THE FUTURE OF CHAPTER 11
A Symposium Cosponsored by the American College of Bankruptcy

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**SOME CONFIRMED CHAPTER 11 PLANS FAIL. SO WHAT?**

*Stephen H. Case*

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**Abstract:** Critics of the feasibility requirement set forth in 11 U.S.C. § 1129(a)(11) contend that the current bankruptcy system inadequately prevents repeat Chapter 11, or “Chapter 22,” filings. Undoubtedly, there are instances of confirmed Chapter 11 plans that turn out to be unfeasible despite court findings to the contrary. Given the uncertainties of investment projections and capital markets, however, the occasional failure of Chapter 11 plans is not necessarily a greater evil than alternatives such as liquidation or excessively conservative capital structures. Chapter 11 is, by its very definition, a hit-or-miss venture; thus, it misses occasionally. Some confirmed Chapter 11 plans fail. So what?

**NO EASY ANSWERS: SMALL BUSINESS BANKRUPTCIES AFTER BAPCPA**

*Hon. James B. Haines, Jr. & Philip J. Hendel*

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**Abstract:** Among the changes the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 brings to the Bankruptcy Code are a host of new burdens on small business debtors attempting to reorganize under Chapter 11. This Article examines those provisions affecting small business debtors and outlines suggestions for navigating through the new requirements without jeopardizing a small business’s chances for a successful and expeditious reorganization. In particular, this Article argues for the formation of active prepetition creditors’ committees for those businesses that intend to seek Chapter 11 protection. Finally, this Article suggests that a potential solution to the problems faced by small business lies in expanding Chapter 12 to permit non-agricultural small businesses to fall within its protection.
THE EVOLVING BANKRUPTCY BENCH: HOW ARE THE “UNITS” FARING?

Ralph R. Mabey

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Abstract: Life on the bankruptcy bench has evolved in recent years. This Article examines these changes from the perspective of bankruptcy judges themselves. Randomly selected bankruptcy judges were surveyed on a variety of topics including law clerks, job satisfaction, case management, bankruptcy appellate panel service, prior career, and publication of opinions. This Article compiles and analyzes the results of those surveys, and concludes that, overall, bankruptcy judges are satisfied and appear resilient to the changes and frustrations facing the bench.

IS CHAPTER 11 BANKRUPT?

Harvey R. Miller & Shai Y. Waisman

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Abstract: This Article discusses the continuing contraction of business reorganization under the Bankruptcy Code. It argues that it is wrong to assume that there is no need for a business reorganization law in a modern, service-oriented economy that has well-developed capital markets. The Article first analyzes and contrasts bankruptcy law in the United States under the Chandler Act of 1938, which fostered the concept of reorganization and rehabilitation of distressed business entities, and under the Bankruptcy Reform Act of 1978, which built upon lessons learned under the Chandler Act and pursuant to which bankruptcy reorganization became an appropriate and necessary vehicle to preserve and protect the values of major business organizations. The Article then traces the economic, legal, political, and ideological changes that threaten the viability of corporate rehabilitation, including the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Finally, this Article responds directly to anti-Chapter 11 theorists, arguing: (1) reorganization remains relevant to preserving going-concern values in today’s economy, (2) Chapter 11 has significant value as a transparent, neutral, multi-party forum to address the insolvency of a business, even when a marketplace exists for the debtor’s assets, and (3) the privatization of the insolvency process is both unworkable and undesirable.
THE FUTURE OF THE DOCTRINE OF NECESSITY AND CRITICAL-VENDOR PAYMENTS IN CHAPTER 11 CASES

Alan N. Resnick

Abstract: This Article explores the history and justification for the doctrine of necessity in Chapter 11 cases. It discusses the doctrine’s gradual narrowing, due to appellate courts’ reluctance to permit payment of prepetition debts or recognize courts’ authority to authorize such payments. The Article analyzes the effect of recent amendments to the Bankruptcy Code on the doctrine and confirms that there is uncertainty regarding the propriety of payment of certain prebankruptcy debts. The Article proposes that the Code be amended to clarify the extent to which the doctrine of necessity applies in Chapter 11 cases and asserts that courts should recognize different standards depending on the type of debt being repaid. Finally, this Article argues that courts should have discretion to authorize payments in extraordinary circumstances when they follow procedural safeguards.
A little over twenty-five years ago, Congress passed the Bankruptcy Reform Act of 1978 (the “Reform Act”). Chapter 11 of the Code, named Reorganization, was the product of American experience under the Chandler Act of 1938. The Chandler Act, which amended the Bankruptcy Act of 1898, grew out of the federal equity receiverships that saved the railroads. Chapter 11 melded certain aspects of Chapters X and XI of the Chandler Act. In the new, unified reorganization chapter, the debtor would remain in possession of, and operate its business during, the bankruptcy proceeding unless there was strong reason to replace the debtor. A right to adequate protection replaced the secured creditor’s rights to its collateral and control over a case. A debtor could impose a plan on a creditor against its will. The absolute priority rule was made less absolute because a senior creditor could waive it by accepting a plan that did not give it absolute priority over junior parties. The Securities and Exchange Commission’s role in the reorganization drama was reduced significantly.

The drafters hoped these changes would encourage companies to seek Chapter 11 relief in time to have a chance to reorganize. Consolidation of reorganization relief into a single chapter would eliminate the wasteful off-the-merits litigation regarding the appropriate relief chapter. Readjusting the balance of power between debtor and secured creditor would increase the likelihood of successful reorganization. According to its legislative history, Chapter 11 was also designed to permit a business to restructure its finances so it could continue to operate, employ workers, pay its creditors, and produce a return for its stockholders.

The premise of a business reorganization under the Reform Act is that assets used for production in the industry for which they were
designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it can often be returned to a viable state. It is thus more economically efficient to reorganize than to liquidate because it preserves jobs and assets.3

And so, with the Reform Act, the American experiment in bankruptcy law moved forward. Laws, however, are not the only things that change and laws, like war plans, often reflect what was, rather than what is. During the brief and, for some, glorious days of the 1980s and early 1990s, the nature of capital markets and business was changing. More and more, the manufacturing company employing several hundred people in a community was becoming less and less a reflection of postmodern American business. Service industries were replacing manufacturing enterprises. Financial markets were becoming increasingly global as well as more sophisticated and efficient. Investors were buying bankruptcy claims for pennies on the dollar, seeking a quick return on their investment. Instead of debtors using Chapter 11 to reorganize, secured creditors were using Chapter 11 to accomplish a federal foreclosure sale. The paradigm upon which Chapter 11 was imagined no longer reflected the reality of many businesses. Consequently, Chapter 11 was unresponsive to many postmodern distressed businesses, their creditors, and the world in which they operated.

Along with an increasing dissonance between the law of reorganization and the realities of the marketplace, Chapter 11 had its own internal problems. It was too expensive and cumbersome for small businesses to use it successfully. Big businesses who had “successfully” reorganized were reappearing at Chapter 11’s doorstep to file a “Chapter 22” or “Chapter 33” case. Judicial reliance on the doctrine of necessity to authorize payment of “critical” vendors upset the Code’s delicate distributive balance. Judicial reliance on the doctrine of substantive consolidation upset reasonable creditor expectations.

In the following pages, some of the country’s finest bankruptcy minds discuss some of Chapter 11’s thorniest issues, now further complicated by the overlay of the Bankruptcy Abuse Prevention and

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Consumer Protection Act of 2005. Perhaps two different reorganization chapters are necessary after all: a general chapter and another specially tailored—streamlined—for small businesses? Perhaps investors need greater protection after all? Today’s situation is reminiscent of the nineteenth-century pattern of bankruptcy legislation followed by repeal followed by new legislation followed by repeal. The late twentieth- and early twenty-first-century pattern is legislation followed by amendments followed by more amendments and more amendments after that. Both patterns reflect the ongoing difficulty of striking a proper balance between the interests of creditors and debtors in a constantly changing society that encourages risk-taking and incurring debt. These are exciting times because the genius of our legal system is its adaptability. This adaptability is a product of smart lawyers and judges devising creative responses to the latest set of challenges.

On behalf of all those who attended the Symposium on the Future of Chapter 11 or who read this issue of the *Boston College Law Review*, I thank both the American College of Bankruptcy and the *Boston College Law Review* for the privilege of listening to, and reading, some of our smartest lawyers’ and judges’ thoughts on Chapter 11.

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SUBSTANTIVE CONSOLIDATION TODAY

DOUGLAS G. BAIRD*

Abstract: In large corporate reorganizations, bankruptcy judges often confirm plans of reorganization that call for “substantive consolidation” of the different corporate entities comprising the corporate group. Substantive consolidation allows the general creditors of the various entities to share in a common pool of assets; it often simplifies a reorganization and wins broad support among the creditors. Nevertheless, a statutory basis for the doctrine is hard to find, and the lower court practice is often at odds with the doctrine as spelled out in appellate court opinions. The emerging debate over the proper scope of substantive consolidation shows how much bankruptcy law remains a common-law discipline whose contours are shaped in the courtroom as well as in Congress.

INTRODUCTION

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 is the most sweeping change in bankruptcy law in a quarter century.1 Much of bankruptcy law, however, remains judge-made, and here the area is in considerable flux. This Article focuses on the question of substantive consolidation, a bankruptcy-law analogue to veil-piercing, to show how judges can shape the legal landscape as much as legislators.2

Part I of this Article sets out the background through a hypothetical. Part II examines substantive consolidation as commonly practiced in the bankruptcy courts.3 Part III reviews the evolution of the doctrine and shows how modern practice has lost its moorings

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3 See infra notes 6–49 and accompanying text.
and is likely to be vulnerable if the U.S. Supreme Court confronts the question.\(^4\)

I. The Mechanics of Substantive Consolidation

A large business often consists of many corporate entities. When the parent corporation declares bankruptcy, each entity typically files its own Chapter 11 petition, and the cases are then administratively consolidated. One judge presides over all the cases, and one set of lawyers represents the various debtors. The separateness of the legal entities is preserved, and the general creditors of each entity share the entity’s assets with the other general creditors of that entity. In a number of complex reorganizations—WorldCom being a recent example—those running the reorganization want to take the next step and substantively consolidate the various cases. Under substantive consolidation, the liabilities and assets of the various entities are put into the same pot, and the assets are distributed ratably among the general creditors. Under this scheme, some general creditors fare better and others worse.

Enhancing the rights of some creditors at the expense of others in this fashion requires justification. In some cases, the institutional lenders have already treated the business as a single entity. For them, unscrambling the many intercorporate relationships introduces complexities to the reorganization without corresponding benefits. Figuring out the exact pro rata share does not make sense, especially if virtually all the players have already agreed on a plan of reorganization.

The following hypothetical reflects a common pattern. Premium Paint is one of the largest manufacturers, distributors, and retailers of paint and paint-related merchandise in the Midwest.\(^5\) It consists of six separate corporations. Premium Paint Co., Inc., is a publicly traded Delaware corporation that serves as a holding company for its subsidiaries. RetailCo operates most of the retail paint and paint-related stores; NewRetailCo operates the balance. Several years ago, Premium acquired NewRetailCo from a competitor and assumed all of its debt, including long-term unsecured notes. Aside from intercorporate obligations (of which there are many), NewRetailCo is in the best financial shape of any of the subsidiaries. ManufacturerCo manufac-

\(^4\) See infra notes 50–81 and accompanying text.

\(^5\) These facts are loosely based on In re Standard Brands Paint Co., 154 B.R. 563, 564–65 (Bankr. C.D. Cal. 1993), and to a lesser extent, on Flora Mir Candy Corp. v. R.S. Dickson & Co. (In re Flora Mir Candy Corp.), 432 F.2d 1060, 1061–62 (2d Cir. 1970).
tures paint and paint-related items. DistributorCo is the distribution subsidiary for paint manufactured by ManufacturerCo. RealtyCo owns or manages real estate holdings, including those where RetailCo and NewRetailCo operate the retail paint stores.

The six corporations operate together as a functional whole. Separate books and records are kept for internal purposes, but the debtors report to the SEC on a consolidated basis. The institutional creditors that lend to any entity typically secure cross-guarantees from the others. Cash from each Premium Paint entity is swept every day into one common account. Intercompany accounts are kept, but no cash changes hands and no accounts are ever closed out. Assets such as computer software are shared, as is office space. Employees of the different entities work together in planning new products and advertising campaigns. Overhead costs are divided among the different entities according to a formula fixed long ago.

In fine print, invoices indicate the separate corporate status of the different entities, but other communications are less clear. All the entities use the Premium Paint logo on their stationery, advertising, and press releases. They usually also include their own names. For example, RetailCo’s letterhead reads, beneath the Premium Paint logo, “RetailCo, a member of the Premium Paint Group.” DistributorCo’s letterhead reads, beneath the same logo, “DistributorCo, a division of Premium Paint.” “Divisions” at Premium Paint, however, do not always correspond with discrete legal entities. ManufacturerCo is divided into several product lines (such as Premium Outdoor and Premium Metallic), and occasionally these have identified themselves as “divisions” of Premium Paint, even though they are part of ManufacturerCo and not separate legal entities.

The board of directors of each subsidiary consists entirely of officers of the parent. The debtors, however, have always paid meticulous attention to corporate formalities, such as holding meetings and keeping minutes. Institutional lenders know they are dealing with different legal entities, as do the largest trade vendors. There is disclosure of the corporate structure in an exhibit to Premium Paint’s 10-K and some discussion of some of the entities in the body of the 10-K and footnotes to the company’s financial statements. Nevertheless, most trade vendors and the public at large are not aware of the distinctions among individual members of the group. On-the-ground employees are not always completely aware of the different entities either. They sometimes blur the lines in accounting for costs and recording intercompany transactions.
Premium Paint files for Chapter 11, and the plan that emerges consolidates the claims against all the entities. Substantive consolidation avoids the complications that arise from sorting out both the many intercorporate balances and the rights that different creditors have against the various entities. The competing groups of creditors may reach agreement with one another, and the court may then approve what is, for practical purposes, a consensual plan.

But what happens if the negotiations fail? Can Premium Paint’s plan be confirmed over the objection of the creditors? As with many other aspects of modern Chapter 11 practice, the debtor’s ability to confirm such a plan is not clear. Those most likely to raise objections to the Premium Paint plan are the noteholders of NewRetailCo. They lent to NewRetailCo before it became part of the Premium Paint group. Existing practice in the bankruptcy courts suggests that substantive consolidation in a case such as Premium Paint might be appropriate, but, as we shall see, there is good reason to be skeptical.

II. The “Functional” Approach to Substantive Consolidation

Someone wanting to argue in favor of substantive consolidation for Premium Paint might begin by invoking Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.).\(^6\) As read by other courts, Auto-Train requires a three-part inquiry.\(^7\) First, those proposing substantive consolidation have to show “a substantial identity between the entities to be consolidated.”\(^8\) The presence of consolidated financial statements and a seamless interaction among the various entities, such as what we see with Premium Paint, may be sufficient to make such a showing.\(^9\) Second, proponents need to show that “consolidation is necessary to avoid some harm or to realize some benefit.”\(^10\) Here, the difficulty of sorting out Premium Paint’s many intercorporate transactions and the need to protect the vast majority of creditors who thought they were dealing with a single business might well satisfy this test.\(^11\)

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6 See 810 F.2d 270, 276 (D.C. Cir. 1987).
7 Auto-Train discusses substantive consolidation only in dictum and purports to follow the cases in the Second Circuit. Nevertheless, other courts have managed to tease out of it a test for substantive consolidation that is distinctly different from that of the Second Circuit and is far less demanding.
8 Auto-Train, 810 F.2d at 276.
10 Auto-Train, 810 F.2d at 276.
11 See First Nat’l Bank of El Dorado v. Giller (In re Giller), 962 F.2d 796, 799 (8th Cir. 1992); Eastgroup Props. v. S. Motel Ass’n, 935 F.2d 245, 250 (11th Cir. 1991); In re World-
At this point, the burden shifts to the opponent of consolidation to show that “it relied on the separate credit of one of the entities and that it will be prejudiced by the consolidation.”

Under our facts, only the noteholders of NewRetailCo can argue that they relied on the separate form of NewRetailCo. So long as these creditors consent to the plan, there may be no one to rebut the presumption of consolidation. Even if a few of these noteholders do dissent, they may not be able to show that the harm to them outweighs the benefits that everyone else enjoys from the consolidation.

The dissenting noteholders of NewRetailCo may have to contend with two additional issues as well. First, if the premerger noteholders of NewRetailCo approve, as a class, the proposed substantive consolidation plan, an unhappy individual noteholder holding a claim within that class may be out of luck. This is true because the typical case today does not involve substantive consolidation in the traditional sense. The entities retain their separate identities after the reorganization. (Indeed, the failure to do this will trigger tax liabilities.) Substantive consolidation is done for distributional purposes only, whereby the proposed plan pays out different claims as if the entities were consolidated, but the entities are not actually consolidated. As such, if the other members of the class accept their distributions under the plan, the dissenter can insist only on receiving what it would have received in a Chapter 7 liquidation, which may have been little or nothing.

A second issue that dissenting noteholders may face is the difficulty of showing that substantive consolidation prejudices them, given that complex intercorporate liabilities are present. This issue exists even if the dissenting noteholders as a class reject the plan. Suppose NewRetailCo has assets of $100 and its only creditors, the old NewRetailCo noteholders, are owed $100. They would be paid in full if each corporate entity were treated separately. But let us assume that after consolidation, the NewRetailCo noteholders and all the other creditors receive only forty cents on the dollar. Absent intercorporate liabilities, the noteholders are worse off than they would have been without consolidation.

Intercorporate liabilities, however, cloud the issue considerably. NewRetailCo owes money to ManufacturerCo, RealtyCo, and Distribu-

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12 _Auto-Train_, 810 F.2d at 276.

torCo for paint purchases, rent, and advertising and other expenses. There are objections to the formula used to apportion overhead. Workers paid by other divisions may have worked for NewRetailCo. If NewRetailCo and the other entities enter into a comprehensive settlement of intercorporate obligations in which NewRetailCo has net obligations of $60 or more, the dissenting creditors will be unable to show that substantive consolidation prejudices them. If they cannot show prejudice, they have not met the burden that the third prong of the *Auto-Train* test places on them.\(^{14}\)

The *Auto-Train* test has morphed into long laundry lists.\(^{15}\) This array of tests and factors, however, suggests that substantive consolidation is plausible in a case such as Premium Paint, where everything, including cash, is centrally managed and controlled and where the different legal entities function as a unit, rather than as a mere collection of discrete businesses under one corporate umbrella. We have substantial identity, benefits from consolidation, and relatively few who can show reliance on corporate separateness. The harm that the creditors suffer from the plan may be modest relative to the benefits of a fast and efficient reorganization, especially if intercorporate transfers make uncertain creditors’ payout under a stand-alone plan.

The WorldCom reorganization showed how the pressures to ensure a speedy reorganization can be overwhelming.\(^{16}\) As in our hypothetical, the *WorldCom* plan proposed substantive consolidation for distributional purposes only.\(^{17}\) The reorganization did not affect the legal and organizational structure of the various WorldCom entities themselves for tax or any other purposes.\(^{18}\) Again, as in the hypothetical, a group of noteholders stood in a position analogous to the note-

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\(^{14}\) *Auto-Train*, 810 F.2d at 276.

\(^{15}\) See, e.g., *Giller*, 962 F.2d at 799 (three-factor test); *Eastgroup Props.*, 935 F.2d at 249–50 (two-part test in which court can incorporate *In re Vecco Construction or Pension Benefit Guaranty Corp. v. Ouimet* factors); Pension Benefit Guar. Corp. v. Ouimet Corp., 711 F.2d 1085, 1093 (1st Cir. 1983) (five nonexclusive factors); *In re Vecco Constr.*, 4 B.R. 407, 410 (E.D. Va. 1980) (a seven-factor test). The Third Circuit summarized the state of the law of substantive consolidation obliquely in *Nesbit v. Gears Unlimited*, 347 F.3d 72, 86 n.7 (3d Cir. 2003), when it asked whether a business consisting of a number of different legal entities should be treated as one for purposes of Title VII, which applies only if a firm employs a minimum number of workers. *Id.* at 85–86.

\(^{16}\) See *In re WorldCom*, 2003 WL 23861928, at *37.

