customers for the debtor's business to continue to provide the customers with a source of products. Similarly, long-standing relationships were also shared among debtors and financial institutions.

Distressed debt trading and changing relationships as a result of globalization and technology have upset the symbiotic relationship of a debtor and its creditors. Traders purchase debt claims at a substantial discount, as they are concerned solely with the return on their investment. Worse yet, traders may purchase debt in order to obtain control of the debtor and dominate the administration of the reorganization case. In either case, from the perspective of the distressed debt trader, time is of the essence in order to maximize the return on its investment. The sooner a trader or group of traders can force a debtor out of Chapter 11, the sooner they can monetize their claim and obtain a return on their speculation, without regard to any other factor, including whether or not the debtor had been fully rehabilitated when it was pushed out of Chapter 11.

In the same context, creditor financial institutions are no longer con-

strained by relationships with management and may choose not to carry large defaulted loans as such loans must be marked to market with attendant charges to the lender. In such circumstances, financial institutions often seek liquidity in the market and lower risks and thus sell the debt notwithstanding any prior relationship with the particular debtor.

Purchasers of distressed debt rely upon the principle that "a claim or interest in the hands of a purchaser has the same rights and disabilities as it did in the hands of the original claimant or shareholder."[140]

To the extent they are able to, and in their efforts to maximize returns, distressed debt traders will impose constraints upon the debtor's management. Such a strategy limits the options a debtor may have enjoyed prior to the onset of large scale debt trading that became popular after the amendment to Bankruptcy Rule 3001(e) in 1991[141] facilitated the trading of claims and eliminated bankruptcy court oversight from claims trading.

Unfortunately in some respects, distressed debt traders' entry into the reorganization paradigm has transformed Chapter 11 reorganizations from primarily rehabilitative processes to dual-purpose processes that stress maximum enhancement of creditor recovery in addition to rehabilitation of the debtor entity. The dual objectives are often in conflict as the debtor strives to rehabilitate its business while creditors seek a fast recovery on their claims irrespective of the debtor's need to reinvest in the business to make it viable. As a result, distressed debt trading may be a material cause of recidivism, forcing reorganized debtor entities to return to the bankruptcy court to pursue another Chapter 11 reorganization effort.[142]

C. Access to Capital and Credit

As a business entity incurs losses in operations and experiences high debt to equity leverage ratios, its ability to access capital markets becomes more and more restricted. As credit tightens, the whirlpool of illiquidity develops. Without access to capital and credit, the debtor is unable to continue or pursue operations that might lead to its rehabilitation and becomes mired in an ever increasing and worsening situation as it navigates the waters of Charybdis. In order to obtain even limited access to capital and credit, as well as relief from credit agreement covenants, the debtor is often compelled to agree to substantial charges and even more oppressive conditions for continued credit extensions.

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[140]Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 Cardozo L. Rev. 1, 13 (1990).

[141]Fed. R. Bankr. P. 3001(e).

[142]Harvey R. Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 55 Vand. L. Rev. 1987, 2016 (2002) ("distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments").

Subsequent to the commencement of a Chapter 11 case, lenders and secured creditors have been successful in imposing more demanding affirmative and negative covenants and conditions upon a debtor in possession. Through the medium of debtor in possession credit agreements or the use of collateral agreements, lenders and secured creditors may effectively assume control of the Chapter 11 process, further limiting the debtor's flexibility in exploring reorganization options. Cash collateral agreements approved in recent Chapter 11 cases include covenants requiring a debtor to take certain actions, the failure of which permit the lenders to terminate the agreement and effect a stranglehold on the debtor.[143] Examples of such provisions include: deadlines by which the debtor(s) must receive the lenders' approval for a business plan; limiting disbursements to those approved by the lenders in a budget; limiting the payment of prepetition claims even if approved by the court; requiring the debtor(s) to meet certain cash receipts thresholds contained in a budget; limitations on inter-company disbursements to non-debtors; requiring debtor(s) to make certain payments on leases and other interests; and requiring the retention of financial advisors or a chief restructuring officer.

Access to capital and credit markets has had another impact on traditional reorganization scenarios. The ability of third parties to access substantial sums, e.g., private equity and hedge funds, for investment purposes has created a relatively new circumstance in reorganization situations. In contrast to prior economic periods, a single investor or a single group of investors may amass funds to purchase an entire firm (or its assets) at costs that may exceed $1 billion, thus removing risk of potential losses due to dismemberment of the firm (or its assets) and the increased costs associated with breakups.[144]

D. A SERVICE-BASED ECONOMY AND THE CONTRACTION OF HARD ASSETS

The United States has become a service-based economy. Professors Douglas G. Baird[145] and Robert K. Rasmussen[146] have noted that industrial plants no longer dominate the economic scene.[147] Intangible assets now comprise almost half of the value of non-financial firms in the United States.[148]

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[143] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN L. REV. 751, 784-85 (2002); *See* Letter from Judge Peter J. Walsh regarding First Day DIP Financing Orders, at 6 (April 2, 1998) (on file with authors).

[144] *See, e.g., In re* Allegiance Telecom, Inc., No. 03-13057 (RDD) (Bankr. S.D.N.Y. 2003); *In re* Burlington Indus., Inc., No. 01-11282 (PJW) (Bankr. D. Del. 2001); *In re* Bethlehem Steel Corp., No. 01-15288 (BRL) (Bankr. S.D.N.Y. 2001); *In re* LTV Steel Co., Inc., No. 00-43866 (WTB) (Bankr. N.D. Ohio 2000).

[145] Harry A. Bigelow Distinguished Service Professor, University of Chicago Law School.

[146] Director, Law and Economics Program; Professor of Law, Vanderbilt Law School.

[147] *See* Baird & Rasmussen, *supra* note 143, at 765-66.

[148] *Id.*

The number of people working in the service industries has more than doubled over the past twenty years.[149] More than twice as many people today work in service industries as in manufacturing. The hard assets in the service industries consist of general office space, desks, chairs, and word processors.