\(^{17}\) *Id.* at *6.

holders of NewRetailCo: they had lent to MCI before WorldCom acquired it.\textsuperscript{19} Hence, these creditors could easily show that they had not dealt with WorldCom as a single entity. The plan of reorganization as originally proposed, however, would pay some of them nothing—even though creditors of a parent, who were structurally junior to them, would enjoy substantial distributions.\textsuperscript{20}

The court allowed substantive consolidation in an unpublished opinion.\textsuperscript{21} Two factors proved decisive. First, as often happens in bankruptcy practice, the major parties reached a deal with one another.\textsuperscript{22} The court did not face the concerted opposition among the parties that would have led, among other things, to a strongly contested appeal of the decision. Second, and much more importantly, both the size and number of intercorporate transfers were staggering.\textsuperscript{23} In a single month, for example, more than 600,000 transactions took place.\textsuperscript{24} Millions of transactions flowed through intercompany accounts, and these totaled one trillion dollars.\textsuperscript{25}

Although the court allowed substantive consolidation in this case, one can doubt whether the decision was as cut and dried as the court made it seem. The WorldCom court was located in the Second Circuit and thus had to apply the test that the Second Circuit set out in 1988 in Union Savings Bank v. Augie/Restivo Baking Company, Ltd. (\textit{In re Augie/Restivo Baking Co.}).\textsuperscript{26} In Augie/Restivo, the Second Circuit held that substantive consolidation was appropriate only when (1) the creditors had dealt with the entities as single economic units and had not relied on their separate identities or (2) the debtors’ affairs were so entangled that consolidation would benefit all creditors.\textsuperscript{27}

The first circumstance serves as the bankruptcy analogue for piercing the corporate veil.\textsuperscript{28} The two doctrines are not quite the
same. Veil-piercing allows the creditors of a subsidiary to reach the assets of the parent, but does not at the same time allow creditors of the parent to reach the assets of the subsidiary.\(^\text{29}\) In contrast, substantive consolidation puts all the assets in a common pool, and creditors of the various entities share in it pro rata.\(^\text{30}\) Nevertheless, both doctrines apply when the debtor has disregarded separateness so significantly that creditors treated the different corporations as one legal entity.\(^\text{31}\) The idea is that the affairs of the two corporations are so closely entwined that each lacks a separate existence for all practical purposes. In the \textit{WorldCom} case, however, the reliance of the MCI noteholders on MCI as a separate entity made it hard to justify substantive consolidation on these grounds.\(^\text{32}\)

It was more plausible in \textit{WorldCom} to rely on the second prong of \textit{Augie/Restivo}.\(^\text{33}\) This prong recognizes that keeping the corporations’ affairs separate must be practical. We need to look at the costs of sorting out the affairs of two related corporations if they are treated as one entity versus if they are treated as two.\(^\text{34}\) Even though the corporations are sufficiently separate such that we would not pierce the corporate veil outside of bankruptcy, their affairs may have become so entangled and their assets so meager that unscrambling the mess may not be worth the cost.\(^\text{35}\) When the administrative costs of sorting out the obligations of the two corporations dwarf the benefits that any group of creditors might reap from keeping the corporations separate, it is in everyone’s interest to consolidate the two.\(^\text{36}\) But the \textit{WorldCom} plan wiped out some creditors entirely, whereas they might have received something once the accounts were sorted out. Even if the accounts could never be completely reconciled, one might still be

\begin{itemize}
\item between other kinds of entities as well, such as between partners and partnerships or even between two individuals. \textit{See FDIC v. Colonial Realty Co.}, 966 F.2d 57, 59–61 (2d Cir. 1992).
\item \textit{See, e.g., In re Owens Corning}, 419 F.3d 195, 206 (3d Cir. 2005).
\item \textit{See id. at} 205–06.
\item The court, however, concluded otherwise. \textit{See In re WorldCom}, 2003 WL 23861928, at *37 (finding the first prong of \textit{Augie/Restivo} was satisfied because “a substantial portion of creditors dealt with the Debtors as a single economic unit and did not rely on the separate identity of any particular Debtor entity in extending credit”).
\item \textit{See id. (“The facts amply demonstrate that the Debtors’ operational and financial affairs are so entangled that the accurate identification and allocation of assets and liabilities either could never be accomplished, or, even if it could be accomplished, would take so long and be so costly such that creditors as a whole would be substantially harmed by the effort. Thus, disentangling the financial affairs of the Debtors is a practical impossibility.””).}
\item \textit{See Augie/Restivo}, 860 F.2d at 519.
\item \textit{See id.}
\item \textit{See id; see also In re The Leslie Fay Cos.}, 207 B.R. 764, 779–80 (Bankr. S.D.N.Y. 1997).
\end{itemize}
able to find that enough assets remained in the relevant entity for the creditors to receive something.

When the bankruptcy court—and everyone else—wants to confirm a plan and enable a business to exit rapidly from Chapter 11, there is a natural tendency to find that substantive consolidation is possible under whatever test is supposed to apply. Bankruptcy judges enjoy considerable discretion, and they are often willing to allow practical considerations to trump legal principle. Some courts of appeals, however, resist any interpretation of the Bankruptcy Code that is made chiefly to accommodate pragmatic concerns.37 This reluctance is illustrated most vividly in the Third Circuit’s recent decision in In re Owens Corning.38

In In re Owens Corning, the district court had confronted a set of facts even weaker than those seen in the Premium Paint example yet allowed substantive consolidation under a variation of the Auto-Train test.39 The court held that two circumstances together created a prima facie case for consolidation: (1) a central committee exercised common control over the operations and finance of the subsidiaries, and (2) the subsidiaries were created for the convenience of the parent, primarily for tax reasons.40 The remaining question under the Auto-Train test was whether creditors relied on the separateness of the entities.41 Here, the court found that the failure to track the finances of the individual subsidiaries was fatal:

There can be no doubt that the Banks relied upon the overall credit of the entire Owens Corning enterprise. Each Bank’s commitment was to the entire enterprise. The decision as to whether funds would be borrowed by the parent company, or by one or more of the subsidiaries, was made by the borrowers, not by the lenders. All of Owens Corning’s

37 Judge Easterbrook’s opinion in In re Kmart, rejecting the doctrine of necessity, is a typical example. See 359 F.3d 866, 871 (7th Cir.) (calling the doctrine of necessity “just a fancy name for a power to depart from the Code”), cert. denied, 125 S. Ct. 495 (2004). Many courts embrace literal interpretations of the Bankruptcy Code. See, e.g., RCI Tech. Corp. v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257, 266–70 (4th Cir. 2004) (insisting on literal interpretation of rules governing assumption of executory contracts); Perlman v. Catapult Entm’t, Inc. (In re Catapult Entm’t, Inc.), 165 F.3d 747, 749–50 (9th Cir. 1999) (same).

38 See In re Owens Corning, 419 F.3d at 207–12.


40 Id. at 171.

41 Id.
It was not sufficient that the banks counted on the corporate separateness to ensure their own priority position. As is often the case when applying the *Auto-Train* test, the burden of showing substantial identity is relatively light, and the burden of showing reliance on the part of the creditor resisting substantive consolidation is heavy.  

The Third Circuit flatly rejected this approach, holding that substantive consolidation was possible only under “compelling circumstances.” It focused squarely on the principles set out in *Augie/Restivo* and required proponents of substantive consolidation to show either: “(i) [P]repetition [the different debtors] disregarded separateness so significantly [that] their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) [P]ostpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.”

Applying this test to the facts, the case was easy. Indeed, the court questioned whether there could ever be a “deemed” substantive consolidation such as in *WorldCom*. The entities could not be both so entangled as to justify consolidation and yet so distinct that it was possible and desirable to keep them separate after bankruptcy.

Quite apart from which test was being used, however, the outcome in *In re Owens Corning* was almost foreordained. The district court decision had broken too much china. Substantive consolidation in such a case would have effectively undermined bank loans, totaling $2 billion, which had been made in a conventional and commercially

42 *Id.* at 172.
43 *See, e.g.*, *Eastgroup Props.*., 935 F.2d at 251–52.
44 *In re Owens Corning*, 419 F.3d at 210–11.
45 *Id.* at 211.
46 *Id.* at 214–15.
reasonable way.\textsuperscript{47} Allowing substantive consolidation would have unsettled too many established practices.\textsuperscript{48}

Still left undecided are the burdens on the proponents of substantive consolidation in going forward, in the Third Circuit and elsewhere, when the affected lenders are not as careful and attention to corporate form is more casual. In reaching its decision in \textit{In re Owens Corning}, the Third Circuit took pains to affirm the existence of the substantive consolidation doctrine and the power of bankruptcy courts to order substantive consolidation under appropriate circumstances.\textsuperscript{49} The foundations of the doctrine itself, however, are less solid than even the Third Circuit made them out to be. One cannot be confident that other courts of appeals will likewise affirm the existence or the legitimacy of the doctrine.

\textbf{III. THE UNCERTAIN FUTURE OF SUBSTANTIVE CONSOLIDATION}

Substantive consolidation lacks the solid foundation one usually expects of doctrines so firmly embedded in day-to-day practice. The U.S. Supreme Court has never formally embraced the concept. Justice William O. Douglas came closest to doing so in 1941 in \textit{Sampsell v. Imperial Paper & Color Corp.}, but that case involved a recovery of assets that had been fraudulently conveyed from one corporate entity to another.\textsuperscript{50} Moreover, the objecting creditor “had at least some knowledge as to the fraudulent character of [the] corporation.”\textsuperscript{51} As late as 1964, one could still argue that substantive consolidation required a fraudulent conveyance.\textsuperscript{52}

The first cases to develop substantive consolidation as a doctrine separate from fraudulent conveyance law relied squarely on corporate law and the power to pierce the corporate veil.\textsuperscript{53} The first opinions came out shortly after the 1938 U.S. Supreme Court decision in \textit{Erie Railroad v. Tompkins},\textsuperscript{54} at a time when courts had not yet absorbed \textit{Erie}’s full impact. If they had, courts might have rationalized the location of the doctrine in federal common law as part of their inherent

\begin{itemize}
\item \textsuperscript{47} \textit{Id.} at 216.
\item \textsuperscript{48} \textit{Id.}
\item \textsuperscript{49} 419 F.3d at 205–09.
\item \textsuperscript{50} 313 U.S. 215, 219–220 (1941).
\item \textsuperscript{51} \textit{Id.} at 221.
\item \textsuperscript{52} See Soviero v. Franklin Nat’l Bank, 328 F.2d 446, 448 (2d Cir. 1964).
\item \textsuperscript{53} See, e.g., Stone v. Eacho (\textit{In re Tip Top Tailors, Inc.}), 127 F.2d 284, 288 (4th Cir. 1942); Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940).
\item \textsuperscript{54} 304 U.S. 64 (1938).
\end{itemize}
power to flesh out the interstices of bankruptcy law with common-law reasoning. As it was, however, they did not invoke any special power of bankruptcy courts as courts of equity, but simply looked to nonbankruptcy law. As the Fourth Circuit stated in 1942 in *Stone v. Eacho (In re Tip Top Tailors, Inc.)*:

> It is well settled that courts will not be blinded by corporate forms nor permit them to be used to defeat public convenience, justify wrong or perpetrate fraud, but will look through the forms and behind the corporate entities involved to deal with the situation as justice may require.\(^{55}\)

In these cases, courts relied on common-law principles, not on a doctrine peculiar to bankruptcy or courts of equity:

> ‘Although we know of no instance in which it has been done in matters of receivership, we cannot see why . . . the law does not impose upon a court the same duty in a receivership matter when, as here, the facts are substantial enough to justify, indeed to compel, a finding that the five corporations were so identified with the parent corporation as to be a part of it.’\(^{56}\)

Even into the 1960s, substantive consolidation was merely a federal common-law variation of basic corporate law principles:

> It is difficult to imagine a better example of commingling of assets and functions and of the flagrant disregard of corporate forms than as here demonstrated by the bankrupt. One gains the distinct impression that the bankrupt held up the veils of the fourteen collateral corporations primarily, if not solely, for the benefit of the tax gatherer, but otherwise completely disregarded them. Even Salome’s could not have been more diaphanous.\(^{57}\)

Substantive consolidation finally acquired a rationale rooted in bankruptcy policy in *Chemical Bank New York Trust Co. v. Kheel*. In that case, the Second Circuit relied not on the lack of separateness of the legal entities but on the sheer cost of sorting out the various rights and obligations:

\(^{55}\) 127 F.2d at 288.

\(^{56}\) Id. at 289 (quoting Tr. Sys. Co. of Pa. v. Payne, 65 F.2d 103, 107 (3d Cir. 1933)).

\(^{57}\) Soviero, 328 F.2d at 448.
[W]here the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.58

This rationale was at the center of the typical cases decided by bankruptcy judges in the 1970s. In *In re Commercial Envelope Manufacturing Co.*, unscrambling the various transactions might well have proved impossible for the bankruptcy court:

Many of the day to day operations have occurred as though the debtors were one consolidated and integrated entity. The effusion of time and money would be almost prohibitive were any sophisticated effort to make sense out of the complex of cross lines undertaken. . . . Due to the immense internal confusion, even if the expense of an audit were undertaken, there could be no assurance that it would be successful in unscrambling the relationships.59

But even with this additional rationale, the Second Circuit permitted substantive consolidation only in the rarest of circumstances. For instance, *Flora Mir Candy Corp. v. R.S. Dickson & Co.* (*In re Flora Mir Candy Corp.*) involved multiple subsidiaries and “a multitude of intercompany transactions, many without apparent business purpose.”60 The court adopted the district court’s finding that this state of affairs, standing alone, was “grossly insufficient” to allow substantive consolidation, especially because the objecting creditor, like the noteholders of NewRetailCo in our example, entered the picture before the debtor joined the corporate group.61

A court that follows the doctrine as developed in the Second Circuit is unlikely to allow substantive consolidation in cases such as Premium Paint. Common control, consolidated financials, and modern cash management are not enough to justify substantive consolidation grounded in veil-piercing and alter-ego actions, especially where corporate formalities have been followed and the separate entities will be maintained going forward. The cost-saving rationale of substantive

60 432 F.2d 1060, 1061 (2d Cir. 1970).
61 *Id.* at 1062.
consolidation is similarly unlikely to be available. To have an impact, these costs must threaten to leave every creditor worse off.\textsuperscript{62} Untangling obligations among different corporate entities may be expensive, but it will rarely come close to consuming so much of the estate as to undo the structural priority some creditors enjoy over others when corporate form is respected. The trillion-dollar mess in \textit{WorldCom} is exceptional, and even there the court might have been able to do more than simply throw up its hands. As the court noted in \textit{In re Owens Corning}, perfection is not required, and some inaccuracies can be tolerated.\textsuperscript{63}

In many substantive consolidation disputes, the creditors' reliance on corporate separateness seems a critical issue. Both \textit{Flora Mir} and \textit{Union Savings Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)}—cases in which the Second Circuit denied substantive consolidation—involved creditors who could show that they dealt with their respective debtors as distinct entities.\textsuperscript{64} Moreover, Judge Ambro of the Third Circuit couches his formulation of the test in \textit{In re Owens Corning} in terms of reliance.\textsuperscript{65} The logic of substantive consolidation, at least as developed in the Second Circuit, however, suggests such an emphasis on reliance is not appropriate. Reliance is irrelevant to the cost-saving prong of \textit{Augie/Restivo}, and the other prong is satisfied only when conditions are such that veil-piercing or alter-ego actions could be brought outside of bankruptcy.\textsuperscript{66} These are available when there is deliberate undercapitalization, misrepresentation, or failure to follow corporate formalities.\textsuperscript{67} Establishing these has little to do with reliance.

\textsuperscript{62} \textit{See In re Owens Corning}, 419 F.3d 195, 211 & n.20 (3d Cir. 2005); \textit{Chem. Bank}, 369 F.2d at 847.

\textsuperscript{63} \textit{See} 419 F.3d at 214 ("Neither the impossibility of perfection in untangling the affairs of the entities nor the likelihood of some inaccuracies in efforts to do so is sufficient to justify consolidation."). In reaching this conclusion, the Third Circuit relied on the analysis of the court in \textit{R2 Investments, LDC v. World Access, Inc. (In re World Access Inc.)}. \textit{See id.} at 214–15. In \textit{R2 Investments}, the court had stated that "perfection is not the standard in the substantive consolidation context." \textit{R2 Invs., LDC v. World Access, Inc. (In re World Access Inc.)}, 301 B.R. 217, 279 (Bankr. N.D. Ill. 2003).

\textsuperscript{64} \textit{Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)}, 860 F.2d 515, 519 (2d Cir. 1988); \textit{In re Flora Mir Candy Corp.}, 432 F.2d at 1062–63.

\textsuperscript{65} \textit{In re Owens Corning}, 419 F.3d at 212. At the same time, however, he rejects suggestions that lenders must engage in elaborate gymnastics to prove actual reliance. \textit{See id.} at 212–14.

\textsuperscript{66} \textit{See} 860 F.2d at 518–19.

A debate over different approaches to substantive consolidation, however, should not obscure a more fundamental problem. One cannot be sure that an appellate court would allow substantive consolidation at all, particularly given that the Supreme Court has never adopted it. Far from providing a basis for substantive consolidation, cases such as Sampsell rely explicitly on fraudulent conveyance doctrine and thus underscore the need to find an explicit grant of power somewhere.\(^68\) Section 1123(a)(5)(C) of the Bankruptcy Code may be a possible source of support.\(^69\) This section provides that “[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan’s implementation, such as . . . merger or consolidation of the debtor with one or more persons.”\(^70\)

This section provides a thin reed for justifying substantive consolidation, however. The language “notwithstanding any otherwise applicable nonbankruptcy law” cannot sensibly be read as a broad grant of power. It cannot, for example, give the debtor the ability to merge itself with any third party it pleases, whether that party wants the merger or not. Even if the provision contemplates “consolidation” under Chapter 11 that could not have taken place elsewhere, nothing suggests that such a consolidation can compromise the otherwise valid claims of creditors of each entity. This section does not itself grant a substantive right.

The absence of any clear statutory authority in the Bankruptcy Code throws into question the viability of the doctrine in an appellate court that focuses on the language of the Bankruptcy Code and refuses to look beyond it.\(^71\) Substantive consolidation is, as the term suggests, a substantive power. In the view of some courts, substantive powers such as this are permitted only to the extent that they grow out of substantive provisions of the Bankruptcy Code. Courts have stated again and again that substantive powers cannot be derived from section 105 of the Bankruptcy Code.\(^72\)

\(^68\) In permitting substantive consolidation, Justice Douglas, writing for the Court in Sampsell, explicitly relied on the existence of a fraudulent conveyance. 313 U.S. at 220.


\(^72\) To be sure, 11 U.S.C. § 105(a) reads, in part, “[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a) (2000). As Judge Easterbrook notes, however, “[t]he power conferred
There is still another reason to question the continued viability of substantive consolidation. In the 1999 decision *Grupo Mexicano de Desarrollo v. Alliance Bond Fund, Inc.*, the U.S. Supreme Court found that, in the absence of explicit congressional authorization, district courts lack the power to issue preliminary injunctions to protect the rights of general creditors.\(^7\) The reasoning of *Grupo Mexicano* is broader than its narrow holding and suggests that federal courts cannot create new powers as courts of equity. Courts lack the power to “create remedies previously unknown to equity jurisprudence.”\(^7\) Equitable powers are limited to those that have a long history.\(^7\) New rules can “radically alter the balance between debtors’ and creditors’ rights which has been developed over centuries through many laws—including those relating to bankruptcy, fraudulent conveyances, and preferences.”\(^7\)

The court in *In re Owens Corning* cited this language in rejecting the idea that *Grupo Mexicano* is inconsistent with substantive consolidation.\(^7\) By taking explicit note of bankruptcy rules that emerged over time, the Supreme Court in *Grupo Mexicano* was apparently distinguishing them from the judicially created doctrine it struck down in that case.\(^7\) But the Supreme Court’s endorsement of bankruptcy doctrines that have developed over time does not extend to substantive consolidation. Unlike the law governing preferences and fraudulent conveyances, this doctrine did not develop over “centuries.” Cases such as *Sampsell* do not provide any additional support for substantive consolidation as a long-standing doctrine because they rely instead on fraudulent conveyance, veil-piercing, or other well-established doctrines.\(^7\) Substantive consolidation emerged as a distinct power apart from veil-piercing and fraudulent conveyance actions only in the 1960s and 1970s. Indeed, the first use of the term “substantive consolidation” in a reported opinion was not until 1975—the same year the remedy struck down in *Grupo Mexicano* was first identified.\(^8\)

\(^7\) 527 U.S. 308, 333 (1999).
\(^7\) Id. at 332.
\(^7\) See id. at 330–32; see also Tucker, supra note 71, at 440, 442–45.
\(^7\) *Grupo Mexicano*, 527 U.S. at 331.
\(^7\) *In re Owens Corning*, 419 F.3d at 208 n.14.
\(^7\) *Grupo Mexicano*, 527 U.S. at 331.
\(^7\) Id.; *Sampsell*, 313 U.S. at 221.
\(^8\) See Talcott Inc. v. Wharton (*In re Cont’l Vending Mach. Corp.*), 517 F.2d 997, 1004 n.3 (2d Cir. 1975).
Substantive consolidation doctrine lives in a peculiar netherworld. The more a substantive consolidation claim looks like a fraudulent conveyance claim, the more likely it is that the court will demand the dispute be resolved on that basis. The more the power of substantive consolidation departs from traditional veil-piercing, the harder it is to locate the power inside the Bankruptcy Code. The bankruptcy judge does have some discretion to fill the interstices, but, as Judge Posner and others are quick to remind us, “[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.”

Conclusion

Given the uncertain future of substantive consolidation, the time is ripe for a serious and thoughtful debate. The doctrine could evolve in any of three or more radically different directions. A variant of the test used in Auto-Train may continue to live in the bankruptcy courts, even as the courts give lip service to In re Owens Corning and Augie/Restivo. When a corporate group functions as a single whole, courts may be quick to find “substantial identity.” They may be easily persuaded that creditors relied on the debtor as a single legal entity. Such reasoning is hard to resist when, in cases such as WorldCom, confirmation will lead to a quick exit from bankruptcy and the creditors overwhelmingly support the plan. For this reason, every prudent lender is well advised to document reliance on corporate separateness as part of every extension of credit.

Alternatively, in the wake of In re Owens Corning, there may be a revival of the Augie/Restivo test. Substantive consolidation may be allowed only under narrow and extraordinary circumstances. Courts might permit it only when each debtor so lacks a separate identity that the legal forms should no longer be recognized or when the different debtors’ affairs are so entangled and assets so meager that unscrambling the mess is not worth the cost. One can also imagine approaches that combine elements of Auto-Train and Augie/Restivo or that go in still different directions altogether.

81 In re Chi., Milwaukee, St. Paul & Pac. R.R., 791 F.2d 524, 528 (7th Cir. 1986).
Finally, there is the possibility that a court could extend the reasoning in *Grupo Mexicano* or otherwise find that the doctrine does not exist. They might decide that veil-piercing actions under nonbankruptcy law and the trustee’s avoiding powers may be deemed sufficient. For practitioners who have lived with the doctrine for decades and never doubted its existence, such a possibility seems remote. But we have been surprised before.
A LOOK AT TRANSNATIONAL INSOLVENCIES AND CHAPTER 15 OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

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Abstract: Transnational insolvency cases inherently involve questions of jurisdiction and conflicts of law. In an attempt to add uniformity to international insolvency law, the United Nations Commission on International Trade Law (UNCITRAL) unanimously adopted the text of the Model Law on Cross Border Insolvency on May 30, 1997. Congress, drawing from UNCITRAL’s Model Law, reformed the United States’ statutory law on international bankruptcies, namely section 304 of the Bankruptcy Code, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. This Article examines current theoretical approaches to international insolvencies, prior law on international insolvency, and the probable effect of Chapter 15’s addition to the Bankruptcy Code.

INTRODUCTION

Historically, little has been done on an international basis to promote cooperation between bankruptcy courts of various nations. Because most nations have their own bankruptcy laws, many of which differ dramatically, and because it is difficult to resolve such conflicts without a comprehensive international insolvency framework, few

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countries have entered into multinational and bilateral treaties relating to bankruptcy. Due to the lack of a comprehensive framework, many courts have been forced to deal with transnational insolvencies on a case-by-case basis.

The difficulties involved in this case-by-case approach prompted an effort to reconcile the international insolvency laws in a global arena. The growing number of multinational companies and cross-border insolventies have accelerated the need for an efficient international insolvency system to allow bankruptcy courts in multiple jurisdictions to coordinate and cooperate in the administration of a bankruptcy proceeding involving a transnational debtor. Such coordination and cooperation are essential, as cross-border insolventies can involve (1) a debtor with a single international creditor, or (2) multiple debtors with subsidiaries, assets, operations, and creditors in dozens of nations.

Congress attempted to address this problem head-on with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”). Although the focus of the public press has been on BAPCPA’s consumer bankruptcy provisions, the international insolvency community has for the most part been pleased to witness the enactment of the 500-plus pages of Chapter 15 dealing specifically with cross-border insolvency cases. This new Chapter 15 replaces section 304 of the former Bankruptcy Code, which

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previously dealt with cases ancillary to foreign proceedings. Through the enactment of BAPCPA, Congress attempted to establish the United States as a leader in the movement towards greater cooperation in international insolvencies.

Part I of this Article examines competing academic approaches to transnational insolvencies and the resolution of international bankruptcy disputes through ancillary and parallel proceedings. Part II analyzes section 304 under the former Bankruptcy Code. Part III examines the creation of the Model Law of International Insolvency and the increasing desirability of uniform insolvency laws. Part IV focuses on the recently enacted Chapter 15 and its potential impact on international insolvencies.

I. COMPETING ACAD EMIC APPROACHES TO THE POLICIES UNDERLYING INTERNATIONAL INSOLVENCIES—TERRITORIALISM, UNIVERSALISM, AND CONTRACTUALISM

A. Territorialism: The “Grab Rule”

Territorialism, as one may guess, contemplates that each country maintains control over all assets located within its territory for the benefit of its local creditors. This theory is based upon the idea of national sovereignty, in that national sovereignty “imposes the law of the sovereign on all within its territorial reach.” Accordingly, the law of the situs controls the assets located within the territory. Significantly, the local law controls how the debtor’s assets will be dis-

6 See infra notes 11–50 and accompanying text.
7 See infra notes 51–62 and accompanying text.
8 See infra notes 63–177 and accompanying text.
9 See infra notes 178–99 and accompanying text.
10 See infra notes 200–28 and accompanying text.
11 Jay Lawrence Westbrook, Multinational Enterprises in General Default: Chapter 15, the ALI Principles, and the EU Insolvency Regulation, 76 AM. BANKR. L.J. 1, 5 (2002). Local creditors would likely benefit from a territorialistic approach because they would not have to adjudicate their claims abroad. See M. Cameron Gilreath, Note, Overview and Analysis of How the United Nations Model Law on Insolvency Would Affect United States Corporations Doing Business Abroad, 16 BANKR. DEV. J. 399, 406 (2000). Similarly, local creditors would have assurance that the local law of their “home country” would apply. See id.
12 Westbrook, supra note 11, at 5.
13 Id.
tributed among creditors, including the priority of such distribution.\textsuperscript{14} Thus, there are no extraterritorial results.\textsuperscript{15} Given this theory and its embodiment of notions of national sovereignty, it is often referred to as the “grab rule.”\textsuperscript{16} Some scholars have acknowledged that this approach may actually make it more difficult to reorganize a multinational business because most of the reorganization would be done piecemeal under various (and often differing) laws.\textsuperscript{17} Adding more fuel to the fire, courts applying a territorialistic approach would likely be uncooperative with extra-jurisdictional courts.\textsuperscript{18} Accordingly, a multinational debtor would potentially have to file for bankruptcy relief in each country in which it has assets, operations, or creditors.\textsuperscript{19}

Because of this “grab rule” approach, many academics have criticized its application as contravening the principle of creditor equality and encouraging a race to the courthouse.\textsuperscript{20} It has been argued that this race to the courthouse encourages multiple bankruptcy proceedings and duplicative administrative expenses.\textsuperscript{21}

As Professor Jay L. Westbrook, a leading expert in U.S. bankruptcy and international insolvency law and one of two leaders of the American delegation to UNCITRAL, noted, although many academics favor universalism\textsuperscript{22} (discussed below), countries have generally applied a

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\textsuperscript{14} See id.
\textsuperscript{15} Gilreath, \textit{supra} note 11, at 406.
\textsuperscript{16} See Westbrook, \textit{supra} note 11, at 8. The Report of the National Bankruptcy Review Commission perhaps summarized this rule best when it said: “When a person or a company with international operations falls into serious financial trouble, each country employs its insolvency laws to grab local assets and administer them locally according to the procedures and priorities of that country’s laws.” See \textsc{Nat’l Bankr. Review Comm’n, Bankruptcy: The Next Twenty Years} 355 (1997), available at http://govinfo.library.unt.edu/nbrc/report/10transn.pdf.
\textsuperscript{18} See id.
\textsuperscript{20} See Gilreath, \textit{supra} note 11, at 406.
\textsuperscript{21} See id.
\textsuperscript{22} Westbrook, \textit{supra} note 11, at 8. In fact, the Report of the National Bankruptcy Review Commission notes that many scholars and practitioners have criticized territorialism for five major reasons:

(a) Reorganization is difficult or impossible, because each uncoordinated local proceeding is focused on maximizing the return for local creditors. The local officials are often unwilling to permit any use of local assets for ongoing international operations. Indeed, in many countries there is no authority for cooperation with foreign proceedings even if the local officials were so in-
more territorialistic approach.\textsuperscript{23} Some countries, including the United States, have even gone so far as to adopt a rule which grants their own courts worldwide jurisdiction, although simultaneously refusing to recognize the international jurisdiction of other countries.\textsuperscript{24} 

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\textsuperscript{23} Westbrook, \textit{supra} note 11, at 8; see also Levenson, \textit{supra} note 17, at 293 (acknowledging that the “grab rule” represents the rule in international insolvencies for a majority of countries). Additionally, many countries apply a territorialistic approach because most nations do not have treaties, protocols, and conventions establishing any framework for cooperation relating to international insolvencies. \textit{See} Elizabeth J. Gerber, \textit{Not All Politics Is Local: The New Chapter 15 to Govern Cross-Border Insolvencies}, 71 \textit{Fordham L. Rev.} 2051, 2058 (2003).

\textsuperscript{24} Westbrook, \textit{supra} note 11, at 8. Congress defined “property of the estate” under section 541 of the Bankruptcy Code to include all the debtor’s interests in property “wherever located.” \textit{See} 11 U.S.C. § 541(a) (2000). This language expresses a clear intent to exercise worldwide subject matter jurisdiction over a debtor’s assets. That intent is even more clearly expressed by 28 U.S.C. § 1334(e), which provides that the Bankruptcy Court shall have jurisdiction over property of the debtor’s estate “wherever located.” 28 U.S.C. § 1334(e); see also Celotex Corp. v. Edwards, 514 U.S. 300, 308 (1995) (acknowledging that “Congress intended to grant \textit{comprehensive jurisdiction} to the bankruptcy courts so that they might deal efficiently and expeditiously with all matters connected with the bankruptcy estate”) (emphasis added).
Despite these two extremes, as Andre J. Berends has noted, “no country applies either the universality principle or the territoriality principle without any deviation. Every domestic insolvency law is a mixture of [these] two principles.”25 Whichever approach is ultimately applied, most commentators agree that an “optimal” choice-of-law system is one that is cost effective, fair, and predictable.26

Though territorialism and universalism (discussed below) represent the two extremes of choice-of-law principles, other, more intermediate approaches have developed, including modified territoriality, cooperative territoriality, modified universalism, and contractualism.27 These intermediate approaches are discussed briefly below.

1. Modified Territoriality

Under a modified territoriality approach, a local court would apply its own law regarding the collection and distribution of a debtor’s assets located within its jurisdiction.28 This theory is closely analogous to the modified universalism approach described below.

2. Cooperative Territoriality

As one author recently explained, a “cooperative territoriality” approach perhaps best represents the approach that many courts have embraced when dealing with international insolvencies.29 Under this approach, foreign representatives30 of the various bankruptcy-related proceedings could enter into agreements to regulate certain aspects of the bankruptcy proceeding.31 By entering into such agreements, the debtors maximize the distribution of their assets and, as a result, the creditors are treated equally.32 Accordingly, the local law of each

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26 See Levenson, *supra* note 17, at 296.
27 Id. at 294–96.
28 See id. at 295.
29 Id.
30 Under the recently amended Bankruptcy Code, a “foreign representative” is defined as “a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of such foreign proceeding,” BAPCPA, Pub. L. No. 109-8, § 802(b), 119 Stat. at 145 (to be codified at, and amending, 11 U.S.C. § 101(24)).
31 Levenson, *supra* note 17, at 295.
32 See id.
creditor no longer predominates and controls the priority and distribution of such assets.  

B. Universalism

1. Pure Universalism

In contrast to territorialism, universalism promotes a cooperative approach between each affected country in the administration of a debtor’s estate. This system promotes a centralized administration of the debtor’s assets in one main proceeding. Ideally, the debtor’s assets, wherever located, would be transferred to the main proceeding to be distributed under that forum’s local law. This approach embraces the ability of courts to work together in a collective effort to maximize the value of the debtor’s assets and recovery to creditors. If a creditor, however, does not submit his claim and participate in the main bankruptcy proceeding, the creditor would be precluded from submitting and adjudicating such claim at a later time. Thus, under this approach, creditors could be severely prejudiced by the unexpected application of a foreign law. Because the ultimate goal of a pure universalism approach is to develop a common insolvency framework, commentators argue that this theory is problematic, as universalism, in order to work effectively, requires each country to have similar laws, with all creditors represented in a single, centralized proceeding.

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33 See id.
34 Westbrook, supra note 11, at 6. As Professor Westbrook noted, “[o]ne traditional idea was in rem jurisdiction, so that one court would enjoy jurisdiction over the entire ‘estate’ of the indebted company . . . .” Id.
35 See Levenson, supra note 17, at 292–93; see also Gerber, supra note 23, at 2056 (acknowledging that two elements are required in a universalism regime: (1) a single forum; and (2) a single law to govern every case).
36 See Levenson, supra note 17, at 293; see also Paul L. Lee, Ancillary Proceedings Under Section 304 and Proposed Chapter 15 of the Bankruptcy Code, 76 Am. Bankr. L.J. 115, 119 (2002) (stating that “universalism envisions that the countries that hold assets of the debtor will turn over those assets to the trustee or liquidator in the central proceeding and that creditors worldwide will be required to submit their claims to this central proceeding”).
37 See Levenson, supra note 17, at 293.
38 Gilreath, supra note 11, at 407.
39 Id. at 407–08.
40 Id. at 408–09. It has been suggested, however, that this problem could be remedied through the use of reciprocal legislation or treaties. Id. at 409. The United States, however, along with many other countries, is not a party to any bankruptcy treaty. Gerber, supra note 23, at 2052.
Like territorialism, however, universalism has its critics.\textsuperscript{41} One of the most vocal critics of universalism, Professor Lynn LoPucki, has argued that, because multinational companies do not have home countries in any meaningful sense, the indeterminacy of the home-country standard under a universalistic approach would lead to forum shopping and promote jurisdictional competition.\textsuperscript{42}

2. Modified Universalism

As with territorialism, intermediate approaches to universalism have also developed. In fact, some believe that a “modified universalism” approach best described the system under section 304 of the former Bankruptcy Code.\textsuperscript{43} As discussed below, under section 304, a foreign representative could commence an ancillary proceeding in the United States for the limited purpose of assisting a pending foreign insolvency proceeding.\textsuperscript{44} Section 304 presented a modified version of universalism as U.S. courts had discretion to grant a foreign representative relief.\textsuperscript{45}

C. Contractualism

A third theory, known as contractualism, has been espoused by Professor Robert Rasmussen.\textsuperscript{46} This approach essentially allows a debtor through contract to choose which country’s bankruptcy law will

\textsuperscript{42} See id. Professor Lynn LoPucki has challenged universalists to answer three questions, each of which addresses how one is to determine the identity of a debtor’s home country. \textit{Id.} at 143–44. First, when the principal assets, operations, headquarters, and place of incorporation are in different countries, which is the “home country?” Second, does “home country refer to the home country of a corporate group or does each corporation in the group have its own “home country?” Third, what rules will govern the inevitable changes in the “home country” that will occur after credit has been extended? \textit{Id.} Professor LoPucki contends that the leading universalists offer no answers to these questions. \textit{Id.} at 144.
\textsuperscript{43} See Levenson, \textit{supra} note 17, at 294; see also \textit{In re} Maxwell Comm. Corp., 170 B.R. 800, 816 (Bankr. S.D.N.Y. 1994) (acknowledging that “[a]s the enactment of Section 304 of the Bankruptcy Code demonstrates, the United States in ancillary bankruptcy cases has embraced an approach to international insolvency which is a modified form of universalism accepting the central premise of universalism, that is, that assets should be collected and distributed on a worldwide basis, but reserving to local courts discretion to evaluate the fairness of home country procedures and to protect the interests of local creditors”).
\textsuperscript{45} See id.
\textsuperscript{46} See Levenson, \textit{supra} note 17, at 296.
According to Professor Rasmussen, contractualism merely extends the general rule favoring party choice in contractual settings. This theory recognizes that contracts are often entered into by sophisticated parties in multiple jurisdictions who, he postulates, should have the freedom to negotiate. Under this approach, the parties essentially decide which law would apply.

Contractualism, however, bears many procedural problems, as a debtor may choose differing jurisdictions with contracting parties or may not be in a financially desirable bargaining position to control its bankruptcy forum. Obviously, such scenarios result in duplicative estate administration and a waste of judicial resources.

D. Competing Methods of Adjudicating International Insolvency Matters: Ancillary and Parallel Proceedings

In addition to the choice-of-law approaches to cross-border insolvencies discussed above, Professor Jay Lawrence Westbrook has identified an additional classification that does not fit directly under either territorialism or universalism. This additional classification to resolving international insolvencies includes two basic approaches: the ancillary-proceeding approach and the parallel approach.

1. Ancillary Proceedings

Ancillary proceedings are not full domestic insolvencies, but rather, are limited proceedings which have the narrow purpose of assisting a foreign “main” proceeding. Ancillary proceedings arise only after a domestic court is satisfied that the international proceeding will be fair and adequate, as judged by national law and policy. Once an
ancillary proceeding is invoked, the domestic court’s primary responsibility is to aid the foreign court in administering the debtor’s assets.\textsuperscript{55}

Professor Westbrook has noted two advantages to this ancillary proceeding approach.\textsuperscript{56} First, ancillary proceedings are generally cheaper and more efficient because they do not require all of the complications of a full insolvency case.\textsuperscript{57} Second, ancillary proceedings permit the coordination of a worldwide resolution because local rules do not apply (discussed further below).\textsuperscript{58}

2. Parallel Proceedings

In contrast to the ancillary proceeding, parallel proceedings are full domestic insolvencies (as opposed to limited proceedings with a narrow purpose) in each country where the debtor has assets.\textsuperscript{59} Under this approach, judges of various nations coordinate and cooperate in administrating the debtor’s estate.\textsuperscript{60} Although it has been suggested that this approach favors local creditors, Professor Westbrook argues that virtually all well-developed legal systems afford foreign creditors equal status with local creditors.\textsuperscript{61} Thus, the effect of a parallel proceeding would be to favor local law, while theoretically being neutral to domestic and foreign creditors alike.\textsuperscript{62}

II. Former Section 304 of the Bankruptcy Code: Cases Ancillary to Foreign Proceedings

In order to understand the effects, if any, of the new Chapter 15, one must first have a basic knowledge of the Bankruptcy Code’s former method of handling ancillary foreign cases.\textsuperscript{63} Section 304 of the Bankruptcy Code provided authority for adjudicating international

\textsuperscript{55} Id.
\textsuperscript{56} Westbrook, supra note 11, at 10.
\textsuperscript{57} Id.
\textsuperscript{58} Id.
\textsuperscript{59} Id.
\textsuperscript{60} Id.
\textsuperscript{61} Westbrook, supra note 11, at 10–11.
\textsuperscript{62} See id. Professor Jay Westbrook has also identified a subcategory of the parallel proceeding, called the secondary proceeding. Id. This approach, according to Professor Westbrook, is best understood as a parallel proceeding “which goes beyond mere coordination with other jurisdictions by requiring the local proceeding and local law to defer in some respects to a foreign main proceeding.” Id.
insolvency issues where a proceeding has already been filed, or would be more appropriately filed, in a foreign jurisdiction.\textsuperscript{64}

Section 304 of the Bankruptcy Code authorized the filing of ancillary cases in U.S. bankruptcy courts to protect the dignity of concurrently existing foreign proceedings.\textsuperscript{65} “The purpose of a [section] 304 petition [was] to prevent the piecemeal distribution of assets in the United States by means of legal proceedings initiated in domestic courts by local creditors.”\textsuperscript{66} In other words, section 304 was designed to act as a “gateway,” shielding American creditors and assets situated within the borders of the United States from foreign reorganization or liquidation procedures (procedures which undoubtedly would alter the priority and distribution schemes under U.S. law). The “philosophy [of section 304] was that of deference to the country where the primary insolvency proceeding [was] located . . . and flexible cooperation in administration of assets.”\textsuperscript{67} These competing goals resulted in wide judicial latitude and, therefore, significant precedential divergence in interpreting section 304.

A. Statutory Framework of Section 304

1. Section 304(a): Restrictions to Filing

Even though section 304 is broad in its application,\textsuperscript{68} subsection (a) of the rule required that a “foreign representative” commence a case “ancillary” to a “foreign proceeding.”\textsuperscript{69} An ancillary case, as discussed above, was limited to proceedings narrow in scope. Accordingly, ancillary proceedings under former section 304 did not result in a conventional reorganization or liquidation, did not create a bankruptcy estate,\textsuperscript{70} and did not result in the appointment of a U.S. trustee.\textsuperscript{71} Fur-

\textsuperscript{64} See id.
\textsuperscript{65} Controle et Revision S.A. v. Refco F/X Assocs., Inc. (\textit{In re Koreag}), 961 F.2d 341, 348 (2d Cir. 1992).
\textsuperscript{67} Hong Kong & Shanghai Banking Corp. v. Simon (\textit{In re Simon}), 153 F.3d 991, 998 (9th Cir. 1998).
\textsuperscript{68} LAWRENCE P. KING, \textsc{Collier on Bankruptcy} ¶ 304.01[1] (15th ed., rev. 2004).
\textsuperscript{69} 11 U.S.C. § 304(a) (2000), \emph{repealed} by \textit{BAPCPA} § 802(d)(3), 119 Stat. at 146.
\textsuperscript{70} KING, supra note 68, ¶ 304.03[1].
thermore, section 304 cases were procedurally conducted as adversary proceedings.\textsuperscript{72} In short, section 304 acted as a jurisdictional aid to foreign bankruptcy representatives by providing for discovery and a structured distribution of assets.\textsuperscript{73}

Additionally, only a “foreign representative” could commence a section 304(a) case ancillary to a “foreign proceeding.”\textsuperscript{74} The Code defined “foreign representative” as a “duly selected trustee, administrator, or other representative of an estate in a foreign proceeding.”\textsuperscript{75} The Code defined “foreign proceeding” as a:

proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor’s domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or affecting a reorganization.\textsuperscript{76}

While these terms were already broadly defined in the Code, not even requiring a foreign bankruptcy proceeding as long as some process of liquidation or reorganization had been instituted, U.S. bankruptcy courts applied section 304 even more expansively through their interpretation of subsections (b) and (c).\textsuperscript{77} The strong policy of avoiding piecemeal asset distribution drove this approach.