As the U.S. economy continues to expand its service-based foundation, the outsourcing of product development, data processing, clerical duties, etc., is accelerating at a high rate. The traditional business organization has been diminished. The absence of hard assets and the often-minimal value attributable to intellectual property militates against the traditional concept of corporate reorganization. Even in those situations in which there are hard assets held by a distressed debtor, the value of those assets is no longer dependent upon being within a particular firm, a basic predicate of the Baird and Rasmussen thesis. Such assets are fungible. Their value, essentially, is the same whether they are owned by Bethlehem Steel, United States Steel Corporation, National Steel, or International Steel Group.

E. The Fungibility of Assets of a Debtor and the Transitory Nature of the Firm

If the debtor's assets are marketable, the contemplation of an extended Chapter 11 administration, which occurred in the major Chapter 11 cases in the early 1990s, such as *Federated Department Stores*, *R.H. Macy & Co.*, *LTV Steel*, and others, may be undesirable to debt traders and other stakeholders. Effectuating the objective of creditor recoveries may be implemented by a sale of all or substantially all of the debtor's assets as soon as practicable after the commencement of a Chapter 11 case and often as part of a pre-existing agreement. The use of § 363(b) of the Bankruptcy Code to implement that objective is common in today's Chapter 11 cases.[150] As long as an active marketplace exists for a debtor's assets, it will present an alternative to internal reorganization under Chapter 11.

III. THE HAPLESS DEBTOR AMONG THE GROWING SOPHISTICATION OF CREDITOR INTERESTS

Since the enactment of the Bankruptcy Reform Act in 1978 and in the context of the many and substantial Chapter 11 reorganizations that have occurred since 1979, including the major reorganization cases following the recession of 1990 and the onset of the major fraud cases commencing in 2000, creditors have become more and more educated as to the principles underlying the Bankruptcy Code. Senior creditors have been educated as to the

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[149]*Id.*

[150]*See infra* notes 197-207, 209-16.

absolute priority rule, and secured creditors have asserted their rights to the preservation of collateral and the requirement of adequate protection in connection with the debtor's retention and use of such collateral.

A. The Limitations Upon Access to Debtor in Possession Financing and the Conditions Required by Existing Secured Creditors

In most large reorganization cases today, by the time a debtor has acknowledged its need to commence a Chapter 11 case, the debtor has subjected some or all of its assets to liens and security interests in favor of secured lenders. Secured lenders routinely demand that such protections, as well as others, be memorialized in postpetition financing or cash collateral agreements. Given the timing of such issues at the outset of a Chapter 11 case, which is the most traumatic period in Chapter 11, the debtor is presented with a Hobson's choice. The debtor must, in its most fragile state, either challenge the lender's liens and security interests or seek to use the lender's cash collateral over the lender's objection, which, if they are options at all, involve lengthy and resource draining proceedings, or accede to the lender's demands. Today, such provisions can permeate and control every facet of a debtor's operations. These provisions may include: (i) requiring the debtor to operate within a budget approved by the lenders; (ii) limiting disbursements other than those approved by the lenders in a budget; (iii) limiting the payment of prepetition claims even if approved by the court; (iv) requiring the debtor to meet a variety of performance hurdles related to, among other things, revenue, (v) limiting inter-company disbursements to non-debtors; (vi) requiring the rejection of executory contracts that the lenders believe unfavorable; (vii) requiring the payment of certain lease obligations; (viii) requiring the appointment of a chief restructuring officer approved by the lenders; (ix) requiring that certain assets be sold by certain fixed dates; (x) requiring the filing of a plan of reorganization by a fixed date; and (xi) requiring the debtor to obtain the court's approval of a disclosure statement by a fixed date.

In recent years, courts, including the United States Bankruptcy Court for the Southern District of New York and the United States Bankruptcy Court for the District of Delaware, have come to realize that, as a result of the lender's leverage over a desperate and hapless debtor at the onset of a Chapter 11 case, debtors tend to agree to provisions that are, in the words of Bankruptcy Judge Walsh of the United States Bankruptcy Court for the District of Delaware, "unnecessary, overreaching or just plain wrong."[151]

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[151] Walsh, *supra* note 143, at 1 (on file with authors). *Cf.* General Order No. M-274 of the United States Bankruptcy Court for the Southern District of New York dated September 9, 2002 (Bernstein,

B. The Imposition of a Chief Restructuring Officer by Secured Creditors or other Controlling Creditors

Upon the occurrence of default, institutional lenders and often creditor representatives question the competence and ability of a debtor's management and governing body to formulate and direct a successful reorganization. As noted above, if a creditor is in a position to impose controls and influence the course of the reorganization effort, it will take that position. Beyond the ability to impose contractual obligations, there is often a desire on the part of institutional creditors to augment the management of a distressed debtor by the "consensual" appointment of a third party or organization as a principal player in the management and administration of the debtor's business and assets and in the development of the reorganization scenario.

Soon after the enactment of the Bankruptcy Code, this objective was pursued by seeking the appointment of a "responsible officer."[152] Generally, the responsible officer is a person or organization selected or approved by a major creditor constituency and compensated by the debtor. Major executive functions were vested in the responsible officer and it was granted direct reporting and access to the debtor's governing body. However, as the use of the responsible officer concept became more popular, questions were raised as to the authority for the appointment of such an officer who essentially operated outside of normal corporate governance strictures. It was noted that the Bankruptcy Code contained no provision for the appointment of a responsible officer vested with executive decision-making power who had been essentially selected by certain creditors not in accordance with normal governance rules. Under the Bankruptcy Code, the alternatives available to creditors to displace management were appointment of an examiner under § 1104 of the Bankruptcy Code or appointment or election of a trustee.

Accordingly, the responsible officer disappeared from the lexicon of the reorganization scenario under Chapter 11. However, the concept did not die. It has been reincarnated under the title Chief Restructuring Officer ("CRO"). Essentially it is very reminiscent of the responsible officer concept. At the "suggestion" of a major creditor constituency, the debtor agrees to the appointment of a CRO. The CRO is vested with executive decision making powers and direct access to the debtor's governing body. Direct access to the CRO is given to the creditor constituency responsible for the CRO's appointment. The CRO has the authority to meet privately with the creditor

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C.J.); Standing Order 2000-7 of the United States Bankruptcy Court for the Northern District of Texas dated December 21, 2000 (McGuire, C.J.).