2. Section 304(b): Judicial Enforcement Powers

Although many of the powers of the Bankruptcy Code were not available to a foreign representative because section 304 only provided for ancillary proceedings, bankruptcy courts were hardly con-

\textsuperscript{72} See \textit{id}.
\textsuperscript{73} \textit{King, supra note 68, ¶ 304.01[1].}
\textsuperscript{74} 11 U.S.C. § 304(a), \textit{repealed by BAPCPA § 802(d)(3)}, 119 Stat. at 146.
\textsuperscript{75} \textit{Id. § 101(24), repealed by BAPCPA § 802(b)}, 119 Stat. at 145.
\textsuperscript{76} \textit{Id. § 101(23), repealed by BAPCPA § 802(b)}, 119 Stat. at 145.
\textsuperscript{77} \textit{See In re Brierley, 145 B.R. 151, 167 (Bankr. S.D.N.Y. 1992) (holding that it was sufficient in an ancillary proceeding for the entity to be a debtor under its own laws, even if the entity does not meet the requirements of 11 U.S.C. §§ 101 and 109 of the Bankruptcy Code); see also Goerg v. Parungao (\textit{In re Goerg}), 844 F.2d 1562, 1568 (11th Cir. 1988) (holding that a foreign representative of a foreign proceeding involving an insolvent decedent’s estate could commence an ancillary case even though such entity did not fall within the Bankruptcy Code’s definition of debtor); Saleh v. Triton Container Int’l, Ltd. (\textit{In re Saleh}), 175 B.R. 422, 425 (Bankr. S.D. Fla. 1994).
strained from asset distribution based on the language of section 304(b). Section 304(b) stated, in relevant part:

[T]he court may—
(1) enjoin the commencement or continuation of
   (A) any action against—
   (i) a debtor with respect to property involved in such foreign proceedings; or
   (ii) such property; or
   (B) the enforcement of any judgment against the debtor with respect to such property, or any act or the commencement or continuation of any judicial proceedings to create or enforce a lien against the property of such estate;
(2) order turnover of the property of such estate, or the proceeds of such property to such foreign representative; or
(3) order other appropriate relief.

For example, an automatic stay is not invoked in a section 304 ancillary proceeding. Expansive interpretation of section 304(b)(1), however, has resulted in U.S. bankruptcy courts obtaining the effect of a stay by issuing an injunction. Similarly, foreign representatives were not vested with the power to commence avoidance actions under sections 542, 543, 545, 547, 548, 549, 550, and 553 of the Bankruptcy Code. Representatives would, on the other hand, seek relief under foreign laws in the U.S. ancillary court by following standard choice-of-law rules. Thus, avoidance actions still could be filed in the ancillary proceeding; they simply did not stem from the Bankruptcy Code.

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78 See 11 U.S.C. § 304(b) (2000), repealed by BAPCPA § 802(d)(3), 119 Stat. at 146. 79 Id. 80 See King, supra note 68, ¶ 304.06; see also Schimmelpenninck v. Byrne (In re Schimmelpenninck), 183 F.3d 347 (5th Cir. 1999) (acknowledging that the automatic stay did not apply to foreign proceedings, but stating that injunctive relief could be granted under section 304 if actions to be enjoined concerned property “involved in” the foreign proceeding and relief would ensure economical and expeditious administration of the estate). 81 See 11 U.S.C. §§ 542, 543, 545, 547, 548, 549, 550, 553. 82 See Metzeler v. Bouchard Transp., Co. (In re Metzeler), 78 B.R. 674, 677 (Bankr. S.D.N.Y. 1987) (“With respect to the exercise of avoidance powers, the foreign representative should be limited to the powers available under the Laws of the State where the foreign proceeding is pending. The section 304 court’s tasks should be to assist implementation of the foreign court’s decrees [when not contrary to fundamental domestic policies] not to provide the foreign representative with the benefit of American avoidance powers, which may be better [from a debtor’s perspective] than those available in the foreign court.” (quoting R.A. Gitlin and E.D. Flaschen, The International Void in the Law of Multinational Bankruptcies, 42 Bus. Law. 307, 319 (1987)).
In addition to the relief available under former section 304, bankruptcy courts have held that the judicial power to order any appropriate relief under section 304(b)(3) should be interpreted expansively, “in near blank check fashion.”

Pointing to this “other appropriate relief” language, bankruptcy judges have ordered discovery, required that matters be adjudicated in the original, foreign jurisdiction, and heard issues based solely on foreign law. Section 304(b)(3) also provided the judge with powers that were not dispositive of property, such as in In re I.G. Services, Ltd., where the court relied on this section when issuing confidentiality orders to protect creditor identities.

More innovative measures have been introduced in complex cross-border insolvency proceedings. As expansive as section 304(b) became, subsection (c) expressly qualified its powers by outlining a series of competing balancing factors.

3. Section 304(c): Balancing Fairness and Comity

Section 304(c) lent bankruptcy judges the discretion to balance judicial bankruptcy ideals with the interests of foreign and domestic creditors. The enumerated factors were relied upon when fashioning a broad spectrum of judicial relief, “including dismissal or suspension of a case before the court, enjoining prosecution or commencement of a separate and independent case or proceeding, turnover of property, enjoining the disposition or transfer of property, and discovery.” The factors were “designed to give the Court maximum flexibility and permit it to ‘make the appropriate orders under all of the circumstances of

83 See In re Culmer, 25 B.R. 621, 624 (Bankr. S.D.N.Y. 1982); see also In re Brierley, 145 B.R. at 160.
86 In re Metzeler, 78 B.R. at 678.
88 See, e.g., In re Maxwell Comm. Corp., 170 B.R. 800, 802 (Bankr. S.D.N.Y. 1994). In In re Maxwell Communication Corp., the court appointed an examiner to harmonize the British and U.S. proceedings to permit a reorganization under U.S. law that would maximize the return to creditors. The examiner ultimately succeeded in negotiating a joint plan of reorganization under U.S. law and a scheme of administration under English law that provided for the partial reorganization and partial liquidation of the Maxwell entities.
90 See id.
91 King, supra note 68, ¶ 304.08.
each case, rather than being provided with inflexible rules.”

Specifically, section 304(c) stated:

In determining whether to grant relief under subsection (b) of this section, the court shall be guided by what will best assure an economical and expeditious administration of such estate, consistent with—

(1) just treatment of all holders of claims against or interests in such estate;

(2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;

(3) prevention of preferential or fraudulent dispositions of property of such estate;

(4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;

(5) comity; and

(6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

Subsections (1) and (3), which required just treatment to holders of claims against the estate and prevented preferential or fraudulent transfers, suggested that section 304(c) favored a unitary foreign administration.

On the other hand, foreign administration seemed contrary to the second factor enumerated under former section 304(c) (that is, protection of claim holders in the United States). Although comity, a factor under section 304(c)(5), is a principle rooted in deference to foreign laws and administration, subsection (4) called for distribution of the estate in accordance with the Bankruptcy Code. These competing goals are analyzed more fully below.

a. Section 304(c)(1) and (3): Favoring a Unitary Foreign Proceeding

As previously mentioned, section 304’s chief responsibility was to prevent a piecemeal dismemberment of the bankruptcy estate. Thus, ancillary relief, and not a full-scale bankruptcy administration, was best

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94 See id.
95 King, supra note 68, ¶ 304.08.
suited for preventing local creditors from gaining an upper hand over foreign creditors. This aspect of section 304 employed the goal of fair treatment to all claim holders. Also, U.S. bankruptcy courts consistently held that “[i]t is the foreign court which is in the best position to assess where and when claims should be liquidated in order to conserve estate resources and maximize the assets available for distribution” to claim holders. In this regard, foreign law was relied upon in defining and preventing fraudulent and preferential property dispositions so long as the law was not contradictory or repugnant to the laws of the United States.

b. Section 304(c)(2): Protection of U.S. Claim Holders

Section 304(c)(2), providing for the “protection of claim holders in the United States against prejudice and inconvenience,” was the corollary to deferring to foreign proceedings. As the subsection clearly stated, bankruptcy judges had to be mindful of the possibility that foreign reorganization and liquidation laws and procedures could unjustly interfere with U.S. citizens’ rightful claims. Section 304(c)(2), however, was rarely dispositive. The cost of traveling to foreign lands to pursue collection was never held sufficient to justify prejudice and inconven-

97 See In re Culmer, 25 B.R. at 629 (finding that deferring to Bahamian law will best further section 304(c)(1) because it “provides a comprehensive procedure for the orderly and equitable distribution of . . . assets among all . . . creditors,” a substantially similar scheme as that found in the Bankruptcy Code). The “[c]ourt is thus not obliged to protect the positions of fast-moving American and foreign attachment creditors over the policy favoring uniform administration in a foreign court.” Id. (citing Banque de Financement, S.A. v. First Nat’l Bank of Boston, 568 F.2d 911, 921 (2d Cir. 1977)).
100 See In re Kojima, 177 B.R. at 701.
102 King, supra note 68, ¶ 304.08[2].
ience.\textsuperscript{103} In extreme situations, protection of U.S. claim holders prevented ancillary relief. Where foreign law was so grossly unfair that fundamental tenets of American law, such as notice and due process, were not provided, section 304(c)(2) carried a heavy influence.\textsuperscript{104}

c. Section 304(c)(4) and (5): Comity Versus Conformity

Section 304(c)(4) and (5) confront the struggle between respecting international legal schemes and furthering U.S. procedures and policies. In the seminal case of \textit{Hilton v. Guyot}, the U.S. Supreme Court addressed the role of comity:

“Comity,” in the legal sense, is neither a matter of absolute obligation, on the one hand, nor of mere courtesy and good will, upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws.\textsuperscript{105}

Under this standard, when determining whether to defer to foreign proceedings, the bankruptcy courts had to determine whether the law of the foreign jurisdiction incorporated “‘fundamental standards of procedural fairness’” and was not contrary to U.S. legal policies.\textsuperscript{106} Comity is not an obligation, but a consideration, and should be withheld only “when its acceptance would be contrary or prejudicial to the interest of the nation called upon to give it effect.”\textsuperscript{107} Still, the application of comity has caused numerous cases to be either stayed, suspended, or dismissed to permit foreign courts to adjudicate insolvency issues.\textsuperscript{108}

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\item[103] \textit{In re Brierley}, 145 B.R. at 162–63 (“[T]he prejudice and inconvenience of which [the creditor] complains is typical of what every U.S. creditor in a sizeable domestic case encounters when it is forced to litigate its claim.”).
\item[104] See \textit{In re Hourani}, 180 B.R. at 66–69 (finding that Jordanian law lacked fundamental protections, including proper notice to known claimants, thus violating several subsections of section 304(c), including subsection (c)(2)).
\item[105] \textit{Hilton v. Guyot}, 159 U.S. 113, 163–64 (1895).
\item[106] \textit{Allstate Life Ins. Co. v. Linter Group Ltd.}, 994 F.2d 996, 999 (2d Cir. 1993); \textit{see also Phila. Gear Corp. v. Phila. Gear de Mexico, S.A.}, 44 F.3d 187, 191 (3d Cir. 1994).
\item[107] \textit{Cunard S.S. Co. v. Salem Reefer Services AB}, 773 F.2d 452, 457 (2d Cir. 1985) (quoting Somportex Ltd. v. Phila. Chewing Gum Corp., 453 F.2d 435, 440 (3d. Cir. 1971) (internal citations omitted)).
\item[108] \textit{See Cunard S.S. Co.}, 773 F.2d at 457.
\end{footnotes}
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Historically, comity was the most influential factor when determining whether a U.S. judicial proceeding was proper when a foreign action was underway concurrently. Section 304(c), comparatively, placed comity as only one of six “fairness” factors. As one court noted, “[s]ection 304(c)(4), [requiring substantial accord with the Bankruptcy Code,] represents a legislative choice to require courts to consider differences between American priority rules and those applicable to the foreign proceeding in determining whether affording comity will be repugnant to American public policies.” “Substantial accord” is not to be confused with duplication; an exact match with U.S. law was not required. Comity was a strong consideration in a section 304 analysis, but certainly not the sole consideration.

B. A Variation in Choice-of-Law Models Under Section 304—
A Caselaw Approach

As discussed above, much of the debate relating to international insolvencies has centered on the opposing theories of territorialism and universalism. Despite these divergent theories, most scholars believe that the enactment of section 304 was a step toward following the universality approach (or at least a modified universality approach).

Despite this belief, however, uncertainty rooted in balancing the factors enumerated under section 304 has led to several decisions em-

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109 See In re Treco, 240 F.3d 148, 158 (2d Cir. 2001).
111 In re Treco, 240 F.3d at 158–59.
112 See, e.g., In re Ionica PLC, 241 B.R. at 837 (finding compliance with section 304(c)(4) where a foreign distributive scheme gave lower priority to a U.S. creditor’s claim than the creditor would have received under the Bankruptcy Code).
113 King, supra note 68, ¶ 304.08[5][b]; see In re Papeleras Reunidas, S.A., 92 B.R. 584, 594 (Bankr. E.D.N.Y. 1988). (“[I]t is best to equally consider all of the variables of § 304(c) in determining the appropriate relief in an ancillary proceeding.”).
114 See In re Treco, 240 F.3d at 154; see also In re Koreag, Controle et Revision S.A., 961 F.2d 341, 358 (2d Cir. 1992) (stating that “[t]he overriding purpose of § 304 is to prevent piecemeal distribution of a debtor’s estate”); Cunard S.S. Co., 773 F.2d at 455 (stating that “[s]ection 304 may be said to have been designed to accommodate the problems . . . in which foreign bankruptcy proceedings have been instituted and creditors are attempting to seize assets of the debtor located in the United States”); In re Maxwell Comm. Corp., 170 B.R. at 816 (acknowledging that section 304 embraces “a modified form of universalism accepting the central premise of universalism, that is, that assets should be collected and distributed on a worldwide basis, but reserving to local courts discretion to evaluate the fairness of home country procedures and to protect the interests of local creditors”); Jay Lawrence Westbrook, Choice of Avoidance Law in Global Insolvencies, 17 BROOK. J. INT’L L. 499, 517 (1991) (citing section 304 as “the leading example” of modified universalism).
ploying aspects of both universalism and territorialism. Some of these cases are discussed in more detail below.

1. Cases Applying a Territorialistic Approach

a. *In re Toga Manufacturing, Ltd.*

The case of *In re Toga Manufacturing, Ltd.* provides an example of a territorialist outcome. An unsecured creditor of Toga Manufacturing Limited, a Canadian corporation, filed a petition in order to institute an involuntary proceeding in bankruptcy under Canadian and Ontario law before the Supreme Court of Ontario in Bankruptcy on October 18, 1982. Thereafter, on December 14, 1982, Peat Marwick Limited, the Canadian Bankruptcy Trustee of the debtor, brought an ancillary proceeding pursuant to section 304 requesting an injunction prohibiting all creditors of Toga from commencing or continuing to take action against Toga or its assets and an order directing the Wayne County Circuit Court Clerk (Michigan) to turn over the $215,000 fund to the Trustee.

The court began by addressing what effect, if any, was to be given to foreign bankruptcy law as it concerns property located in the United States. The court acknowledged that “[h]istorically, the bankruptcy laws of our country have been hostile towards claims asserted by foreign trustees in bankruptcy against alleged estate property located in the United States. ‘[T]he bankrupt law of a foreign country is incapable of operating a legal transfer of property in the United States.’” Section 304 of the Code embodies the universal theory of conflicts of laws with some qualifications; this theory requires that a judgment rendered in the domicile of the debtor be recognized in all other jurisdictions.

The court acknowledged that, due to the close geographic proximity of Canada and the United States, the creditor would suffer no inconvenience if it were forced to litigate its claim in Canada because the courts of the Province of Ontario were readily available to the credi-

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115 An in-depth case comparison illustrates this point in Part III.B.1.a of this Article. See infra notes 116–26 and accompanying text.


117 *Id.* at 167.

118 *Id.*.

119 *Id.*

120 *Id.* at 167–68.
Additionally, the creditor would receive just treatment of its claim against Toga in the Canadian courts. Upon distribution of the proceeds of the estate under Canadian bankruptcy law, however, the court found that the creditor’s claim would not receive the priority recognition “substantially in accordance with the order prescribed by this title” as required by section 304(c)(4). Specifically, the court found that because the creditor had received a judgment against Toga from a court of competent jurisdiction in Michigan and the fact that it perfected its judgment, the creditor was a lien creditor under U.S. law. Under Canadian law, however, the creditor would most likely have been considered an “ordinary creditor.” The court concluded that this treatment violated section 304(c)(4) and, therefore, denied the trustee’s petition to enjoin the American creditor’s state court action against Toga, the Canadian debtor.

b. *In re Treco*

In *In re Treco*, the liquidators, Alison J. Treco and David Patrick Hamilton, (the “Liquidators”) of Meridien International Bank Limited (“MIBL”), a bank incorporated in the Bahamas undergoing bankruptcy proceedings there, filed a petition in the Bankruptcy Court for the Southern District of New York pursuant to section 304(a) seeking the turnover of certain funds maintained by the Bank of New York and JCPL Leasing Corp.

After the Liquidators moved for partial summary judgment, the bankruptcy court granted the motion and directed turnover. The United States District Court for the Southern District of New York affirmed that decision. The bankruptcy court and district court both held that turnover was appropriate under section 304(c) irrespective of whether the Bank of New York’s (the “BNY”) claim to the funds held by it was secured. On appeal, the Second Circuit Court of Appeals disagreed and concluded that if the BNY’s claim was se-

121 *In re Toga Mfg., Ltd.*, 28 B.R. at 168.
122 Id.
123 Id.
124 Id.
125 Id.
126 *In re Toga Mfg., Ltd.*, 28 B.R. at 168.
127 *In re Treco*, 240 F.3d at 151.
128 Id.
129 Id.
130 Id.
cured, turnover of these funds would be improper because of the extent to which the distribution of the funds’ proceeds in the Bahamian bankruptcy proceeding would not be “‘substantially in accordance with the order prescribed by’” the U.S. Bankruptcy Code.131

The Second Circuit began its analysis by examining the two general approaches to distributing assets in such proceedings, territorialism and universalism.132 Although the Second Circuit acknowledged that the enactment of section 304 was a step toward the universality approach, the court noted that section 304 did not implement pure universality.133

The court focused its analysis on section 304(c).134 In particular, the court acknowledged that comity did not automatically override the other specified factors.135 The statute plainly provided that the other factors may form the basis for denying relief, and thus denying comity, in some cases.136 Additionally, the principle of comity, according to the court, has never meant categorical deference to foreign proceedings.137

In analyzing the factors under section 304(c), the court concluded that section 304(c)(1) was satisfied because the applicable Bahamian law provided for a comprehensive procedure for the orderly and equitable distribution of MIBL’s assets among all of its creditors.138 Additionally, Bahamian law complied with section 304(c)(2) because it protected U.S. claimholders from prejudice and inconvenience in the processing of their claims.139 Finally, Bahamian law prevented preferential and fraudulent dispositions of property and thus satisfied section 304(c)(3).140

Despite the foregoing, however, the Second Circuit found that U.S. law and Bahamian law treated administrative expenses differently—a difference that apparently would have a substantial impact on BNY’s claim.141 Because the Bahamian rule that secured creditors did not have priority over administrative expenses threatened to destroy BNY’s

131 Id.
132 In re Treco, 240 F.3d at 153.
133 Id. at 154.
134 Id. at 156.
135 Id.
136 Id. at 157. In fact, some courts have maintained that comity should not be weighed more heavily than the other factors. See, e.g., In re Papeleras Reunidas S.A., 92 B.R. 584, 594 (Bankr. E.D.N.Y. 1988).
137 In re Treco, 240 F.3d at 157.
138 Id. at 158.
139 Id.
140 Id.
141 Id. at 159.
claim, the Second Circuit concluded that the bankruptcy court abused its discretion by ordering turnover without first determining the impact of Bahamian rule in the discrete context of BNY’s claim against MIBL’s estate.\textsuperscript{142}

2. Cases Applying a Universalism Approach

a. \textit{In re Culmer}

One of the landmark universality-based cases applying section 304 was \textit{In re Culmer}.\textsuperscript{143} In \textit{Culmer}, Banco Ambrosiano Overseas Limited (“BAOL”) was a banking company that was liquidated in the Bahamas on August 16, 1982.\textsuperscript{144} Upon commencement of the liquidation, BAOL maintained clearing, custodial, and brokerage accounts at banks and financial institutions located within the southern district of New York.\textsuperscript{145} Soon thereafter, a petition was filed under section 304 of the Bankruptcy Code seeking injunctive relief in addition to an order that property in the United States be turned over to the Bahamas for administration in the Bahamian liquidation proceeding in accordance with Bahamian law.\textsuperscript{146} American creditors opposed the petition, arguing that their interests should have been determined under U.S. law.\textsuperscript{147} The issue presented, according to the court, was one of first impression in the Second Circuit: “whether this court should in its discretion pursuant to 11 U.S.C. section 304 of the Bankruptcy Code grant the relief sought in the Petition of allowing the transfer of all of BAOL’s assets located within the district to the Bahamas to be dispersed as part of the Bahamian liquidation of BAOL.”\textsuperscript{148}

The court began by analyzing section 304.\textsuperscript{149} The court analyzed the issue of whether deferring to the foreign proceeding would best assure an economical and expeditious administration of the BAOL estate.\textsuperscript{150} The court found that BAOL’s records and pre-liquidation employees were in the Bahamas; the liquidators and their staff were in Nassau and were bound to comply with the laws of the Bahamas and

\textsuperscript{142} \textit{In re Treco}, 240 F.3d at 160–61.
\textsuperscript{143} \textit{In re Culmer}, 25 B.R. at 621.
\textsuperscript{144} \textit{Id.} at 623.
\textsuperscript{145} \textit{Id.}
\textsuperscript{146} \textit{Id.}
\textsuperscript{147} \textit{Id.} at 627.
\textsuperscript{148} \textit{In re Culmer}, 25 B.R. at 627.
\textsuperscript{149} \textit{Id.}
\textsuperscript{150} \textit{Id.} at 628.
the orders of the Bahamas Supreme Court; and the Bahamian court could most efficiently deal with all of BAOL’s creditors, both American and worldwide. In addition, the court found that the Bahamas had the greatest interest in BAOL’s liquidation because neither the United States nor the state of New York had any governmental or public interest in BAOL’s liquidation.