[152] *See generally In re* Gaslight Club, Inc., 782 F.2d 767 (7th Cir. 1986); *In re* United Press Int'l, Inc., 60 B.R. 264 (Bankr. D. Col. 1986); *see also* DEL. CODE ANN. tit. 8, § 303(a) (2004) ("[chapter 11] power[s] and authorit[ies] may be exercised . . . by a representative appointed by the court or the judge").

constituency and otherwise deal with that creditor constituency as to the administration and formulation of a reorganization plan. From the perspective of some observers, the CRO is almost a *de facto* trustee.

The appointment of a CRO may dramatically change the nature of the reorganization process. In many instances, it takes away the decision making power of the debtor in possession and transfers control of the administration of a reorganization in or out of Chapter 11 to third parties other than the debtor.

IV. THE FATALLY FLAWED BUSINESS PLAN

The anti-Chapter 11 theorists argue that a Chapter 11 reorganization cannot rehabilitate a crippled business, even if it maintains hard assets dedicated to such business, if the underlying business plan and objectives are fatally flawed. A prime example cited by Professors Baird and Rasmussen is Webvan, Inc.[153] Webvan made a large investment in hard assets to revolutionize the way in which people purchased groceries. The Webvan entrepreneurs devoted substantial monies and efforts to create a large infrastructure designed to assemble produce and other perishables in sizeable warehouses and distribute them across a large geographic region. Much of the machinery in the particular warehouses was custom designed for the particular objectives of Webvan.

The Webvan business plan did not work. Webvan had substantial operating costs over and above its massive firm-specific investments. Webvan's business plan failed because it was unable to generate a positive cash flow. The assets specifically built for Webvan's purposes, i.e., distribution of groceries, no longer maintained any value. The assets dedicated to the enterprise were no longer viable.

Chapter 11 could do nothing to save Webvan. The result was an orderly liquidation with minimal recoveries in relation to the vast amount of monies invested in the business.[154]

Another example of the fatally flawed business plan is Iridium LLC. Iridium invested $5 billion in a network of satellites in lower earth orbit to provide voice and data transmission capabilities to remote areas.[155] Similar to railroads, the plan took too long to develop. It also proved too expensive to attract the customer base necessary to generate the requisite revenue to service its debt obligations. Other technology superseded the Iridium format. The result was a failure of the business plan. The dedicated assets had little value, and minimal recoveries were available to stakeholders.

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[153]Baird & Rasmussen, *supra* note 143, at 767-68, 781.

[154]*In re* Webvan Group, Inc., No. 01-2404 (CGC) (Bankr. D. Del 2001).

[155]*See generally* Baird & Rasmussen, *supra* note 143, at 767-68, 783-84.

An identical situation existed with Globalstar L.P., another provider of voice and data transmission capabilities to remote areas. Globalstar commenced its Chapter 11 cases with only $573.4 million in assets and over $3.3 billion in debt.[156] As with Iridium, these assets lost most of their value, and the case ultimately resulted in minimal recoveries to stakeholders.

Perhaps the most dramatic example of this phenomenon was the Chapter 11 case of Winstar Communications.[157] Winstar expended approximately $5 billion in constructing broadband networks in numerous cities throughout the United States. Its vision proved as elusive as that of many early railroad pioneers. The network took a great deal of time to construct and required Winstar to raise substantial capital and incur significant debt. When the demand for Winstar's broadband services failed to materialize, Winstar was compelled to commence a Chapter 11 case.

Winstar secured over $175 million in debtor in possession financing by providing the lenders the comfort of a security interest in the assets which had cost over $5 billion to acquire or construct. Winstar's Chapter 11 case was eventually converted to Chapter 7. By the time the proverbial dust settled, all of Winstar's assets were sold to IDT for a mere $38 million, leaving the debtor in possession financiers with a recovery of less than fifty percent on what they believed was a fully secured claim for the post petition financing that was not even fully drawn down. This is a scenario that debtor in possession lenders are not likely to repeat.

V. THE RECIDIVISM RATE - CHAPTER 22, ETC.

> *"Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor."*[158]

Since the enactment of the Bankruptcy Reform Act of 1978 and the increased ability to gather empirical data, academics have tracked recidivism rates; that is, the number of large publicly held debtors that have emerged from Chapter 11 only to return to the bankruptcy court for further relief in another Chapter 11 case.[159] Despite the feasibility requirement of § 1129(a)(11) of the Bankruptcy Code, the recidivism rate has been calculated to be as high as forty-two percent in some districts.[160] Concomitant

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[156] *In re* Globalstar Capital Corp., No. 02-10499 (PJW) (Bankr. D. Del. 2002).

[157] *In re* Winstar Communications, Inc., No. 01-1430 (JJF) (Bankr. D. Del. 2003).

[158] 11 U.S.C. § 1129(a) (11) (2000).

[159] *See generally* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 606-09 (1993).

[160] Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession*, 21 No. 1 BANKR. STRATEGIST 1, 4 (2003).

with the calculation of recidivism rates has developed a debate as to the reasons for the ostensibly high refiling rate, with blame attributed to a wide array of factors, including practices in particular bankruptcy courts and fundamental flaws with the Bankruptcy Code.[161]

Despite the requirement that a plan only be confirmed if it is feasible, the bankruptcy judge is dependent upon the parties presenting the necessary facts to enable the court to apply the law. The bankruptcy judge possesses no resources or capacity to undertake an independent financial and operational analysis of a Chapter 11 plan's feasibility. In judging the feasibility of the proposed reorganization, the bankruptcy court is a captive of the principal parties and the professionals these parties retain. It must rely upon the parties to present the relevant facts.

As illustrated above, the debtor is too often constrained by the covenants in the secured lenders' financing or cash collateral agreement. Subsequently, the distressed debt traders declare themselves the economic stakeholders in the enterprise and, consistent with the adage that time is money, pressure a debtor to quickly emerge from Chapter 11. Together, the now captive debtor and its creditors formulate and propose a "consensual" plan of reorganization. Once the plan is presented, the bankruptcy court is without means to independently assess the plan's feasibility and overcome the weight of the combined creditors and submerged debtors appearing before it urging confirmation. When viewed through this dynamic, the recidivism rate is not so difficult to comprehend. Indeed, with much of the debtor's autonomy arguably usurped by creditors who may have objectives other than the debtor's long term viability, it becomes harder to comprehend why the recidivism rate is not significantly higher.