The court then addressed issues of comity. Specifically, the court looked to the other relevant factors enumerated in section 304(c) to determine whether the evidence presented regarding Bahamian law indicated that its application would be wicked, immoral, or violate American law and public policy. The court’s examination of the provisions of Bahamian law, which related to liquidation proceedings, revealed that they were in substantial conformity with U.S. law. Importantly, the Bahamian Companies Act provided a comprehensive procedure for the orderly and equitable distribution of BAOL’s assets among all of its creditors. The court also found that all of the evidence indicated that BAOL’s Bahamian liquidation proceeding fully satisfied the criteria of section 304(c)(2) because all claim holders in the United States would be adequately protected against prejudice and inconvenience in the processing of their claims in the Bahamian liquidation proceeding under Bahamian law and procedure. Furthermore, BAOL’s Bahamian liquidation satisfied section 304(c)(3) in that preferential or fraudulent dispositions of BAOL’s assets were prohibited. On the contrary, the court noted that allowing BAOL’s creditors to continue their actions in the United States might indeed result in preferential treatment of those creditors. In addition, BAOL’s assets would be disbursed according to statutory prescription in the Bahamas or in the United States: taxes, wages, and administrative costs are paid on a preferential basis; secured claims are paid according to their priorities; unsecured creditors are paid pro rata; and compositions with classes of creditors and compromises with individual creditors require court approval. Because the record was devoid of any evidence of

151 Id.
152 Id. at 628–29.
153 In re Culmer, 25 B.R. at 629.
154 Id.
155 Id.
156 Id.
157 Id. at 630.
158 In re Culmer, 25 B.R. at 630.
159 Id.
160 Id. at 632.
prejudice and because the legal requirements for affording comity to Bahamian proceedings had been satisfied, the court granted the section 304 petition.\textsuperscript{161}

b. \textit{Cunard Steamship Co. v. Salen Reefer Services AB}

A second major decision applying a pro-universality approach under section 304 was \textit{Cunard Steamship Co. v. Salen Reefer Services AB}.\textsuperscript{162} In \textit{Cunard}, Salen Reefer Services, A.B., a business entity established under Swedish law, commenced a bankruptcy proceeding in the Stockholm City Court in the Kingdom of Sweden on December 19, 1984.\textsuperscript{163} In accordance with Swedish law, an interim administrator was appointed to supervise the debtor’s affairs, and creditor actions against the debtor were suspended.\textsuperscript{164} On January 9, 1985, Cunard Steamship Company, Ltd. commenced an action in the District Court for the Southern District of New York and obtained an order of attachment against certain assets of Salen.\textsuperscript{165}

After a hearing, the district court granted Salen’s motion and ordered that the attachment be vacated.\textsuperscript{166} The court found that U.S. public policy would be furthered by granting comity to the Swedish court’s stay on creditor actions during the Swedish bankruptcy proceeding.\textsuperscript{167} Cunard appealed the district court’s order vacating the attachment.\textsuperscript{168}

The issue, according to the Second Circuit, was whether, when a debtor is involved in a foreign bankruptcy proceeding, section 304 was the exclusive remedy for a trustee or representative of the bankrupt who wishes to stay or enjoin creditor actions in the United States.\textsuperscript{169} The Second Circuit denied Cunard’s argument that section 304 was intended to be a foreign debtor’s exclusive remedy and instead applied the principle of comity and other section 304(c) factors.\textsuperscript{170} In referring to the legislative history of section 304, the court explained:

\textsuperscript{161} Id. at 633.

\textsuperscript{162} \textit{Cunard S.S. Co.}, 773 F.2d at 452.

\textsuperscript{163} Id.

\textsuperscript{164} Id. at 454.

\textsuperscript{165} Id.

\textsuperscript{166} Id.

\textsuperscript{167} \textit{Cunard S.S. Co.}, 773 F.2d at 454.

\textsuperscript{168} Id.

\textsuperscript{169} Id.

\textsuperscript{170} Id. at 455.
[t]he court is to be guided by what will best assure an economical and expeditious administration of the estate, consistent with just treatment of all creditors and equity security holders; protection of local creditors and equity security holders against prejudice and inconvenience in processing claims and interests in the foreign proceeding; prevention of preferential or fraudulent disposition of property of the estate; distribution of the proceeds of the estate substantially in conformity with the distribution provisions of the bankruptcy code; and, if the debtor is an individual, the provision of an opportunity for a fresh start. These guidelines are designed to give the court the maximum flexibility in handling ancillary cases. Principles of international comity and respect for the judgments and laws of other nations suggest that the court be permitted to make the appropriate orders under all of the circumstances of each case, rather than being provided with inflexible rules. 171

Accordingly, because section 304 was designed for cases such as this, the Second Circuit found that it would have been eminently proper for the district court to have referred the case to a bankruptcy “unit” of the court. 172

The court went on to explain that “[t]he granting of comity to a foreign bankruptcy proceeding enables the assets of a debtor to be dispersed in an equitable, orderly, and systematic manner, rather than in a haphazard, erratic, or piecemeal fashion.” 173 The Cunard court ultimately held that it was not an abuse of discretion to vacate the attachment and grant comity to pending Swedish bankruptcy proceedings. 174

In both the Culmer and Cunard decisions, the courts focused on whether the foreign country’s laws adhered to certain fundamental notions of fairness and due process. 175 The courts also examined whether the application of the foreign laws would violate American public policy. 176 While this test is inherently subjective (and thus must be applied

172 Cunard S.S. Co., 773 F.2d at 455.
173 Id. at 458.
174 Id. at 461.
175 See Levenson, supra note 17, at 310.
176 See id.
on a case-by-case approach), the majority of courts have followed this pro-universality approach.\textsuperscript{177}

III. THE LACK OF AN INTERNATIONAL BANKRUPTCY LAW AND THE UNCITRAL RESPONSE

A. The Increasing Need for Uniform Insolvency Laws

The proliferation of businesses operating internationally has led to a mounting concern regarding how such companies’ assets should be treated in the event of bankruptcy, especially where company assets are spread throughout several countries.\textsuperscript{178} These countries, of course, likely have their own insolvency laws that specifically address the procedures in administering bankruptcy proceedings; these laws would determine the distribution and priority scheme and such laws would even be determinative of whether a liquidation or reorganization should occur.\textsuperscript{179} As one author has noted, international insolvency is an administrative nightmare when no country holds complete jurisdiction over either the debtor, its assets, or its creditors.\textsuperscript{180} In fact, Professor Westbrook has identified eleven recurring issues as key to the problem of transnational insolvency.\textsuperscript{181} These issues include: a moratorium on creditor action (\textit{i.e.}, a “stay”), standing/title for the liquidator, information sharing, creditor involvement, executory contracts, coordinated claims procedures, priorities and preferences, avoiding powers, discharge, natural and legal persons, and choice of law.\textsuperscript{182}

Recognizing the urgent need for cross-border cooperation and coordination in the supervision and administration of the insolvent debtor’s assets and affairs, the United Nations General Assembly es-

\textsuperscript{177} See id.


\textsuperscript{179} See Levenson, \textit{supra} note 17, at 292.

\textsuperscript{180} See Gilreath, \textit{supra} note 11, at 402; see also NAT’L BANKR. REVIEW Comm’n, \textit{supra} note 16, at 351 (“Administering assets in other countries has historically been difficult for a number of reasons, including no recognition of the ‘foreign’ insolvency proceeding in the country where the assets are located, inadequate notice to foreign creditors, and the inability to stay actions against foreign assets in order to administer them in one collective proceeding to the benefit of all creditors.”).


\textsuperscript{182} Id.
tablished the United Nations Commissions on International Trade Law ("UNCITRAL"), a legal body within the United Nations system in the field of international trade law, in 1967.\textsuperscript{183} UNCITRAL was created in an effort to help unify commercial and trade law.\textsuperscript{184}

\textbf{B. The Model Law on International Insolvency}

Due to the growing number of international insolvencies resulting from an economic downturn in the 1990s and a global cooperation failure among bankruptcy jurisdictions, UNCITRAL, with the assistance from the International Association of Restructuring, Insolvency & Bankruptcy Professionals (the "INSOL"), began investigating the possibility of formulating a model law to coordinate international insolvency proceedings in 1994.\textsuperscript{185} Soon thereafter, a working group\textsuperscript{186} was formed composed of all "state members of the Commission but attended only by certain members."\textsuperscript{187} This working group met periodically in New York and Vienna to formulate a model law on cross-border insolvency.\textsuperscript{188} Overall, approximately fifty countries participated in this project.\textsuperscript{189}

As a result of this collective effort, UNCITRAL unanimously adopted the text of the Model Law on Cross Border Insolvency (the "Model Law") on May 30, 1997.\textsuperscript{190} The Model Law was approved by resolution of the United Nations General Assembly on December 15, 1997.\textsuperscript{191} The thirty-two article Model Law attempts to create an effective


\textsuperscript{184} See generally Khumalo & Universiteit, \textit{supra} note 183. The United Nations General Assembly acknowledged that “many States lack[ed] a legislative framework that would make possible or facilitate effective cross-border coordination and cooperation.” Gilreath, \textit{supra} note 11, at 415; \textit{Model Law, supra} note 178, at 1.

\textsuperscript{185} See Gilreath, \textit{supra} note 11, at 399, 400, 415.

\textsuperscript{186} This “working group” is, in actuality, a formal UN-style meeting. \textit{Nat’l Bankr. Review Comm’n, supra} note 16, at 355.

\textsuperscript{187} Id.

\textsuperscript{188} Id.

\textsuperscript{189} Id.

\textsuperscript{190} See Khumalo & Universiteit, \textit{supra} note 183, at 4; see also Gilreath, \textit{supra} note 11, at 400–01.

\textsuperscript{191} Khumalo & Universiteit, \textit{supra} note 183, at 4.
judicial framework for administering cross-border insolvencies. Professor Westbrook places the Model Law’s thirty-two articles in the following categories: (a) scope; (b) general provisions; (c) access; (d) recognition; (e) effects of recognition; (f) treatment of foreign creditors; (g) cooperation and communication among proceedings in several countries; and (h) coordination of parallel proceedings.

According to UNCITRAL, the Model Law was “designed to assist States to equip their insolvency laws with a modern, harmonized, and fair framework to address more effectively instances of cross-border insolvency.” Those instances include cases where the insolvent debtor has assets in more than one State or where some of the creditors of the debtor are not from the State where the insolvency proceeding is taking place.” Importantly, the Model Law “respects the differences among national procedural laws and does not attempt a substantive unification of insolvency law.” Rather, the Model Law is designed to offer a solution by providing: foreign assistance for an insolvency proceeding taking place in the enacting country, foreign representatives access to courts of the enacting country, recognition of foreign proceedings, cross-border cooperation, and coordination of concurrent proceedings.

Since its adoption by UNCITRAL in 1997, several countries have passed legislation based on the Model Law, including: Eritrea; Japan; Mexico; Poland; Romania; South Africa; within Serbia and Montene-

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193 Westbrook, *supra* note 11, at 12.


195 Id.

196 Id. UNCITRAL quickly realized that any attempt to draft one cohesive bankruptcy system, thereby requiring individual States to modify their bankruptcy codes, would be futile. Neiman, *supra* note 19, at 829–30. Accordingly, UNCITRAL limited its scope to address the procedural aspects regarding transnational insolvencies. Id. at 830.

197 See Model Law, *supra* note 178. According to its Preamble, the purpose of the Model Law “is to provide effective mechanisms for dealing with cases of cross-border insolvency so as to promote the objectives of: (a) Cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency; (b) Greater legal certainty for trade and investment; (c) Fair and efficient administration of cross-board insolvencies that protects the interests of all creditors and other interested persons, including the debtor; (d) Protection and maximization of the value of the debtor’s assets; and (e) Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.” See id.
gro, Montenegro; the British Virgin Islands, an overseas territory of the United Kingdom of Great Britain and Northern Ireland; and the United States of America. The U.S. version of the Model Law, which was recently enacted in BAPCPA, is discussed below.

IV. THE CURRENT APPROACH: CHAPTER 15—ANCILLARY AND OTHER CROSS-BORDER CASES

A. Overview of Chapter 15

Chapter 15, titled “Ancillary and Other Cross-Border Cases,” was enacted to incorporate the UNCITRAL Model Law on Cross-Border Insolvency so as to provide an effective mechanism for dealing with cross-border insolvency cases. The Model Law on Cross-Border Insolvency was designed to assist states by attempting to address instances of cross-border insolvency more effectively.

Despite these new provisions dealing with cross-border insolvency, the substantive rules in Chapter 15 are not significantly different from those previously enacted in former section 304 of the Bankruptcy Code discussed above. In fact, some believe that neither jurisprudence nor practice will change dramatically under the new Chapter 15.
B. Purpose of Chapter 15

The stated purpose of Chapter 15, as with the Model Law, is to: (1) promote cooperation between courts of the United States, United States trustees, trustees, examiners, debtors, and debtors-in-possession and the courts and other competent authorities of foreign countries involved in cross-border insolvency cases; (2) provide greater legal certainty for trade and investment; (3) promote the fair and efficient administration of cross-border insolvencies that protect the interests of all creditors, and other interested entities, including the debtor; (4) protect and maximize the value of the debtor’s assets; and (5) facilitate the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

C. Scope of Chapter 15

As described in section 1501 of the Bankruptcy Code, Chapter 15 applies in four situations, including where:

1. Assistance is sought in the United States by a foreign court or a foreign representative in connection with a foreign proceeding;
2. Assistance is sought in a foreign country in connection with a case under Title 11 of the Bankruptcy Code;
3. A foreign proceeding and a case under Title 11 with respect to the same debtor are pending concurrently;
4. Creditors or other interested persons in a foreign country have an interest in requesting the commencement of, or participating in, a case or proceeding under Title 11.

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206 BAPCPA § 801(a), 119 Stat. at 135 (to be codified at 11 U.S.C. § 1501(a)).

207 Id. (to be codified at 11 U.S.C. § 1501(b)). Section 1501(c) also expressly prohibits Chapter 15’s application to certain individuals and entities that are excluded from being debtors under section 109 (such as insurance companies). See id. (to be codified at 11 U.S.C. § 1501(c)).
D. Statutory Framework

1. Commencement of an Ancillary Case Under Chapter 15

A case is commenced under Chapter 15 by filing a petition for recognition of a foreign proceeding under section 1515. Once filed, prior to the court ruling on the petition, the court may, at the request of the foreign representative, grant certain enumerated forms of provisional relief to protect the assets of the debtor or the interests of creditors. This provisional relief terminates when a petition for recognition is denied.

As discussed above, ancillary proceedings are not full domestic insolvencies, but rather are limited proceedings which have a narrow purpose of assisting the foreign main proceeding. Westbrook, supra note 11, at 10. Accordingly, the use of the word “ancillary” in the title of Chapter 15 illustrates the United States’ policy “in favor of a general rule that countries other than the home country of the debtor, where a main proceeding would be brought, should usually act through ancillary proceedings in aid of the main proceedings, in preference to a system of full bankruptcies in each state where assets are found.” H.R. Rep. No. 109-31, at 107–08 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 171.


A “foreign proceeding” means “a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.” BAPCPA § 802(b), 119 Stat. at 145 (to be codified at, and amending, 11 U.S.C. § 101(23)).

Under section 1515, a foreign representative applies to the court for recognition of a foreign proceeding in which the foreign representative has been appointed by filing a petition for recognition. Id. § 801(a), 119 Stat. at 136 (to be codified at 11 U.S.C. § 1504). Under section 1515, a foreign representative applies to the court for recognition of a foreign proceeding in which the foreign representative has been appointed by filing a petition for recognition. Id. § 801(a), 119 Stat. at 139 (to be codified at 11 U.S.C. § 1515(a)). Certain other documents must accompany the petition to identify the applicable foreign proceeding which has been commenced. See id. § 801, 119 Stat. at 135 (to be codified at 11 U.S.C. § 1515(b)–(c)). These documents include: (1) a certified copy of the decision commencing such foreign proceeding and appointing the foreign representative; (2) a certificate from the foreign court affirming the existence of such foreign proceeding and of the appointment of the foreign representative; or (3) in the absence of the above, any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative. Id. § 801(a), 119 Stat. at 139 (to be codified at 11 U.S.C. § 1515(b)). The petition for recognition also must be accompanied by a statement identifying all foreign proceedings with respect to the debtor that are known to the foreign representative. Id. § 801(a), 119 Stat. at 139 (to be codified at 11 U.S.C. § 1515(c)).

This provisional relief includes: “(1) staying execution against the debtor’s assets; (2) entrusting the administration or realization of all or part of the debtor’s assets located in the United States
recognition is granted. The fact that a foreign representative files a petition under section 1515, however, does not subject the foreign representative to the jurisdiction of any court in the United States for any other purpose.

2. Recognizing a Foreign Proceeding

A court must enter an order recognizing a foreign proceeding if: (1) such foreign proceeding for which recognition is sought is a foreign main proceeding or foreign nonmain proceeding as defined under Chapter 15, (2) the foreign representative applying for recognition is a person or body, and (3) the petition meets the requirements of section 1515. This order recognizing a foreign proceeding is subject to section 1506, which states a public policy exception. A foreign proceeding will be recognized “(1) as a foreign main proceeding if it is pending in the country where the debtor has the center of its

to the foreign representative or another person authorized by the court, including an examiner, in order to protect and preserve the value of assets that, by their nature or because of other circumstances, are perishable, susceptible to evaluation or otherwise in jeopardy; and (3) suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor to the extent this right has not been suspended under section 1520(a); providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor’s assets, affairs, rights, obligations or liabilities; and granting any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550 and 724(a). See id. § 801(a), 119 Stat. at 139–41 (to be codified at 11 U.S.C. §§ 1519, 1521).

213 Id. § 801(a), 119 Stat. at 140 (to be codified at 11 U.S.C. § 1519(b)).
214 “Foreign representative” means “a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of such foreign proceeding.” Id. § 802(b), 119 Stat. at 145 (to be codified at, and amending, 11 U.S.C. § 101(24)).
216 Under Chapter 15, a “foreign main proceeding” means a foreign proceeding pending in the country where the debtor has the center of its main interests; and a “foreign nonmain proceeding” means a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment. See id. § 801(a), 119 Stat. at 135 (to be codified at 11 U.S.C. § 1502(4)–(5)). The principles of section 304 are similar to those of the Model Law to the extent that it contemplates a nonmain proceeding which, to some extent, supports and complements a main proceeding elsewhere. Gropper, supra note 71, at 7.
217 BAPCPA § 801(a), 119 Stat. at 139 (to be codified at 11 U.S.C. § 1517(a)).
main interests; or (2) as a foreign nonmain proceeding if the debtor has an establishment within the meaning of section 1502 in a foreign country where the proceeding is pending.” 219

3. Relief upon Recognition

After a U.S. bankruptcy court recognizes the case as a foreign main proceeding, the foreign representative is entitled to certain specified relief under section 1520, including an automatic stay with respect to the debtor and the debtor’s property within the territorial jurisdiction of the United States, the right to operate the debtor’s business, and the right to sell and deal with property in the same manner as a trustee or debtor-in-possession in the United States. 220 At the request of the foreign representative, the court may grant other relief under section 1521, whether main or nonmain. 221 Upon granting this relief under section 1521 to a representative of a foreign nonmain proceeding, however, “the court must be satisfied that the relief relates to assets that, under the law of the United States, should be administered in the foreign nonmain proceeding or concerns information required in that proceeding.” 222

Section 1507 reads:

[i]n determining if the court will provide “additional assistance” to a foreign representative, the court will consider such additional assistance, consistent with the principles of comity, which will reasonably assure (1) just treatment of all holders of claims against or interests in the debtor’s property; (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding; (3) prevention of preferential or fraudulent dispositions of property of the debtor; (4) distribution of proceeds of the debtor’s property substantially in accordance with the order prescribed by the Bankruptcy Code; and if appro-

219 BAPCPA § 801(a), 119 Stat. at 139 (to be codified at 11 U.S.C. § 1517(b)). “Establishment” means any place of operations where the debtor carries out a nontransitory economic activity. Id. § 801(a), 119 Stat. at 135 (to be codified at 11 U.S.C. § 1502(2)).

220 Id. § 801(a), 119 Stat. at 141 (to be codified at 11 U.S.C. § 1520(a)(1)–(4)); see also Gropper, supra note 71, at 7.


222 Id.
appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.223

These are essentially the same factors which appeared under section 304 of the Bankruptcy Code.224

Additionally, upon recognition, a foreign representative may commence an involuntary case under section 303 or a voluntary case under section 301 or 302 if the foreign proceeding is a foreign main proceeding.225 A case under another chapter of the Bankruptcy Code, however, may only be commenced if the debtor has assets in the United States.226

4. Venue of Cases Ancillary to Foreign Proceedings

With the addition of Chapter 15 to the Bankruptcy Code, Congress has necessarily addressed related statutes, including 28 U.S.C. § 1410, titled “Venue of Cases Ancillary to Foreign Proceedings.”227 Section 1410 allows a case to be commenced under Chapter 15 in the district court of the United States for the district:

(1) in which the debtor has its principal place of business or principal assets in the United States; (2) if the debtor does not have a place of business or assets in the United States, in which there is pending against the debtor an action or proceeding in a Federal or State court; or (3) in a case other than those specified in paragraph (1) or (2), in which venue will be consistent with the interests of justice and the conven-


224 11 U.S.C. § 304, repealed by BAPCPA § 802(d) (3), 119 Stat. at 146. As the legislative history indicates, caselaw analyzing comity and the other factors under section 304(c) is misleading since those enumerated factors under section 304(c) are essentially grounds for granting comity. H.R. Rep. No. 109-31, at 109 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 172. Accordingly, in section 1507, the issue of comity is raised in the introductory language. Id. This placement ensures that comity will be addressed. Id.

225 BAPCPA § 801(a), 119 Stat. at 138 (to be codified at 11 U.S.C. § 1511(a)). Additionally, in the absence of evidence to the contrary, recognition of a foreign main proceeding is, for the purpose of commencing a proceeding under section 303, proof that the debtor is generally not paying its debts as such debts become due. Id. § 801(a), 119 Stat. at 145 (to be codified at 11 U.S.C. § 1531).

226 Id. § 801(a), 119 Stat. at 144 (to be codified at 11 U.S.C. § 1528).

227 Id. § 802(c) (4), 119 Stat. at 146 (to be codified at, and amending, 28 U.S.C. § 1410).
ience of the parties, having regard to the relief sought by the foreign representative.\textsuperscript{228}

**Conclusion**

Chapter 15 represents Congress’s attempt to establish a comprehensive procedural framework to manage cross-border insolvencies. Central to Chapter 15’s framework is an emphasis on transnational comity. Despite the comity language and Chapter 15’s stated purpose, many believe that Chapter 15 merely codifies the precedent established from cases decided under former section 304.

The eventual effect of Chapter 15, however, is uncertain. As the wise Yoda noted in *Star Wars: Episode V—The Empire Strikes Back*, “[d]ifficult to see. Always in motion is the future.”\textsuperscript{229} As international insolvencies emerge in U.S. bankruptcy courts, judges, advocates, and scholars will all play their parts in the application of Chapter 15. Undoubtedly, academic theories such as territorialism and universalism will once again guide the formation of legal precedent.

Whatever the result, substantive differences between the U.S. Bankruptcy Code and the insolvency statutes of other countries will likely become increasingly important. Until such time as international insolvency laws are reconciled, forum shopping will remain a concern as transnational debtors must balance the alternatives available to them in the international insolvency context.

\textsuperscript{228} Id. Under the former venue provisions, a case under section 304 to enjoin the commencement or continuation of an action or proceeding in a state or federal court, or the enforcement of a judgment, could have been commenced only in the district court for the district where the state or federal court sits in which is pending the action or proceeding against which the injunction is sought. See id. Additionally, a case under section 304 to enjoin the enforcement of a lien against a property, or to require the turnover of property of an estate, could have been commenced only in the district court for the district in which such property is found. See id. Finally, a case under section 304 (other than a case specified above), could have been commenced only in the district court for the district in which is located the principal place of business in the United States, or the principal assets in the United States, of the estate that is the subject of such case. See id. § 802(c) (4), 119 Stat. at 146 (to be codified at, and amending, 28 U.S.C. § 1410(c)(4)).

SOME CONFIRMED CHAPTER 11 PLANS FAIL. SO WHAT?

Stephen H. Case*

Abstract: Critics of the feasibility requirement set forth in 11 U.S.C. § 1129(a)(11) contend that the current bankruptcy system inadequately prevents repeat Chapter 11, or “Chapter 22,” filings. Undoubtedly, there are instances of confirmed Chapter 11 plans that turn out to be unfeasible despite court findings to the contrary. Given the uncertainties of investment projections and capital markets, however, the occasional failure of Chapter 11 plans is not necessarily a greater evil than alternatives such as liquidation or excessively conservative capital structures. Chapter 11 is, by its very definition, a hit-or-miss venture; thus, it misses occasionally. Some confirmed Chapter 11 plans fail. So what?

Introduction

Section 1129(a)(11) of the Bankruptcy Code1 makes it a condition precedent to confirmation of a Chapter 11 reorganization plan for the court to find that “[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.”2 The unscholarly folklore suggests that the requirement was created because Congress did not want business debtors to emerge from bankruptcy unless their Chapter 11 plans were soundly contrived, so as to free them from future failure resulting from the vicissitudes of the

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business cycle. In other words, Congress intended to prevent debtors from emerging out of Chapter 11 only to file a second Chapter 11 case soon thereafter—a sequence sometimes colloquially referred to as a “Chapter 22” case.

This Article examines the feasibility requirement of 11 U.S.C. § 1129(a)(11) and considers whether it meaningfully and helpfully predicts future business failures. Part I of this Article outlines the current judicial interpretation of the feasibility requirement. Part II then considers whether courts should develop more specific criteria for feasibility determinations. Part III discusses the present dearth of information needed to determine the effectiveness of the feasibility requirement and its implementation. Part IV proceeds to examine the “real world” operation of the feasibility requirement. Part V presents competing views with respect to whether the court system sufficiently prevents repeat Chapter 11 filings. Finally, Part VI discusses—without conceding that a problem necessarily exists—whether the system can be improved and considers factors that likely contribute to overly optimistic expectations for Chapter 11 plans. The Article concludes by arguing that although some Chapter 11 plans inevitably fail under the current regime, this is no greater evil than other—perhaps even less desirable—alternatives.

I. Judicial Interpretation of the Feasibility Requirement

Conventional approaches to legal scholarship call for analyzing reported judicial rulings in order to illuminate the meaning of a statute. Thus, in order to understand the feasibility requirement set forth in section 1129(a)(11), one must turn to the courts. A frequently cited legal standard for feasibility is whether the factual showing at the plan confirmation hearing establishes a “reasonable assurance of success,” though “[s]uccess need not be guaranteed.” In the context of section 1129(a)(11), relatively few reported cases articulate much more than this basic standard, except to state that Chapter 11 issues are fact-intensive and that trial court decisions will be upheld unless “clearly erroneous.”

3 See id.
4 Kane v. Johns-Manville Corp., 843 F.2d 636, 649 (2d Cir. 1988) (citing Prudential Ins. Co. v. Monnier (In re Monnier Bros.), 755 F.2d 1336, 1341 (8th Cir. 1985); In re Wolf, 61 B.R. 1010, 1011 (Bankr. N.D. Iowa 1986)).
5 See, e.g., In re T-H New Orleans Ltd. P’ship, 116 F.3d 790, 801 (5th Cir. 1997) (quoting In re Briscoe Enters., Ltd., II, 994 F.2d 1160, 1165–66 (5th Cir. 1993)) (explaining that “the [bankruptcy] court need not require a guarantee of success,” and instead may require
The “clearly erroneous” rule is important in the context of appellate review of feasibility determinations. The feasibility of Chapter 11 plans is decided exclusively at the trial court level based on the factual record before the court. Thus, if a busy trial court takes the time to write an opinion that is based heavily on the weight that the court gives to various witnesses and other evidence in the record, it is difficult for a reviewing court to find a lawful basis upon which to reverse the trial court. In other words, due to the “clearly erroneous” standard, reversal on appeal of a reasonably well-drafted trial court opinion or order containing carefully detailed factual findings regarding feasibility is virtually impossible. For instance, according to the U.S. Court of Appeals for the Seventh Circuit, “[t]o be clearly erroneous, a decision must strike [the court] as more than just maybe or probably wrong; it must, as one member of this court recently stated during oral argument, strike [the court] as wrong with the force of a five-week-old, unrefrigerated dead fish.”\(^6\)

II. Should Courts Develop More Specific Feasibility Criteria?

Aside from the frequently cited standard for feasibility referenced in the Second Circuit’s *Kane v. Johns-Manville Corporation*—whether there is a “reasonable assurance of success,” though “[s]uccess need not be guaranteed”—no other clearly articulated appellate standards

\(^6\) Parts & Elec. Motors, Inc. v. Sterling Elec., Inc., 866 F.2d 228, 233 (7th Cir. 1988) (emphasis added).
for what constitutes a feasible plan currently exist. As noted above, the issue of feasibility is decided almost exclusively at the trial court level based on the court’s characterization of the factual record developed at the confirmation hearing. A trial court determination that a Chapter 11 plan is feasible is a determination that both the future performance of the reorganized business and future conditions in the relevant subsector of the economy are going to have favorable characteristics. This is economic crystal-ball gazing. With respect to this type of forecasting, no one is ever right all of the time.

Where does this leave the courts? It is difficult to speculate as to what a court of appeals might say if compelled to adopt a feasibility standard more specific than that articulated in *Kane*. Would a court require fixed criteria based on balance-sheet ratios; for instance, would there have to be a minimum fixed-charge coverage ratio? Would businesses have to demonstrate enough of an equity-weighted capitalization in order to obtain an investment-grade credit rating? These are conventional concepts to those familiar with financial covenants in corporate loan agreements and debt indentures.

The trouble is, however, that these concepts do not work. Generations of bankers and attorneys, who perpetually devise and revise formulae like these as financial covenants in loan agreements, have not yet come up with a way for contractual language to prevent future default in the real world. Furthermore, excessively conservative capital structures intended to provide multiple “cushions” against future default can sometimes hobble enterprises to the point where they inhibit success. In sum, forward-looking contractual language is often no substitute for good, human business judgment applied at the relevant time.

### III. Assessing the Feasibility Requirement’s Effectiveness amid a Lack of Data

No centralized federal system currently exists to collect and publish detailed information with respect to how the Chapter 11 system actually works. Thus, many questions abound. Which industries have higher filing rates than others? How long do cases typically last? How

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7 See 843 F.2d 636, 649 (2d Cir. 1988) (citing Prudential Ins. Co. v. Monnier (In re Monnier Bros.), 755 F.2d 1336, 1341 (8th Cir. 1985); In re Wolf, 61 B.R. 1010, 1011 (Bankr. N.D. Iowa 1986)).

8 See 843 F.2d at 649 (citing Prudential Ins. Co., 755 F.2d at 1341; Wolf, 61 B.R. at 1011).

many cases result in the confirmation of plans? How many jobs are saved or lost as a result of Chapter 11? The lack of data is frustrating to researchers trying to answer these questions.

Recent legislation, however, should address this problem. A new federal statute requires the Attorney General of the United States (who will presumably act through the Office of U.S. Trustee) to promulgate regulations that will require Chapter 11 debtors to file periodic reports. These reports will include, in addition to any other matters proposed at the discretion of the Attorney General, the following:

(1) information about the industry classification, published by the Department of Commerce, for the businesses conducted by the debtor;
(2) length of time the case has been pending;
(3) number of full-time employees as of the date of the order for relief and at the end of each reporting period since the case was filed;
(4) cash receipts, cash disbursements and profitability of the debtor for the most recent period and cumulatively since the date of the order for relief;
(5) compliance with title 11, whether or not tax returns and tax payments since the date of the order for relief have been timely filed and made;
(6) all professional fees approved by the court in the case for the most recent period and cumulatively since the date of the order for relief (separately reported, for the professional fees incurred by or on behalf of the debtor, between those that would have been incurred absent a bankruptcy case and those not); and
(7) plans of reorganization filed and confirmed and, with respect thereto, by class, the recoveries of the holders, expressed in aggregate dollar values and, in the case of claims, as a percentage of total claims of the class allowed.

The statute also requires that the reports

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11 Id. § 602(a), 119 Stat. at 120 (to be codified at 28 U.S.C. § 589b(a)(2)).
12 Id. § 602(a), 119 Stat. at 121–22 (to be codified at 28 U.S.C. § 589b(e)).
shall be designed (and the requirements as to place and manner of filing shall be established) so as to facilitate compilation of data and maximum possible access of the public, both by physical inspection at one or more central filing locations, and by electronic access through the Internet or other appropriate media.\textsuperscript{13}

Nothing in the statutorily mandated contents of the reports requires disclosure of prior Chapter 11 filings by the same or related debtors.\textsuperscript{14} Perhaps, however, commentators will persuade the Attorney General’s office to use its discretion to add to the yet-to-be-promulgated regulations a requirement for the disclosure of such information.\textsuperscript{15}

Notwithstanding any answers this new legislation may eventually yield—both in terms of the statutorily mandated information and any additional information that the Attorney General may require—the fact remains that little data is currently available with respect to whether too many Chapter 11 cases result in the confirmation of unfeasible plans. This raises a compelling question: Is the statutory requirement for feasibility in fact a meaningless phrase frequently honored only in breach?

\textbf{IV. Feasibility Determinations in the “Real World”}

Based on the author’s experience, the scope of feasibility evidence presented to a court in a Chapter 11 plan confirmation hearing is principally a function of whether the plan’s confirmation is contested. Thus, a dichotomy exists in the empirical reality of plan confirmation hearings. On the one hand, if a plan is contested, then the section 1129(a)(11) feasibility issue is likely to be a lightning rod for litigation during the confirmation hearing. Thus, the trial judge in such a case must simply consider the competing evidence and make a decision. The more factually grounded the trial court’s decision, the less likely it is to be reversed on appeal.

On the other hand, uncontested confirmation hearings unfold quite differently and, in the author’s opinion, present the highest danger of excessively optimistic forecasts that could look foolish in hindsight if the debtor files again. For example, if a plan is supported by the “leading players” in most of the significant creditor groups with

\textsuperscript{13} \textit{Id.} § 602(a), 119 Stat. at 120 (to be codified at 28 U.S.C. § 589b(b)).

\textsuperscript{14} See \textit{id.} § 602(a), 119 Stat. at 121–22 (to be codified at 28 U.S.C. § 589b(e)).

\textsuperscript{15} See \textit{BAPCPA} § 602(a), 119 Stat. at 121 (to be codified at 28 U.S.C. § 589b(d)).
no or only token opposition, then the proponent of the plan—often the debtor—files sets of spreadsheets with the court along with supporting affidavits. These filings represent to the court that the projected cash flows of the debtor will be sufficient to cover its liabilities. The filings opine further that, barring unexpectedly severe downturns in the business cycle, the plan confirmation is not likely to be followed by liquidation or the need for further financial reorganization.

With no contrary evidence in the record, and no cross-examination of any feasibility witnesses—whose testimony may even have been filed by affidavit—the court typically will accept this evidence as conclusive proof that the plan is feasible. Thus, in such a situation, a plan could be confirmed without any significant focus on the evidence presented in support of feasibility. It is the author’s opinion, without the benefit of an empirical study, that most repeat Chapter 11 cases, at least in the large-case environment, can probably be traced back to uncontested plan confirmation hearings featuring consensual Chapter 11 plans similar to that described above.

V. Competing Views on the Need for Reform of the Present System

Recently, some commentators have criticized the effectiveness of the feasibility requirement, publishing detailed studies that purport to establish that some jurisdictions have higher rates of repeat-filing Chapter 11 debtors than others and that consider possible explanations for this phenomenon.16 For instance, one recent study concluded that:

Delaware-reorganized firms were significantly more likely to refile, significantly more likely to go out of business . . . and significantly less likely to perform successfully . . . . These findings warrant the conclusion that Delaware-reorganized firms [for the period studied] failed more often than firms emerging from reorganization [elsewhere].17

A recent example of the repeat filing phenomenon is US Airways, which has filed for Chapter 11 protection twice in recent years.18 This is

17 Id.
but one of several examples available in the large company context.\textsuperscript{19} The repeat-filing phenomenon is particularly acute within the airline industry. For instance, Trans World Airlines has filed three times, and Continental Airlines and Midway Airlines have each filed twice.\textsuperscript{20} Situations such as these lead commentators to conclude that the present system needs more backbone—that is, more independent judicial scrutiny of feasibility evidence is necessary to prevent repeat filings.\textsuperscript{21}

Certain cases, however, contradict such criticism of the system. Some Chapter 11 reorganizations have been spectacularly successful.\textsuperscript{22} For instance, the stock of Kmart Holding Corporation performed amazingly well soon after its emergence from Chapter 11 in early 2003.\textsuperscript{23} In a period of approximately two years thereafter, a $10,000 investment in Kmart Holding Corporation stock would have grown in value to more than $53,000.\textsuperscript{24}

Bankruptcies such as that of Kmart Holding Corporation represent a clearly correct finding of feasibility at the confirmation hearing and thus lead to a line of thinking alternative to the views of skeptical commentators who criticize the feasibility requirement’s effectiveness in preventing future Chapter 11 filings. This line of thinking says, in effect: So what? Chapter 11 is difficult. The purpose of the process is to save jobs and protect going-concern value. If it doesn’t work in some situations, then try again. Keep fixing the business until it works.

The debate as to whether reforms are needed has yet to be resolved. The Judicial Conference Committee on the Administration of the Bankruptcy System and the Federal Judicial Center recently held a conference in which judges and attorneys with expertise in large Chapter 11 cases briefly addressed some of the criticisms referenced above.\textsuperscript{25} The participants also briefly debated whether courts should be required to appoint special feasibility experts.\textsuperscript{26} No consensus,

\begin{itemize}
\item \textsuperscript{21} See LoPucki & Doherty, \textit{supra} note 16, at 1984.
\item \textsuperscript{22} See, e.g., \textit{In re Kmart Corp.}, 286 B.R. 345 (Bankr. N.D. Ill. 2002).
\item \textsuperscript{23} See Kmart Holding Stock Report (KMRT), Charts & Returns, http://quicktake.morningstar.com/Stock/Stockperformance.asp?Country=USA&Symbol=KMRT.
\item \textsuperscript{24} \textit{Id.}
\item \textsuperscript{26} \textit{Id.} at 36.
\end{itemize}
however, was reached with respect to either issue.\textsuperscript{27} Additionally, a 1997 federal review of the state of national bankruptcy policy reported no significant problems with respect to the drafting or administration of section 1129(a)(11), although it did not address the feasibility issue directly.\textsuperscript{28}

VI. Is There a Solution (Assuming There Is Even a Problem)?

Undoubtedly, some Chapter 11 plans approved as feasible in confirmation hearings turn out not to be feasible. Observers differ as to whether they believe such outcomes result primarily from insufficient vigilance in the confirmation process.\textsuperscript{29} Blaming bankruptcy judges and creditor constituencies for post-confirmation business failure, however, is not appropriate. No one possesses the proverbial crystal ball. Thus, the only conceivable “fix” of the process may be to conduct a public policy assessment as to whether additional safeguards are necessary in uncontested Chapter 11 confirmation hearings.

In the author’s experience, uncontested Chapter 11 plan confirmation hearings have often been the result of successful consensus-gathering efforts. These efforts frequently result in hearings where the court has no reason to question plan-proponent representations with respect to feasibility. This can result in court acceptance of expectations as to future revenue levels, interest rates, and business activity that might not have been able to withstand an attack from well-prepared creditors opposing the plan. Other times, however, honest, carefully calculated sets of projections in which plan proponents have high levels of confidence are presented at uncontested hearings. Inevitably, even when plan proponents hold a good-faith belief—as most proponents likely do—that the emerged business will generate enough cash to meet the demands imposed by the post-plan capital structure, some projections turn out to be wrong. Plan proponent fatigue and recovery dumping by distress investors are also factors likely contributing to any problem with the feasibility requirement—assuming, of course, that there is one. Both phenomena, in efforts to reach a consensus, can contribute to excessive optimism in plan formulation.

Plan-proponent fatigue occurs when the process of managing a business in Chapter 11 becomes so onerous that pressure to end the

\textsuperscript{27} Id.
\textsuperscript{28} See generally Nat’l Bankr. Review Comm’n, supra note 9.
\textsuperscript{29} See LoPucki & Doherty, supra note 16, at 1984.
case can distort judgment with respect to how well a business will perform when freed from the expenses and distractions of the Chapter 11 proceeding. This sometimes produces an “offer them anything; just get this nightmare over with” attitude among plan proponents. This can result in excessively optimistic projections and, eventually, in Chapter 22. In addition to plan-proponent fatigue, recovery dumping by distress investors can also contribute to excessive optimism with respect to plan feasibility. Distress investors sometimes acquire claims against debtors at attractively low prices and plan to dispose of any recoveries in the markets as soon as possible after plan confirmation. This strategy encourages such investors to vote in favor of questionable plans. Desiring no long-term stake in the business, they simply expect to realize a gain and immediately transfer the risk of a second bankruptcy to marketplace purchasers. From the perspective of distress investors, the more aggressive the plan expectations, the greater their potential reward.

In the hypothetical scenarios described above, and in other situations, each participant in the plan negotiation process has an incentive to err on the side of optimism. If all constituents support the scheme, then it is in the interest of no participant to derail the plan by submitting evidence at the hearing that might cast doubt on its feasibility. Perhaps the only limiting principle currently in place to guard against situations like these is fear of post-plan prosecution for perjury or fraud.

**Conclusion**

All of this produces a conundrum for the courts. Should courts intervene during plan confirmation hearings and ask detailed questions regarding evidence offered to establish feasibility? Should courts do so even if no one at the hearing is contesting the plan? Do courts risk a loss of public confidence if they fail to do so?