The reasons for recidivism and the suggestions for avoiding repeat offenses will undoubtedly continue to be the subject of significant debate. It remains clear, however, that many so-called rehabilitated debtors emerge from Chapter 11 without being effectively reorganized and are required to carry more debt than their resources can support.

VI. THE QUESTIONABLE VITALITY OF THE RAILROAD REORGANIZATION PARADIGM FOR CHAPTER 11

In the twenty-five years since the effective date of the Bankruptcy Re-

[161]*Compare* Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND L. REV. 231, 264 (2001) ("[A] part of Delaware's appeal was its willingness to confirm no-questions-asked reorganizations.") *with* Miller, *supra* note 142, at 2014 ("As creditors' powers expand in conjunction with a constant contraction of a debtor's rights, the debtor has become a less potent force in its own reorganization and is often compelled to succumb to the pressure of creditors, who may have other objectives, and to agree to a plan that may not be feasible in the long term.").

form Act, the world and its economy have undergone dramatic and pervasive changes. The onset of the computer age together with rapid advances in technology have materially changed the manner in which businesses are operated and assets are managed. This has been accompanied by globalization, major changes in business relationships, increased obsolescence, and major consolidations in all segments of the industrial and commercial world. As the introduction of the railroad changed the business world, the foregoing occurrences have affected the world of reorganization. In this rapidly changing environment, academics are questioning whether the reorganization paradigm constructed in the late nineteenth century—that a debtor's business can be reorganized and rehabilitated under the protection of a court and returned to the business world as a viable economic unit—remains viable today. The premise of the Railroad Equity Receiverships—that a reorganized financial entity will realize more value as a going concern than through its liquidation—has remained unchanged despite four extensive amendments to the Bankruptcy Reform Act and a comprehensive review of the operation of the Bankruptcy Reform Act by the National Bankruptcy Commission appointed in 1996.

Notwithstanding the tenacity and success of the debtor in possession model, a concept unique to United States law, and the application of the railroad reorganization paradigm, it has been suggested by Professors Baird and Rasmussen that the reorganization paradigm is obsolete.[162] Indeed, they question the need for Chapter 11. According to Baird and Rasmussen, structural changes in the U.S. economy over the past twenty-five years, including the shift from a manufacturing economy to a service economy, the spiraling costs associated with the commencement and prosecution of Chapter 11 cases, as well as other options available to deal with business failure, make Chapter 11 unnecessary and ill-suited for the twenty-first century.[163] "There is no need for a collective forum that decides the fate of the firm if the firm can be sold in the marketplace as going concern."[164]

Professors Baird and Rasmussen note the use of Chapter 11 is declining.[165] Of the 500,000 firms they projected to fail in 2002, they predicted that only 10,000 firms would commence Chapter 11 cases, half as many as would have filed a decade earlier.[166] Moreover, Baird and Rasmussen noted that the majority of filed Chapter 11 cases were small and "[t]he typical case is the electrical subcontractor who uses the bankruptcy forum to cut a deal

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[162]Baird & Rasmussen, *supra* note 143. The authors express their appreciation for the stimulation provided by Professors Douglas G. Baird and Robert K. Rasmussen in their law review article.

[163]*Id.* at 751-56.

[164]*Id.* at 777.

[165]*See id.* at 752.

[166]*Id.*

with the IRS while keeping other creditors at bay."[167] In sum, "[c]orporate reorganizations have all but disappeared."[168]

Baird and Rasmussen argue that large corporations continuing to use Chapter 11 are using the process in cooperation with their major creditors for the purpose of sanctifying the sale of assets and the division of the proceeds amongst their creditors, rather than to reorganize the business and return to the economy as a restructured viable entity.[169] The declining use of Chapter 11 overall[170] and the increased use of Chapter 11 as a conduit to simply bless a previously negotiated sale[171] have lent credence to Baird and Rasmussen's argument and further thrown into question the continued viability and need for the Chapter 11 process as contemplated in 1978.

Is there a future for Chapter 11? The Chapter 11 process has thrived because preservation of an enterprise was a common goal shared by the debtor and each of the creditor constituencies based upon a mutual understanding that: (i) the assets as a whole were worth more than their liquidation value; (ii) the public interest would be best served by the survival of the business; and (iii) a collective forum was necessary to resolve differences between the debtor and stakeholders. Recent changes in the global economy now challenge the foundations of Chapter 11 on each of these three levels.

A. Going Concern Value: A Concept of the Past?

The last decade has seen significant debate over privatization of the recovery process or "contractualism."[172] Proponents of such contractual models of reorganization argue that the recovery process should be governed by contracts between the debtor and its creditors. Under such a regime, bankruptcy proceedings serve only as an option for those parties who do not enter into contracts that specify and control post-default scenarios.[173] In arguing for the replacement of the Chapter 11 process with a contractual model of reorganization, Baird and Rasmussen cite the lack of "dedicated" or "firm spe-

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[167] *Id.*

[168] *Id.* at 751.

[169] *Id.*

[170] *Id.* at 752. This conclusion remains subject to debate. While, as Baird and Rasmussen point out, the number of Chapter 11 filings in 2000 were less than half of the number of filings in 1991, it remains to be determined whether these two years form a statistically representative basis to infer a downward trend in Chapter 11 filings. Additionally, many variables outside the scope of this paper can be offered to explain the allegedly decreasing use of Chapter 11 such as, for example, the level of interest rates or the increasing sophistication of investors.

[171] *See, e.g.*, *In re* Loral Space & Communications, No. 03-41710 (RDD) (Bankr. S.D.N.Y. 2003); *In re Twinlab* Corp., No. 03-15564 (CB) (Bankr. S.D.N.Y. 2003); *In re* Trans World Airlines, Inc., No. 01-00056 (PJW) (Bankr. D. Del. 2001).

[172] *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 827-30 (2004).

[173] *Id.* at 827.

cific" assets in the businesses of today's economy.[174] Railroad assets are the archetypal examples of such dedicated assets in American bankruptcy law, as individual rails, which together form a track, maintain little value separately, but are far more valuable collectively. If a firm has no dedicated assets, such entity has no additional value as a going concern because theoretically such entity's assets do not exceed their liquidation value. Without the ability to realize going concern value, distressed firms have no need for Chapter 11.[175]

Are the assets of today's businesses less dedicated than the railroad assets? The answer depends upon how the assets are conceptualized. Certainly, the shift to a service economy has meant that capital-intensive, specialized assets, such as steel furnaces and mills, represent a smaller component of today's economy. Indeed, the physical assets of today's service economy are office space, desks, chairs, and word processors. Baird and Rasmussen are correct in that such assets are highly fungible and do not have greater value residing within a particular business. However, the conclusion that firms using Chapter 11 today lack going concern value remains unproven and may run contrary to experience. It is impractical for firms to sell assets as bare as desks or chairs in bankruptcy. Rather, firms sell whole businesses, entities, or divisions in bankruptcy.[176] This fact demonstrates that today's market is rejecting the notion that debtors using Chapter 11 today have little or no going concern value. The integrity of the business as an ongoing operation rather than the separate assets is what results in the enhanced sales prices.

Why do businesses still maintain going concern value despite the increasingly fungible nature of corporate assets? Part of the answer is that assets already in use have more value than assets not yet put into use. Starting a business from scratch is expensive and time-consuming and entails a large degree of entrepreneurial risk. Additionally, companies maintain going concern value as a result of centralized management, overlapping systems, and other benefits of economies of scale. A Chapter 11 reorganization process is useful to the extent that it affords a debtor an opportunity to reorganize intact and continue to tap such benefits. It is not clear that technology and globalization can fully displace these benefits.

The assertion that firms do not differentiate between transactions inside the firm and outside the firm[177] assumes one can obtain the benefits of economies of scale through contracts with the marketplace. However, the flurry of

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[174]Baird & Rasmussen, *supra* note 143, at 758-78.

[175]*Id.*

[176]The number of examples is countless. *See, e.g.*, *In re* Global Crossing Ltd., 295 B.R. 726 (Bankr. S.D.N.Y. 2003); *In re* Enron Corp., No. 01-16034 (AJG) (Bankr. S.D.N.Y. 2002); Trans World Airlines, Inc., No. 01-00056.

[177]Baird & Rasmussen, *supra* note 143, at 768.

recent mergers and acquisitions activity and the move towards consolidation across many industries suggests that there are benefits that cannot be obtained by simply contracting with the marketplace. From this perspective, Chapter 11 can be seen as a process whereby a reorganizing debtor chooses which transactions are valuable to continue to pursue within the firm and which are not.

It is also argued that, in today's winner-take-all economy, only a few successful firms maintain going concern value. In the absence of dedicated assets, going concern value is realized by virtue of a firm's ability to utilize its assets more efficiently than its competitors. The conclusion that firms using Chapter 11, by their nature, lack such an ability[178] appears overly simplistic. Today's firms are multi-national and compete in multiple markets. A firm may commence a Chapter 11 despite having highly profitable lines of businesses or divisions.[179] A company may be competitive in its industry, yet require Chapter 11 protection for reasons not directly related to the company's competitive position.[180] Alternatively, market factors may negatively affect an industry as a whole, forcing multiple competitors to seek the protections of Chapter 11 in order to remain competitive with one another.[181] The distress that precipitated the commencement of a Chapter 11 case may be transient and adequately addressed through reorganization or, where a real marketplace exists, a sale. Under such circumstances, going concern value may be preserved. Experience has demonstrated that the sale of a business as an operating unit enhances value more than the piecemeal sale of particular assets.[182]

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[178]*Id.* at 763-64.

[179]*See, e.g.*, Enron Corp., No. 01-16034 (noting that Enron's trading operations were highly lucrative).

[180]Texaco, for example, filed for bankruptcy in the face of a $10.53 billion judgment to Pennzoil. *In re* Texaco, Inc., No. 87-20142 (HS) (Bankr. S.D.N.Y. 1987); SKEEL, *supra* note 6, at 1 ("When Texaco filed for bankruptcy, no one thought for a moment that the giant oil company would be shut down and its assets scattered to the winds."); *see also In re* WorldCom, Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. 2002) (fraud); Enron Corp., No. 01-16034 (fraud); *In re* Bethlehem Steel Corp., No. 01-15288 (BRL) (Bankr. S.D.N.Y. 2001) (pension liability); *In re* Owens Corning, No. 00-3837 (JKF) (Bankr. D. Del. 2000) (asbestos claims).

[181]Companies within sectors often seem to file for Chapter 11 protection together. *See, e.g., In re* Loews Cineplex Entm't Corp., No. 01-40346 (ALG) (Bankr. S.D.N.Y. 2001); *In re* United Artists Theatre Co., No. 00-3514 (PJW) (Bankr. D. Del. 2000); *In re* Carmike Cinemas, Inc., No. 00-3302 (JBR) (Bankr. D. Del. 2000) (Carmike, United Artists and Loews operated movie theaters); *In re* Aerovias Nacionales de Colombia S.A. Avianca, No. 03-11678 (ALG) (Bankr. S.D.N.Y. 2003); *In re* US Airways Group, No. 02-83984 (SSM) (Bankr. S.D.N.Y. 1997); *In re* UAL Corp., No. 02 B 48191 (ERW) (Bankr. N.D. Ill. 2002); Transworld Airlines, Inc., No. 01-00056; (airlines); *In re* Allegiance Telecom, Inc., No. 03-13057 (RDD) (Bankr. S.D.N.Y. 2003) (telecommunications); *In re* Global Crossing Ltd, No. 02-15749 (REG) (Bankr. S.D.N.Y. 2002); *In re* Worldcom, Inc. No. 02-13533 (AJG) (Bankr. S.D.N.Y. 2002).

[182]*Cf., e.g.*, Bethlehem Steel Corp., No. 01-15288 (ordering sale to International Steel Group, Inc. for $1.5 billion).