Even if a court were to require additional evidence of feasibility at a plan confirmation hearing, such a requirement would likely result only in the presentation of substantially similar evidence that the reorganized debtor could or could not reasonably be expected to “make it.” How is the court to decide? Who can predict stock markets, commodity prices, or business cycles? Fortunes are made and lost by sophisticated investors with their own money at risk, with extensive and expensive advisory resources, and with considerable time to weigh various investment strategies. That fortunes are sometimes lost indicates that forecasters sometimes make major mistakes. How can a busy bankruptcy judge with little
time to conduct a complex confirmation hearing be expected to be as
good as—let alone better than—investment seers who, incidentally, are
sometimes right and sometimes wrong?

Undoubtedly, there are instances of confirmed Chapter 11 plans
that turn out to be unfeasible despite court findings to the contrary.
Yet given the uncertainties of investment projections, the vicissitudes
of markets, and other imponderables, is the fact that some Chapter 11
plans end up failing a greater evil than the various alternatives—such
as excessively conservative capital structures or liquidation with its
rapid, attendant loss of numerous jobs? Opinions differ on this issue.
Nevertheless, one fact remains: Chapter 11 is almost by its very
definition a hit-or-miss venture. Consequently, it misses occasionally.

Some confirmed Chapter 11 plans fail. So what?
NO EASY ANSWERS: SMALL BUSINESS
BANKRUPTCIES AFTER BAPCPA

Hon. James B. Haines, Jr.*
Philip J. Hendel**

Abstract: Among the changes the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 brings to the Bankruptcy Code are a host of new burdens on small business debtors attempting to reorganize under Chapter 11. This Article examines those provisions affecting small business debtors and outlines suggestions for navigating through the new requirements without jeopardizing a small business’s chances for a successful and expeditious reorganization. In particular, this Article argues for the formation of active prepetition creditors’ committees for those businesses that intend to seek Chapter 11 protection. Finally, this Article suggests that a potential solution to the problems faced by small business lies in expanding Chapter 12 to permit non-agricultural small businesses to fall within its protection.

INTRODUCTION

With the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), the future looks more troubled than ever for the small business in financial distress. Although BAPCPA was trumpeted on its way to passage as a legislative solution to perceived widespread abuse in the consumer bankruptcy

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arena, the legislation also heavily affects business reorganizations, particularly small business reorganizations.²

Although the historical concerns underlying past initiatives to reform small business reorganizations³ have worth, and although some pre-BAPCPA initiatives reduced the time and expense of Chapter 11 practice, we believe that the value of BAPCPA’s reforms is outweighed by the procedural burdens the statute imposes on small business debtors. The Chapter 11 process is now chock full of new postpetition documentation, reporting, and related requirements, while, at the same time, it invites early contests where the debtor will bear the burden of proving its reorganizational mettle. The result places potentially debilitating burdens on small business debtors that embark on statutory reorganization in financial extremis.

At the same time, BAPCPA fails to offer the one truly innovative reform that could streamline small business reorganizations: availability of a Chapter 12-type model for plan confirmation under the auspices of an independent, non-operating trustee, without the necessity of creditor solicitation and voting.

Part I of the Article summarizes the key recent changes to the Bankruptcy Code affecting the small business debtor and general BAPCPA provisions affecting such debtors.⁴ Part II then makes a series of practical suggestions for courts and lawyers regarding the treatment of small business debtors under the Bankruptcy Code.⁵

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³ We will discuss more precisely the contours of small business reorganizations below. For now, the reader should know that BAPCPA singles out debtors with less than $2,000,000 aggregate, noncontingent, liquidated, secured, and unsecured debt (other than debt to affiliates and insiders) for potential special treatment as a small business. BAPCPA § 432, 119 Stat. at 110 (to be codified at, and amending, 11 U.S.C. § 101, adding § 101(51D)). We recognize, too, that many individual bankruptcies (generally characterized as “consumer” cases) are, in truth, the result of business failure. See Robert M. Lawless & Elizabeth Warren, The Myth of the Disappearing Business Bankruptcy, 93 Cal. L. Rev. 743, 747 (2005). We will not attempt to treat the myriad issues unique to individual Chapter 11 cases.

⁴ See infra notes 6–83 and accompanying text.

⁵ See infra notes 84–123 and accompanying text.
I. PROBLEMS FOR THE SMALL BUSINESS DEBTOR UNDER THE BANKRUPTCY CODE

A. Summary of Recent Concerns and Suggested Reforms Concerning Small Businesses in Chapter 11

The small business changes wrought by BAPCPA are a product of longstanding frustration with the suitability of the Bankruptcy Code’s Chapter 11 for small enterprises. In the years since the Bankruptcy Code’s passage, a number of bankruptcy courts effected their own reforms, attempting to streamline reorganization for small businesses, and Congress in 1994 passed what proved to be an unsatisfactory attempt to tailor Chapter 11’s processes to the needs of small business cases.

Throughout the 1980s and 1990s, observers commented that the Bankruptcy Code’s “one-size-fits-all” reorganization chapter, in which mom-and-pop stores followed the same reorganization steps as Fortune 500 conglomerates, saddled small businesses and closely held enterprises with a cumbersome, expensive, and slow-moving procedure. The pre-BAPCPA reforms were aimed chiefly at reducing the time debtors spent in Chapter 11, by accelerating reorganization through a combination of early status conferences with the court, firm (and early) deadlines for filing a plan, quick disapproval—or conditional approval—of disclosure statements, plan solicitation using

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11 See Clark, supra note 8, at 176–77; LoPucki, supra note 9, at 730–31, 744–45; Small, supra note 9, at 305–06.
a conditionally approved disclosure statement, and a combined hearing addressing both final approval of the disclosure statement and plan confirmation. The 1994 amendments to the Bankruptcy Code provided clear statutory authority for such reforms, but left it to the debtor to elect small business, or “fast track,” treatment. Experience proved that, although the fast-track treatment could be the best medicine to enhance a reorganizing debtor’s prospects, it was not a medicine debtors were inclined to self-administer. The treatment required prescription. BAPCPA wrote the script, and more.

A second objective of pre-BAPCPA reform efforts was to identify early, and weed out, cases for which there was no reasonable likelihood of reorganization. The reformers considered that a bankruptcy judge’s disciplined use of status conferences early in a case, combined with procedural orders designed to expedite the case’s travel to confirmation and more comprehensive post-filing financial reporting, would prevent these so-called “dead-on-arrival” debtors from languishing in Chapter 11 to no good end.

The National Bankruptcy Review Commission (“NBRC”) embraced many reform initiatives in its 1997 report. For what it considered to be the “relatively small proportion of cases in which the debtor has a reasonable likelihood of confirming a plan and succeeding as a

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12 See Small, supra note 9, at 307–11. Judge Small is credited with pioneering efforts to streamline Chapter 11 for small businesses in the Eastern District of North Carolina.

13 The 1994 amendments included a statutory definition of “small business” as operating companies with aggregate, noncontingent, liquidated, secured, and unsecured debts less than $2,000,000. 11 U.S.C. § 101(51C) (2000), amended by BAPCPA, Pub. L. No. 109-8, § 432(a), 119 Stat. 23, 110. Qualifying debtors could elect small business treatment. 11 U.S.C. § 1121(e) (2000), amended by BAPCPA § 437, 119 Stat. at 113. The election reduced the exclusivity period for filing a plan (from 120 to 100 days) and for plan confirmation (from 180 to 160 days), id., but authorized the debtor to obtain conditional approval of its disclosure statement, solicit plan acceptances with the conditionally approved statement, and proceed to a hearing at which final approval of the disclosure statement and confirmation would be considered together, 11 U.S.C. § 1125(f) (2000), amended by BAPCPA § 431, 119 Stat. at 113.

14 Most debtor’s counsel preferred not to elect mandatory shortened deadlines for plan filing and confirmation. They understood, also, that an involved judge could impose early deadlines, but they expected that to happen only after a status conference and a case-specific determination. Of course in those jurisdictions adopting Judge Small’s procedures, small business debtors were automatically fast tracked when their size put them within the small business category.

15 See infra notes 23–58 and accompanying text.


17 See LoPucki, supra note 9, at 749–52.
going business,” it recommended simplifying disclosure and plan confirmation; mandating prompt plan filing and confirmation; and requiring additional, regular reports of operations, with increased oversight from the Office of the U.S. Trustee.\textsuperscript{18} As for the balance of Chapter 11 cases (the dead-on-arrival cases), the Commission recommended other reforms with the objective of ousting them from Chapter 11, by conversion or dismissal, as early in the case as possible.\textsuperscript{19}

The essential conclusion of the Commission’s recommendations,\textsuperscript{20} many of which later were incorporated in BAPCPA, was that “the appropriate use of Chapter 11 is one in which the debtor confirms and materially performs a plan of reorganization.”\textsuperscript{21} The Commission did not decide that Chapter 11 was any better suited for “orderly liquidations” than Chapter 7, and stated that “[a] case which is converted . . . after a lengthy, inconclusive protection of the debtor in possession . . . should not be considered a success.”\textsuperscript{22}

Of course, there is quite a gap between a confirmed, consummated plan and dismissal or conversion after lengthy, inconclusive delay. Success comes in many forms. To say that confirmation and consummation is \textit{the} appropriate use of Chapter 11 ignores, among other things, that the essential purpose of the process is to rehabilitate the debtor while treating creditors fairly. If that can be accomplished with the aid of Chapter 11, but without consummating a plan, is it appropriate to condemn the result?


\textsuperscript{19} \textit{See id.} at 610–13.

\textsuperscript{20} \textit{See id.} at 609–705.

\textsuperscript{21} \textit{Id.} at 611.

\textsuperscript{22} \textit{See id.} The Commission did acknowledge that different measures of success are possible:

Reasonable people differ about how to define ‘success’ in Chapter 11 cases. Some argue that a Chapter 11 case in which no plan is confirmed should be considered successful where the case produces an orderly sale of assets or a negotiated solution without a formal plan. Creditors may define success in terms of distribution amounts or in terms of preserving future dealings with the debtor. The debtor, on the other hand, may define success in terms of job preservation, enhancement of going-concern value, or future returns to equity. The public may define success in terms of overall fairness.

B. BAPCPA and Small Business Debtors

1. The Statutory Small Business Debtor

BAPCPA reflects a legislative determination that dictating how—and when—things get done in a Chapter 11 case will dictate what gets done. This proposition has application generally for reorganizing debtors, but it is particularly true for those falling within the new definition of “small business debtor” set forth by BAPCPA in amended Code § 101(51D). BAPCPA adds the following definition of the statutory small business debtor\(^\text{23}\) to the Bankruptcy Code:

“small business debtor”—
(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date of the order for relief in an amount not more that $2,000,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor, and
(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,000,000 (excluding debt owed to 1 or more affiliates or insiders).\(^\text{24}\)

For our purposes, we can treat this definition as establishing that businesses with less than $2,000,000 in non-insider, non-affiliate debt are statutory small business debtors unless a creditors’ committee has been appointed.\(^\text{25}\)

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\(^{23}\) We use the term “statutory small business debtor” to refer specifically to those entities that fit the new § 101(51D) definition. As discussed below, there are a great many small businesses that fall outside the definition.

\(^{24}\) BAPCPA § 432(a), 119 Stat. 23, 110 (to be codified at 11 U.S.C. § 101(51D)).

\(^{25}\) One could conclude that businesses within the small business debt limit, and for which a committee is appointed, float in definitional limbo, depending on whether its
a. Expanded Duties of the Small Business Debtor

BAPCPA assigns the statutory small business debtor expanded duties.\textsuperscript{26} It must append to its petition, or in an involuntary case file within seven days of the order for relief, “its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return” or file a verified statement that no such documents have been prepared, or that the tax return has not been filed.\textsuperscript{27} It must “attend, through its senior management” and counsel, “meetings” scheduled by the court or the U.S. trustee, “including initial debtor interviews, scheduling conferences, and meetings of creditors” unless the court, after notice and hearing, waives the requirement “upon a finding of extraordinary and compelling circumstances.”\textsuperscript{28} The small business debtor must also timely pay all postpetition taxes, file all tax returns and other “required government filings,” maintain insurance “appropriate to the industry,” and file all “postpetition financial and other reports” required by the Federal Rules of Bankruptcy Procedure or local rule.\textsuperscript{29}

\begin{footnotesize}
\begin{enumerate}
\item[a.] BAPCPA § 436, 119 Stat. at 112–13 (to be codified at, and amending, 11 U.S.C. § 1116).
\item[B.] Id.
\item[C.] Id.
\item[D.] Id.
\end{enumerate}
\end{footnotesize}
b. Enhanced Post-Filing Financial Reporting Requirements for the Small Business Debtor

BAPCPA requires small business debtors to provide enhanced post-filing financial reports.\textsuperscript{30} Periodic reports must address profitability,\textsuperscript{31} cash receipts and disbursements, and the status of postpetition tax returns, tax payments, and administrative expense payments.\textsuperscript{32} The report must also include financial performance projections and a comparison of actual performance to prior projections, and it must indicate whether the debtor is in compliance with all postpetition requirements of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure.\textsuperscript{33} The reporting must disclose any noncompliance with reporting requirements, any defaults in tax filing and payment, and whether the debtor is current on the payment of administrative expenses.\textsuperscript{34} If shortcomings are reported, the debtor must report “how, at what cost, and when” they will be remedied.\textsuperscript{35}

BAPCPA requires the Judicial Conference to develop report forms and related requirements through the rules enactment process.\textsuperscript{36} BAPCPA also prescribes that the rules and forms be designed to achieve a “practical balance among . . . the reasonable needs of the bankruptcy court, the United States trustee, creditors, and other parties in interest for reasonably complete information;” the debtor’s interest that the reports be “easy and inexpensive to complete;” and “the interest of all parties that the required reports help such debtor understand such debtor’s financial condition and plan the such [sic] debtor’s future.”\textsuperscript{37}

c. Inspections of Books and Records by the U.S. Trustee

After BAPCPA, the Bankruptcy Code now requires the small business debtor to allow the U.S. trustee, or its designated representative, to inspect the debtor’s premises, books, and records “at reason-

\begin{enumerate}
\item Id. § 434(a), 119 Stat. at 111 (to be codified at 11 U.S.C. § 308).
\item “Profitability” is defined as “the amount of money that the debtor has earned or lost during current and recent fiscal periods.” BAPCPA § 434(a), 119 Stat. at 111 (to be codified at 11 U.S.C. § 308(a)).
\item Id. (to be codified at 11 U.S.C. § 308(b)).
\item Id.
\item Id.
\item Id.
\item Id. § 435(a), 119 Stat. at 111–12.
\item Id. § 435(b), 119 Stat. at 112.
\end{enumerate}
able times, after reasonable prior written notice” (unless notice is waivered).  

**d. Expanded Role of the U.S. Trustee**

In order to enable the U.S. trustee to consider the debtor’s viability and business plan early, so that it may explain the debtor’s post-filing duties, and so that it may attempt to negotiate a scheduling order, the U.S. trustee is required to conduct an “initial debtor interview.” On an ongoing basis, the U.S. trustee is to “review and monitor diligently the debtor’s activities” so that it may “identify as promptly as possible whether the debtor will be unable to confirm a plan.” If the U.S. trustee finds “material grounds” for relief under § 1112 (dismissal or conversion) of the Bankruptcy Code, it “shall apply promptly” to the court for such relief.

**e. Exclusivity and Confirmation for Statutory Small Business Debtors**

Under BAPCPA, statutory small business debtors are provided a 180-day exclusivity period, and are required to have filed the plan and disclosure statement within 300 days after entry of the order for relief. Both deadlines are subject to extension, but the debtor must obtain the extension by motion on notice and hearing. The order must be “signed” before the deadline expires and must include a new deadline. In support of the extension motion, the debtor must prove by a preponderance of evidence that “it is more likely than not” that a plan will be confirmed “within a reasonable period of time.”

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38 Id. § 436, 119 Stat. at 112 (to be codified at 11 U.S.C. § 1116); see also id. § 439, 119 Stat. at 113–14 (to be codified at, and amending, 28 U.S.C. § 586(a)) (“[I]f determined to be appropriate and advisable, [the U.S. trustee shall] visit the appropriate business premises of the debtor, ascertain the state of the debtor’s books and records, and verify that the debtor has filed its tax returns . . . .”).

39 BAPCPA § 439, 119 Stat. at 113–14 (to be codified at, and amending, 28 U.S.C. § 586(a)).

40 Id.

41 Id.

42 Id. § 437, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1121(e)).

43 Id.

44 BAPCPA § 437, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1121(e)).

45 Id.

46 Id.
ther mandates that, if the plan complies with Code requirements, the court “shall confirm” the plan “not later than 45 days” after it is filed.\textsuperscript{47}

BAPCPA retains the option for a small business debtor to seek conditional approval of its disclosure statement, with final approval to be considered at the confirmation hearing.\textsuperscript{48} And it goes one better: the court may determine that the plan itself contains adequate information so that a separate disclosure statement is not required.\textsuperscript{49} In addition, BAPCPA anticipates the adoption of standard-form disclosure statements\textsuperscript{50} and directs the Judicial Conference to create an official form for small business debtor disclosure statements.\textsuperscript{51} Conditional approval of disclosure statements, and combined plan/disclosure statements, will likely become the norm for small business debtors, given that plans are expected to be filed contemporaneously with disclosure statements\textsuperscript{52} and that the existing rules governing all Chapter 11 cases now require twenty-five days’ notice for hearings on a disclosure statement’s adequacy\textsuperscript{53} and, thereafter, twenty-five days’ notice for plan confirmation.\textsuperscript{54} Without conditional approval, an integrated plan/statement, or motions to shorten time, the preexisting notice requirements simply do not square up with the new statutory requirement that the small business debtor’s plan be confirmed or denied within forty-five days of the plan’s filing.\textsuperscript{55}

\textbf{f. Restricted Availability of the Automatic Stay}

BAPCPA restricts availability of the automatic stay for small business debtors that have had a case dismissed or a plan confirmed within two years of a second filing.\textsuperscript{56} To gain the benefit of the stay, the debtor must prove that the subsequent filing resulted from “circumstances beyond the control of the debtor” and that a nonliquidat-

\textsuperscript{47} Id. § 438, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1129).
\textsuperscript{48} Id. § 431(2), 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1125(f)(3)).
\textsuperscript{49} BAPCPA § 431(2), 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1125(f)(1)).
\textsuperscript{50} Id. (to be codified at, and amending, 11 U.S.C. § 1125(f)(2)).
\textsuperscript{51} Id. § 433, 119 Stat. at 110–11.
\textsuperscript{54} Fed. R. Bankr. P. 2002(b).
\textsuperscript{55} BAPCPA § 438, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1129).
\textsuperscript{56} Id. § 441, 119 Stat. at 114–15 (to be codified at 11 U.S.C. § 362(n)(1)(B), (C)).
ing plan will be confirmed within a “reasonable period of time.” The restriction also applies to an entity that has acquired substantially all the assets of a small business debtor that meets the mentioned criteria, unless it “establishes by a preponderance of the evidence” that it acquired the assets “in good faith and not for the purpose of evading this paragraph.”

2. General BAPCPA Provisions of Concern to Small Business Debtors

Taken one at a time, the changes for statutory small business debtors, though considerable, may appear more helpful than not. But they must be viewed in context, and the context includes broader Chapter 11 changes, which apply to all reorganizing entities.

a. Expansion of Priority for Administrative Claims

BAPCPA extends administrative priority to accounts payable for goods delivered to Chapter 11 debtors within twenty days of filing and expands the period for reclamation claims to goods delivered within forty-five days of case commencement. Not only will these changes increase the debtor’s administrative debt burden, but they may also serve to frustrate pre-filing cash management strategies.

b. Assurance of Payment for Utility Service Does Not Include Administrative Expense Priority

BAPCPA amends § 366 of the Code to require expressly that a debtor’s “assurance of payment,” which a utility may require in order to continue providing service postpetition, does not include a stipula-

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57 Id. (to be codified at 11 U.S.C. § 362(n)(2)).
58 Id. (to be codified at 11 U.S.C. § 362(n)(1)(D)).
59 We do not attempt encyclopedic recitation of all BAPCPA has wrought for Chapter 11. Rather, we will discuss selected changes that, coupled with the special provisions aimed at the statutory small business debtor, present challenges to the reorganizing small enterprise. See id. § 404, 119 Stat. 23, 104–05 (to be codified at, and amending, 11 U.S.C. § 365(d)(4)). Other revisions to Chapter 11—for example the amendment to § 365(d)(4), which requires assumption of nonresidential real estate leases within 120 days of case commencement, subject only to a ninety-day extension without landlord consent—could be problematic for the small business debtor, but are more likely to have substantial impact in cases of large retail chain debtors. See id.
60 BAPCPA § 1227(b), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 503(b)(9)).
61 Id. § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).
tion providing administrative expense priority. A utility may successfully demand that it be provided assurance in the form of a cash deposit, a letter of credit, a certificate of deposit, a surety bond, or prepayment.

c. Conversion, Dismissal, and Trustee Appointment

All of the debtor’s duties and requirements must be viewed in light of the expanded grounds for conversion or dismissal established by BAPCPA. The new law not only expands the grounds, but it also effects a major change in the burdens of prosecuting and defending such motions—a change that will generate expense and could distract debtors’ management, likely at early stages of reorganization.

Pre-BAPCPA, section 1112 of the Code provided a nonexclusive list of grounds for conversion or dismissal of a Chapter 11 case, including: (1) continuing loss to or diminution of the estate, (2) inability to effectuate a plan, (3) unreasonable delay that is prejudicial to creditors, (4) failure to propose a plan by a court-fixed deadline, (5) repeated denials of plan confirmation, (6) revocation of confirmation, (7) inability to consummate a plan in a substantial manner, (8) material default under the terms of a confirmed plan, (9) termination of the plan, and (10) nonpayment of U.S. trustee fees.