B. THE CONTINUING POTENTIAL BENEFITS OF BUSINESS REORGANIZATION UNDER CHAPTER 11

Business reorganization under Chapter 11 offers troubled firms distinct advantages that are not otherwise available in an out-of-court restructuring or liquidation. Whereas reorganization was, perhaps, the only option available to distressed railroads in the late nineteenth century because no single entity could amass enough capital to purchase an established line or unit,[183] in today's market the proliferation of private equity funds, venture capital funds, buyout funds, vulture funds, and other alternative forms of investment, as well as myriad financial tools that have developed to aggregate capital, have significantly reduced concerns that firms entering Chapter 11 with assets more valuable as a whole may be broken apart in order to effectuate a Chapter 11 plan.

Professors Baird and Rasmussen[184] argue that the single comprehensive sale eliminates the need for the collective forum provided by Chapter 11.[185] Moreover, the single comprehensive sale often precipitates the use of Chapter 11 to effectuate a sale under § 363(b) of the Bankruptcy Code to eliminate potential "hang-over" claims against the purchaser. However, a § 363(b) sale dramatically changes the concept and nature of the Chapter 11 process from one of rehabilitation of the debtor and its business to a potential auction that will leave a pool of cash (or other consideration) to be divided up among the debtor's creditors. What Baird and Rasmussen fail to acknowledge is that one of the fundamental precepts of Chapter 11 is maximizing and allocating return to creditors. To this end, there are many instances when use of the Chapter 11 process to properly marshal claims and sell assets free and clear of all claims raises the purchase price, a result that cannot be achieved outside the Chapter 11 process.

Recent examples of the use of § 363(b) to effect a sale of all or substantially all of a debtor's assets include but certainly are not limited to the Chapter 11 cases of: *Bethlehem Steel Corporation,*[186] *Budget Group,*[187] *Top-Flite,*[188] *Velocita,*[189] *LTV Steel,*[190] *Trans World Airlines,*[191] *Bridge Information Systems,*[192] *AT&T Latin America Corp.,*[193] *Globalstar, L.P.,*[194] *Asia*

[183]Baird & Rasmussen, *supra* note 143, at 759.

[184]Director, Law and Economics Program; Professor of Law, Vanderbilt Law School.

[185]Baird & Rasmussen, *supra* note 143, at 777.

[186]Bethlehem Steel Corp., No. 01-15288.

[187]*In re* Budget Group, No. 02-12152 (MFW) (Bankr. D. Del. 2002).

[188]*In re* Top-Flite, Inc., No. 03-12003 (MFW) (Bankr. D. Del. 2003).

[189]*In re* Velocita Corp., No. 02-35895 (DHS) (Bankr. D.N.J. 2002).

[190]*In re* LTV Steel Co., Inc., No. 00-43866 (WTB) (Bankr. N.D. Ohio 2000).

[191]*In re* Trans World Airlines, Inc., No. 01-00056 (PJW) (Bankr. D. Del. 2001).

[192]*In re* Bridge Info. Sys., Inc., No. 01-41593-293 (DPM) (Bankr. E.D. Mo. 2001).

[193]*In re* AT&T Latin Am. Corp., No. 03-13538 (RAM) (Bankr. S.D. Fl. 2003).

Global Crossing Ltd.,[195] *Touch America Holdings, Inc.*,[196] *Winstar Communications, Inc.*,[197] *EXDS, Inc. (f/k/a Exodus Communications, Inc.)*,[198] *Genuity Inc.*,[199] *Polaroid Corporation*,[200] *ANC Rental Corporation*,[201] *Pillowtex Corporation*,[202] *Allegiance Telecom Inc.*,[203] *Medical Wind Down Holding II, Inc. (f/k/a Maxxim Medical Group Inc.)*,[204] *BII Liquidation, Inc. (f/k/a Burlington Industries, Inc.)*,[205] *National Steel Corporation*,[206] and *Loews Cineplex Entertainment Corporation*.[207]

1. *The Benefits of Section 363(b)*

The filing of Chapter 11 petitions to consummate § 363(b) sales without any intention to reorganize[208] further demonstrates the value of Chapter 11 as a transparent multi-party forum. Though troubled corporations are not required to use Chapter 11 as a conduit for a sale of their businesses, § 363(b) sales remain a common occurrence. The filing of a Chapter 11 petition often creates a market for the debtor's assets. Companies are frequently "shopped" unsuccessfully prior to the commencement of a Chapter 11 case and only become attractive upon the filing of the Chapter 11 petition. For such corporations, Chapter 11 provides a market for the sale and creates a forum for addressing the future of the business and the liquidation of its assets to pay creditors.

The use of Chapter 11 persists because of its unique ability to bring all parties in interest to the table (as further discussed below), marshal assets and liabilities of a debtor, and effect an efficient resolution of all of the claims against the debtor. Chapter 11, through procedures such as estimation and the use of reserves, can even address and resolve unknown or contingent liabilities. This unique ability to cleanse the assets of a distressed company attracts potential purchasers as it removes the cloud of uncertainty associated with purchasing assets. Such uncertainty is naturally greater when evaluating the purchase of assets of a distressed business and potentially chills the

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[194] *In re* Globalstar, L.P., No. 02-10504 (PJW) (Bankr. D. Del. 2002).

[195] *In re* Asia Global Crossing Ltd., No. 02-15749 (REG) (Bankr. S.D.N.Y. 2002).

[196] *In re* Touch America Holdings, Inc., No. 03-11915 (KJC) (Bankr. D. Del. 2003).

[197] *In re* Winstar Communications, No. 01-01430 (JBR) (Bankr. D. Del. 2001).

[198] *In re* EXDS, Inc., No. 01-10539 (PJW) (Bankr. D. Del. 2001).

[199] *In re* Genuity Inc., No. 02-43558 (PCB) (Bankr. S.D.N.Y. 2002).

[200] *In re* Polaroid Corp., No. 01-10864 (JPW) (Bankr. D. Del. 2001).

[201] *In re* ANC Rental Corp., No. 01-11200 (MFW) (Bankr. D. Del. 2001).

[202] *In re* Pillowtex Corp., No. 03-12339 (PJW) (Bankr. D. Del. 2003).

[203] *In re* Allegiance Telecom Inc., No. 03-13057 (RDD) (Bankr. S.D.N.Y. 2003).

[204] *In re* Medical Wind Down Holding II, Inc., No. 03-10438 (PJW) (Bankr. D. Del. 2003).

[205] *In re* BII Liquidation, Inc., No. 01-11282 (JBR) (Bankr. D. Del. 2001).

[206] *In re* Nat'l Steel Corp., No. 02-08697 (JHS) (N.D. Ill. 2002).

[207] *In re* Loews Cineplex Entm't Corp., No. 01-40346 (ALG) (Bankr. S.D.N.Y. 2001).

[208] Baird & Rasmussen, *supra* note 143, at 751 (citing the bankruptcies of Trans World Airlines and Enron).

interest of buyers who are wary of issues such as successor liability. The Chapter 11 process helps remove this uncertainty, which in turn provides a market for the sale and maximizes the recovery to stakeholders of the debtor.

2. *A Single Collective Forum v. "Contractualism"*

An additional benefit of Chapter 11 is the single collective forum it establishes for parties in interest to work towards a plan of reorganization or a sale. The automatic stay prevents the "race to the courthouse" or dismemberment of a debtor's assets prior to adequate consideration of the interests of all parties to the proceeding and a determination as to the appropriate course of action.

Proponents of a contractual model of reorganization have not yet identified a successful example wherein parties efficiently allocated control rights via contract. To the contrary, countless large commercial cases, including *Enron,*[209] *Global Crossing,*[210] *WorldCom,*[211] *W.R. Grace,*[212] *Armstrong,*[213] *Conseco,*[214] *A.H. Robins,*[215] and *Johns-Manville,*[216] have demonstrated that prepetition agreements alone are incapable of resolving complex inter-creditor issues and that Chapter 11 safeguards are necessary to preserve the assets of the firm on a going concern basis for the benefit of all interested parties.

Baird and Rasmussen cite high-tech "startup" corporations, like Webvan, as working models of contractualism.[217] However, such examples are not useful in determining whether a single collective forum may be beneficial to troubled firms in today's economy. By their own admission, startups possess little, if any, debt. They are typically controlled by a group of sophisticated equity investors (usually a venture capital fund with experience incubating similar startups) better equipped to make efficient decisions than the average individual shareholder. Unlike the railroads of the nineteenth century, startups do not have fragmented equity ownership and significant debt and tend to have simple capital structures including only one, if any, class of debt. Railroads, however, carried substantial secured debt, unsecured debt, and equity—all of which were fragmented among numerous parties in interest.[218] The associated increase in parties in interest in today's troubled firms (and the number of parties that need to be noticed in any proceeding) makes con-

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[209]Enron Corp., No. 01-16034.

[210]*In re* Global Crossing Ltd., 295 B.R. 726 (Bankr. S.D.N.Y. 2003).

[211]WorldCom, No. 02-13533.

[212]*In re* W.R. Grace & Co., No. 01-1139 (JKF) (Bankr. D. Del. 2001).

[213]*In re* Armstrong World Indus., Inc., No. 00-4471 (JJF) (Bankr. D. Del. 2000).

[214]*In re* Conseco, Inc., No. 02-49672 (CAD) (Bankr. N. D. Ill. 2002).

[215]*In re* A.H. Robins Co., Inc., No. 85-1307-R (BNS) (Bankr. E.D. Va. 1985).

[216]*In re* Johns-Manville Corp., No. 82 B 11656 (BRL) (Bankr. S.D.N.Y. 1982).

[217]Baird & Rasmussen, *supra* note 143, at 780-82.

[218]SKEEL, *supra* note 6, at 58.

tracting control rights among disputing parties exceedingly difficult and increases the potential that any one party may wreak havoc by "jumping" the line and collecting before others.

Not only are high-tech startups not indicative of a typical Chapter 11 debtor, but also the rising power of vendors (trade creditors), illustrated above, together with the importance of involuntary tort creditors, two phenomena unique to today's economy, further increase the need for a single collective forum. The goals of such creditor constituencies are divergent from those of secured and other unsecured creditors. Accordingly, in light of the increasing number of parties in interest with largely divergent goals, the value of a transparent Chapter 11 process has become more readily apparent.

3. *Creditor Constituencies and the Resolution of Conflicting Interests*

In the world of complex financial transactions and divergent creditor interests, Chapter 11 has provided a forum within which such interests may be resolved. The need for a forum addressing creditor concerns has magnified given the expanding power and control of creditors in Chapter 11 reorganizations. Creditors in recent years, particularly secured creditors, have become more adept at gaining leverage over a debtor. For example, provisions of a secured credit facility may provide for the appointment of a CRO if an entity should file a Chapter 11 petition. The Bankruptcy Code generally validates such provisions, as the prohibition against *ipso facto* clauses does not apply to such clauses within lending agreements.[219]

The Bankruptcy Code affords the debtor some protections from the expansion of power by secured creditors.[220] For example, the Bankruptcy Code provides for: (i) the appointment of a statutory committee of unsecured creditors;[221] (ii) a basis for the re-characterization or equitable subordination of secured claims;[222] and (iii) bankruptcy court approval for a debtor's decision to obtain debtor in possession financing[223] or to sell assets.[224]

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[219]*See* 11 U.S.C. § 365(e)(2)(B) (2000).

[220]Similarly, the Bankruptcy Code affords the debtors some protections from the expansion of power of trade creditors and tort creditors through, for example, the automatic stay. *See* 11 U.S.C. § 362 (2000). However, recent scholarship has focused mainly on the expanding power of the secured creditor. *See, e.g.*, Westbrook, *supra* note 172. There remains the question as to whether or not the current safeguards sufficiently protect the debtor against secured creditor control. Debtors often favor the secured creditor's position and courts are deferential to the debtor's decision under the "business judgment" standard of review. Matt Miller and Terry Brennan, *Creditors in Possession*, THE DEAL, Jan. 12, 2004, at 26-27 (interview with Harvey Miller). This legal standard does not demand that a bankruptcy court independently evaluate the debtor's judgment and, as discussed above, may be the cause of recidivism.

[221]11 U.S.C. § 1102 (2000).

[222]*See id.* at §§ 105, 510; Bayer Corp. v. MascoTech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726, 748 (6th Cir. 2001) (stating that the power to recharacterize stems from 11 U.S.C. § 105, which grants courts general equitable powers).

[223]11 U.S.C. § 363 (2000).

Although the Chapter 11 process has witnessed a rise in the power of trade creditors and certain other unsecured creditors, this expansion in power has failed to match the expanding control of secured creditors. For example, unsecured bonds are routinely issued to potentially thousands of investors pursuant to a single indenture agreement. Bondholders appear to sacrifice priority and control for a higher rate of interest, perhaps because their disaggregated nature makes them less suited to the degree of oversight that a syndicate of banks can exercise. Secured bank groups, in comparison, often extend secured credit pursuant to a credit facility that contains restrictive covenants and rights of control. While the loan amounts are syndicated to spread risk, they remain aggregated among a small number of banks. Furthermore, a syndicate of banks will typically appoint one of the lenders as the agent to represent the syndicate and to maintain a powerful voice in the reorganization proceedings. Finally, bank groups and agents tend to be sophisticated parties with prior experience in large Chapter 11 reorganizations.

Advocates of the contractual model do not recognize the value of transparency in the Chapter 11 process or address the possibility that a contractual model of reorganization could further expand the power and control of secured creditors in the reorganization process at the expense of both the debtor and other creditor constituencies. Many commentators have voiced concern over secured creditors' expanding control over the process and the "creditor-in-possession" dilemma. For example, Professor Jay Lawrence Westbrook[225] has argued that secured creditors already exert too much influence over bankruptcy auctions and promote sale prices that result in too little value for unsecured creditors and other stakeholders.[226]

4. *The Public Interest and the Preservation of Employment Opportunities*

As discussed above, the need for a bankruptcy law during the railroad failures of the late nineteenth century drew national attention in light of the importance of railroads to the rapidly industrializing economy and concern for the public interest. Chapter 11 provides the debtor and courts the opportunity to weigh public policy considerations and to consider economic externalities. Under a regime of free-market contractualism, as contemplated by Baird and Rasmussen, parties will secure their own financial security without regard to costs or benefits of potential transactions that are currently considered in the bankruptcy process (e.g., maximization of return to all creditors,

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[224]*Id.* at § 363.

[225]Professor Jay Lawrence Westbrook is the Benno C. Schmidt Chair of Business Law, University of Texas School of Law.

[226]*See* Westbrook, *supra* note 172, at 845-47.

continued workforce employment, environmental concerns, equity and the public interest).

Beyond pure economics, Chapter 11 provides a court with the opportunity to weigh the public interest in preserving employment and other social benefits.[227] Absent Chapter 11, the risk that employees would be displaced, firms would be dissolved, and the market would be flooded with workers would increase exponentially. Increased unemployment and contraction of income can have dramatic effects upon a local economy. If the firm is large enough or enough firms fail, job losses could have a profound impact.

Bankruptcies, by their very nature, can raise concerns regarding additional issues such as antitrust,[228] national security,[229] public health,[230] and transportation.[231] Proponents of contractualism have failed to address how the contractual model can adequately address public policy concerns given the difficulty in predicting which public interests may be affected. This problem would be heightened where public policy claimants have limited interests and little incentive to participate. Accordingly, Chapter 11 provides a forum to foster discussion and debate over public policy, the benefits of which would be lost in a contractual reorganization.

CONCLUSION

Bankruptcy law in the United States has evolved through a number of cycles of change and reform. As one looks at the twenty-five years following the enactment of the Bankruptcy Reform Act and the changes the bankruptcy world is undergoing today, one potentially sees a new and deeper cycle. Many of today's changes go to the core of the whole concept and objective of Chapter 11 and challenge the need for a reorganization statute altogether. As countries in Europe move towards a reorganizational model

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[227]*See, e.g., In re* Bethlehem Steel Corp., No. 01-15288 (BRL) (Bankr. S.D.N.Y. 2001) (noting that the debtors' ability to avoid liquidation saved thousands of jobs).

[228]Many Chapter 11 cases involving sales require antitrust clearance such as Hart-Scott-Rodino approval. *See, e.g., In re* Allegiance Telecom, Inc., No. 03-13057 (RDD) (Bankr. S.D.N.Y. 2003). Furthermore, a Chapter 11 filing, by its nature, can improve an overcrowded industry's health by decreasing capacity or it can decrease competitiveness in a healthy industry by removing a player from the market.

[229]*See, e.g., In re* Global Crossing, Ltd., No. 02-40188 (REG) (Bankr. S.D.N.Y. 2002); *In re* WorldCom, Inc., No. 02-13533 (AJG) (Bankr. S.D.N.Y. 2002).

[230]*See, e.g., In re* United Healthcare Sys., Inc., No. 97-1159, 1997 WL 176574, at *5 (D.N.J. Mar. 26, 1997) (in evaluating sale of assets, the district court must look to the overriding consideration of public health); *In re* Brethren Care of South Bend, Inc., 98 B.R. 927 (Bankr. N.D. Ind. 1989) (stating that, in evaluating sale of not-for-profit nursing care facility's assets, the well-being of the residents of the facility is of particular concern).

[231]*See, e.g., In re* UAL Corp., No. 02 B 48191 (ERW) (Bankr. N.D. Ill. 2002); *In re* US Airways Group, No. 02-83984 (SSM) (Bankr. E.D. Va. 2002); *In re* US Airways Group, No. 04-13820 (SSM) (Bankr. E.D. Va. 2004). Like the railroads of the nineteenth and twentieth centuries, air travel has had a profound effect on American society and is a critical part of the economy's infrastructure.

similar to the Chapter 11 debtor-in-possession concept, the United States may be moving in the opposite direction.

Many of these changes are beneficial. To the extent a distressed company can better repay creditors by selling its businesses rather than attempting to reorganize, such efforts facilitate the maximization of recovery to creditors, a fundamental goal of bankruptcy. However, not all recent transformations in the bankruptcy landscape have been positive. The power and influence of creditors and distressed debt traders in the reorganization process have increased dramatically. The legacy of nineteenth century courts that championed the interests of employees and public policy has become endangered. It remains to be seen whether these trends will continue and whether Chapter 11 will survive this challenge. What is clear, however, is that the argument that a reorganization statute is unnecessary is premature. In some ways, the changes identified suggest that our reorganization laws should be strengthened. Only time will tell.