BAPCPA adds to the list and amends it to make reference to statutory deadlines for plan confirmation (discussed above). New grounds for conversion or dismissal include: (1) “gross mismanagement,” (2) failure to maintain “appropriate insurance,” (3) “unauthorized use of cash collateral substantially harmful to 1 or more creditors,” (4) failure to comply with an order of the court, (5) unexcused failure to timely meet reporting requirements, (6) failure to attend the § 341 meeting or a Rule 2004 examination, (7) failure to provide information or attend meetings “reasonably requested” by the U.S. trustee, and (8) failure to “timely” pay postpetition taxes or file tax returns.

62 Id. § 417, 119 Stat. at 108 (to be codified at 11 U.S.C. § 366(c)(1)(B)).
63 Id. (to be codified at 11 U.S.C. § 366(c)(1)(A)).
66 Id. One might reasonably question how necessary the additional grounds are, given that many (for example, failure to pay postpetition taxes and failure to confirm a plan within a given time) come within existing grounds (for example, continuing loss or diminution and inability to effectuate a plan). Moreover, given that the existing list is non-
The most troublesome aspects of Code § 1112, as amended by BAPCPA, are how it curtails the bankruptcy judge’s discretion and how it shifts the burden of proof. Section 1112(b)(1) now provides that, after notice and a hearing,

absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, the court shall convert a case under this chapter to a case under chapter 7 or dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, if the movant establishes cause.67

The new section 1112(b)(4) goes on to identify the nonexclusive list of grounds referred to above as “cause.”68 Before BAPCPA, section 1112 provided that the court “may” dismiss or convert a case, “whichever is in the best interest of creditors and the estate,” if the movant established cause.69

These changes are striking in at least two ways. Among the newly identified grounds establishing cause for conversion or dismissal are what could be relatively minor infractions: being a day late or a dollar short on postpetition taxes, missing (or incompletely submitting) a monthly postpetition operating report, using cash collateral for an off-budget emergent expense that results in missing a payment to a lender, or failing to respond adequately to a “request” of the U.S. trustee. Once cause is established, the court is duty bound to dismiss or convert the case at the movant’s behest, absent “unusual circumstances” demonstrating that conversion or dismissal is not in the best interest of the estate or the creditors.70 It may be the case in some instances that conversion or dismissal is a bad idea for all (or substantially all) the case’s constituents such that other creditors may spring to the reorganization’s defense, but it is far more likely that the debtor will bear the burden of proving up the case against conversion or dismissal. The statute removes the bankruptcy court’s discretion in

67 Id. § 442, 119 Stat. at 115–16 (to be codified at 11 U.S.C. § 1112(b)(1)) (emphasis added).
68 Id. (to be codified at 11 U.S.C. § 1112(b)(4)(A)–(O)).
70 BAPCPA § 442(a), 119 Stat. at 115–16 (to be codified at, and amending, 11 U.S.C. § 1112(b)(2)).
the face of a prima facie showing of cause, and it eliminates from the movant’s case the burden of demonstrating where the best interests of the estate and the creditors lie. This reflects a legislative judgment that the articulated grounds for cause are in the usual case (absent “unusual circumstances”) enough to warrant conversion or dismissal. Among other things, the amendments to § 1112 will embolden disgruntled creditors to make a run at scuttling an infant reorganization. And, in response to each such motion, the debtor will be required to muster proof, at no little expense, of “unusual circumstances” demonstrating that the case should go forward.\footnote{Id. (to be codified at 11 U.S.C. § 1112(b)(2)).} For smaller debtors, including the statutory small business debtor, whose resources are thin and whose creditor body tends to be less sophisticated, § 1112’s new paradigm will be problematic.\footnote{One could argue that the shortened time within which the court must hear (thirty days from filing) and decide (within fifteen days of the hearing’s commencement) conversion and dismissal motions, see id. (to be codified at 11 U.S.C. § 1112(b)(3)), will keep costs down. Such a motion is the dissatisfied creditor’s, or the U.S. trustee’s, nuclear weapon. The debtor will have to scramble mightily to meet it, particularly because the burden of proof lies with the debtor. One might also question why a statute should require such a momentous motion to be heard and determined so quickly. The mandated timeframe provides less time for litigation than 11 U.S.C. § 362 provides for relief-from-stay hearings. Cf. Grella v. Salem Five Cent Savs. Bank, 42 F.3d 26, 31–35 (1st Cir. 1994) (describing how relief-from-stay disputes must be summarily resolved, given the compressed statutory time limits under which they proceed, and explaining how the orders determining them have limited preclusive effect). The same can be said regarding those BAPCPA provisions that now require a confirmation hearing to convene within forty-five days of plan filing and to be decided within thirty days thereafter. The statute provides the court little leeway (absent complete agreement among the parties) to provide time for discovery, litigation, or negotiation.\footnote{BAPCPA § 442(b), 119 Stat. at 117–18 (to be codified at 11 U.S.C. § 1104(a)(3)).} }

The same grounds that will support dismissal or conversion also constitute cause for appointment of a Chapter 11 trustee “if the court determines that appointment of a trustee or an examiner is in the best interests of the creditors and the estate.”\footnote{See supra notes 23–58 and accompanying text.}

3. An Assessment: BAPCPA and the Statutory Small Business Debtor

Recall the panoply of duties the statutory small business debtor must now shoulder: reporting, submitting to inspections, and meeting with the U.S. trustee.\footnote{See supra notes 23–58 and accompanying text.} As to reporting, no one would argue that it is not important for debtors, and some would say particularly for statutory small business debtors, to assemble and provide reporting regarding their finances as early in the case as possible. And no one
would dispute that current reporting of postpetition operations is critically important. But many small business debtors employ outside accountants and bookkeepers for such elementary tasks as payroll and tax filings. No doubt the reporting requirements BAPCPA imposes will increase administrative expenses, either directly or by diversion of in-house manpower. As to pre-filing reports, the debtor may file a verified statement that the expected reports have not been prepared (or taxes not filed), but that will invite contest, discovery, and more administrative expense. Failure to submit timely post-filing reports constitutes cause for dismissal or conversion (or appointment of a trustee), just as the failure to submit timely, accurate reporting of defaults, as required, provides cause for the same.

It is true that “senior management” should be informed about, and invested in, the reorganization process. But small business managers (often the owners) whose businesses are in financial distress can be expected to be devoting as much time as possible to business operations and related matters, like negotiating for financing. Will it really improve the quality of the reorganization to require them to attend all “meetings” scheduled by the court and by the U.S. trustee? Would the fact that their time and attention would be better spent elsewhere because of their close involvement in day-to-day operations qualify as “extraordinary and compelling circumstances” to excuse their attendance, given that their circumstances might well be quite ordinary for their business and similar businesses? Should the debtor be required to file a motion (generating more counsel fees) to obtain a “waiver” from the attendance requirement?

It remains to be seen how the U.S. trustee’s expanded role in the statutory small business case will work out. Certainly, BAPCPA expects (and requires) a great deal from the U.S. trustee. But how will an early U.S. trustee assessment that the reorganization is not “viable” be greeted by the court and by creditors (whose wallets are actually in the case) that have not yet assessed the situation for themselves? To expect deference to the U.S. trustee’s judgment and recommendations at such an early juncture is expecting a lot. And, again, contest-

75 We have yet to compare the new, monthly financial report to the monthly operating statement provided by the U.S. trustee before BAPCPA, but the statutory requirements that the new report include projections, compare actual performance to past projections, and report “profitability” would lead to the conclusion that the new report will be substantially more elaborate than the old.

76 BAPCPA § 442(a), 119 Stat. at 115–16 (to be codified at, and amending, 11 U.S.C. § 1112(b)(4)(F)).
ing any U.S. trustee action or recommendation will cost the debtor in administrative expense.

Under BAPCPA there is much fodder for conversion, dismissal, and trustee appointment motions. Defending those motions requires much of the debtor. The automatic stay, once a given, may not apply (or there will be litigation regarding its application) in small business cases where there has been a prior bankruptcy. Reporting requirements and attendance requirements also will cost debtors. At the same time, many debtors will face other new, large administrative expenses in light of the utility deposit, the forty-five-day reclamation claim period, and the delivery-within-twenty-days administrative expense rule.

BAPCPA does have some positive attributes. It plainly authorizes, and directly encourages, the increased use of status conferences. The possibilities for conditional approval of disclosure statements (or of forgoing them altogether) can expedite the confirmation and reduce costs. Permitting plan solicitation consistent with lawful prebankruptcy activities may be helpful to some debtors, and small business debtors will welcome the expanded 180-day exclusivity period that BAPCPA provides.

In our view, however, the net result for small businesses in Chapter 11, statutory small businesses, and others, will be increased litigation and administrative expense early in the case and increased likelihood that the small business debtor will not survive the cure for its financial ills. For a debtor with all its ducks in a row before filing, BAPCPA may offer a quick trip to confirmation and beyond. But for the larger share of small business debtors, those upon whom the enormity of their distress dawns late and those who do not know how many ducks they have, let alone how to line them up, BAPCPA’s “reformed” reorganization process will prove daunting. The “breathing space” historically pro-

77 Id. § 441(2), 119 Stat. at 114–15 (to be codified at, and amending, 11 U.S.C. § 362(n)(1)).
78 Id. § 417, 119 Stat. at 108 (to be codified at, and amending, 11 U.S.C. § 366(b), (c)).
79 Id. § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 346(c)).
80 Id. § 1227(b), 119 Stat. at 200 (to be codified at, and amending, 11 U.S.C. § 303(b)).
81 BAPCPA § 440, 119 Stat. at 114 (to be codified at, and amending, 11 U.S.C. § 105(d)). The amendment to Code § 105(d)(1) effected by BAPCPA’s § 440 can be characterized as a toothless tiger. See id. Section 105(d)(1)’s new direction to the court is to “hold such status conferences as are necessary to further the expedient and economical resolution of the case.” Id.
82 Id. § 408, 119 Stat. at 106 (codified at 11 U.S.C. § 1125(g)).
83 Id. § 437, 119 Stat. at 113 (to be codified at, and amending, 11 U.S.C. § 1121(e)(1)).
vided by bankruptcy will be reduced to a “panting space,” without real opportunity for the debtor to catch its breath and move forward. Moreover, pre-filing actions taken to prepare for bankruptcy may trigger creditor response in the form of involuntary petition, and those thrown into the small business reorganization stew involuntarily and without adequate preparation will find the going treacherous.

II. PRACTICAL SUGGESTIONS FOR NAVIGATING THROUGH THE SWAMP

Seventy-five percent of the 1465 American Bankruptcy Institute members responding to a 1996 survey came to some unsurprising conclusions with respect to small business Chapter 11 cases.\textsuperscript{84} The following comprise three anchors of the survey results:

1. An attempt should be made to make it easier for small business debtors to preserve a fresh start;
2. An effort should be made to enhance distribution to creditors; and
3. Delays in administration and excessive professional fees and expenses should be avoided.\textsuperscript{85}

These findings facially appear no more controversial than motherhood and apple pie. Upon further reflection, however, there is an inherent inconsistency between preserving a fresh start and enhancing distribution to creditors. Where do you draw the line to prevent an inequity to one constituency in a case, as opposed to (and often at the expense of) another? The solution is not new: the courts must act as the ultimate arbiter. The task is to weigh the various factors that are relevant in every small business case, including the debtor’s background, the adequacy of the debtor’s books and records, and the likelihood that confirmation of a plan will not be followed shortly by another bankruptcy filing.

Looking at the existing small business chapter and the new small business amendments contained in BAPCPA, one questions whether Congress has achieved a fair balance between the rights of creditors and the rights of debtors. If anything, the pendulum appears to have swung in the direction of secured creditors. Undersecured creditors


\textsuperscript{85} See generally id.
with large deficiency claims have always carried a big club in small business bankruptcies, by virtue of their ability to block the general unsecured class’s acceptance of a proposed plan. The new mandatory reporting requirements for small business debtors, in addition to mandatory conversion or dismissal for a number of events deemed “cause” (not the least of which is the “unauthorized” use of cash collateral), stacks the deck even further in favor of secured creditors, which tend to have sufficient financial and professional resources to bring the debtor’s shortcomings to the bankruptcy court’s attention early in the case.

Against this backdrop, it appears that in order to achieve a successful reorganization of small businesses, debtors’ counsel will need to become more imaginative. Now more than ever, there is an extraordinary need to think “outside the box” to achieve a favorable result for one’s client. Counsel must be prepared to pursue and implement alternative remedies well in advance of the filing of a case. The game plan may change midstream, but one thing is a given: the more time counsel has to evaluate the debtor client’s ability to achieve a successful reorganization, the better the chance of success.

The 1994 amendments imposed limited exclusivity and short-term limitations on small business debtors attempting to confirm a plan. It is, therefore, understandable that experienced bankruptcy counsel have avoided using the small business statutory scheme. Unfortunately, Congress has now mandated that almost all businesses that seek Chapter 11 relief with secured and unsecured debts of less than two million dollars use the small business provisions. Congress, perhaps unintentionally, failed to recognize that “small business” today encompasses much more than the ubiquitous mom-and-pop enterprises. The word “large” is not a defined term in the Bankruptcy Code. A “large” case in today’s parlance, however, is considered by most bankruptcy profes-

86 See 11 U.S.C. § 1126(c) (2000) (defining “acceptance” of plan by a class of creditors to require approval of holders of two-thirds in dollar amount, and more than half in number, of claims held by the class).
88 Id. § 442, 119 Stat. at 115–16 (to be codified at, and amending, 11 U.S.C. § 1112(b)).
90 See BAPCPA § 432, 119 Stat. at 110 (to be codified at 11 U.S.C. § 101(51D)) (defining “small business debtor” as any debtor that falls beneath the debt ceiling, in a case where there is no meaningful committee oversight).
cionals to be a public corporation having several millions of dollars of layered secured and unsecured debt, with operations in several locations. The preservation of hundreds, if not thousands, of jobs is at stake in such cases. What is missing from both the prior amendments to the Code and the BAPCPA amendments is a viable process for the rehabilitation of small entities with unsophisticated financial structures and, most often, an unenergized creditor constituency.

A. Thinking Outside the Box

1. Pragmatism Should Prevail: Think Before You File

With the proliferation of lawyers in general, many of the smaller cases today are handled by less-than-experienced counsel. There is little incentive for an experienced bankruptcy boutique or large firm with a bankruptcy department to handle these matters. They are simply not economical. This is unfortunate for small business clients, many of whom end up in a Chapter 11 they cannot afford, often on the advice of counsel who lacks the experience and expertise to appreciate the nuances of small business bankruptcy. Attorneys should be careful not to develop a “file first, think later” mentality, especially because of the inherent conflict between the attorney’s desire to generate legal fees and the client’s need for an expeditious and cost-effective resolution. A Chapter 11 filing motivated by the attorney’s desire for pecuniary gain, however slight, is a particularly insidious breach of professional ethics—capable of repetition, yet evading review. Often the best and least expensive legal advice (though not always the easiest for the client to swallow) is that there is no purpose in attempting to reorganize, and thus nothing to be gained by a Chapter 11 filing.

2. Alternatives to Cash Retainers for Legal Fees

Most lawyers willing to handle a Chapter 11 case require a substantial retainer before filing. Ironically, this payment often serves to rob the small Chapter 11 debtor of the cash it requires in order to procure raw materials and other services necessary for its survival. This situation brings the inherent conflict of interest between attorney and small business client to the forefront. To be sure, retainers are a tried-and-true staple of any insolvency practice. If a cash retainer threatens the client’s prospects for reorganization, however, counsel should consider alternative means of obtaining payment of legal fees—for example, from an outside, third-party source such as a family member of the client, or by means of a security interest in under-
encumbered assets of the business. If a retainer using the “life blood” cash of the business is the only way to go, then counsel should be all the more certain that Chapter 11 is appropriate.

3. Energizing Languid Creditor Committees

Few bankruptcy lawyers used the 1994 small business provisions, as there were simply no tangible benefits to the debtor. With the BAPCPA amendments, however, small business treatment is mandatory if the court determines that the creditors’ committee is “not sufficiently active and representative to provide effective oversight of the debtor.”

Counsel can no longer avoid the small business provisions by opting out, so they will need to be more proactive in assisting the formation of an active creditors’ committee. This will be no easy task. There is typically very little creditor interest in small business cases; it approaches apathy. Trade creditors, as the result of years of frustration in no-asset cases, tend to write off the debts of small businesses that file for Chapter 11 protection. Except in rare cases, usually involving substantial assets, creditors take no active involvement in committee activities. Energizing such a languid creditor body will require substantial prebankruptcy planning, some creativity, and more than a little cheerleading. If it is done right, however, the small business debtor may be able to request creditors with which it has enjoyed a fairly prolonged relationship to act as members of a prepetition committee. This may result in significant time and cost savings.

4. An Active Creditor’s Committee Is Preferable to Heightened Oversight from the U.S. Trustee

Attempting to put together a committee prepetition to ensure active committee participation should also serve to mitigate the harshness

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91 Id.
92 See 11 U.S.C. § 1102(b)(1) (2000) (allowing a prepetition committee to serve as the official committee if it was “fairly chosen” and is “representative of the different kinds of claims to be represented”). Another advantage to selecting one’s own committee prepetition is the possibility of excluding industry competitors from the group of creditors who will be receiving detailed, firsthand information about the debtor’s business operations. Although the bankruptcy court has the ability to protect against the disclosure of trade secrets, see 11 U.S.C. § 107(b)(1) (2000), and to order a change of committee membership when necessary “to ensure adequate representation of creditors” (for example, by excluding a potential committee member who has an interest materially adverse to the estate), BAPCPA § 405, 119 Stat. at 105 (to be codified at 11 U.S.C. § 1102(a)(4)), it can exercise those powers only on motion by a party in interest, and after notice and a hearing.
of BAPCPA’s U.S. trustee provisions. The lack of committee participation in smaller cases usually invites heightened U.S. trustee oversight, which can result in distractions from the debtor’s day-to-day business activity. Under BAPCPA, the problem certainly will be exacerbated because the U.S. trustee is obligated to evaluate small business debtors’ financial viability; even highly experienced professional financial consultants might have a tough time fulfilling that mandate! Although time will tell, it seems that with all of these additional duties, the U.S. Trustee’s office should have little interest in overseeing the debtor’s operations that appear adequately looked-after by an active creditors’ committee. Active participation by creditors, who have a concrete stake in the outcome of the case, should be reassuring to the Office of the U.S. Trustee. Moreover, appointment of an official creditor’s committee will take the debtor directly out of the statutory small business category.

5. Increased Participation of Judges Through Frequent Status Conferences

Bankruptcy judges today have handled a wide variety of small business cases that have some promise for emerging from Chapter 11. They have substantial business savvy. Judges are capable of discerning rather quickly when, and if, conversion or dismissal is in the best interest of all parties. They are also familiar with the ability and trustworthiness of the lawyers appearing before them. Under these circumstances, bankruptcy judges hopefully will play a more proactive role in determining the direction of a small business case from its inception. They can accomplish this by using frequent status conferences, both to acquire a feel for the severity of the problems and to set appropriate deadlines for their resolution. Indeed, § 105(d) of the Code now requires the bankruptcy court to hold “such status conferences as are necessary to further the expeditious and economical resolution of the case,” though the qualifying language “as are necessary” obviously affords the judge wide latitude in determining whether, when, and how often to hold such conferences. The need for judicial discretion in small business cases is great. But, as explained above, BAPCPA has retooled important provisions relating to such critical events as conversion, dismissal, trustee appointment, and

93 BAPCPA § 439, 119 Stat. at 113–14 (to be codified at 28 U.S.C. § 586(a)(7)).
94 See id. § 440, 119 Stat. at 114 (to be codified at, and amending, 11 U.S.C. § 105(d)). Prior to BAPCPA, the use of section 105(d) status conferences was discretionary.
confirmation, reducing or removing the judge’s discretion in such matters.95

6. The Social Benefit of Helping Small Businesses to Survive

There is unmistakably a social purpose that is served by providing some slack to small business debtors. It has been said that the first principle of bankruptcy law is that the insolvent debtor always gains from more time: “Liquidate today and he loses everything, wait until tomorrow and something may turn up.”96 The typical Chapter 11 case provides an invaluable opportunity for a small business debtor to remain in operation, either in its present form or by the creation of a new entity in the event of conversion or dismissal. This makes sense. Saving jobs in small business enterprises, which are disappearing with alarming frequency, may be essential to the preservation of the American way of life. Competition and convenience disappear without them. We know this from common experience in the retail industry. When the small, local business disappears, consumers are left largely with the regional megastores. Less competition usually results in higher prices and poorer service.

B. A Plan for Balancing the Priorities

1. Eliminate the Disclosure Statement Requirement for Cases Under $10 Million

To the extent possible under the Code, the courts must establish new local practices to achieve, economically, the primary goals of the bankruptcy system. Ideally, the disclosure statement requirement in cases under $10 million should be eliminated.97 Does anyone, other than the few professionals involved in the case, read them? Congress, to its credit, has seen fit possibly to eliminate the disclosure statement requirement altogether in cases under $2 million.98 This approach should be modified or expanded to include larger entities.

95 See supra notes 67–73 and accompanying text.
98 See BAPCPA § 431, 119 Stat. at 109–10 (to be codified at, and amending, 11 U.S.C. § 1125(f)).
2. Confirm Plans That Include Alternative Provisions Triggered by the Debtor’s Post-Confirmation Performance

The quality of proof required from a small business debtor in a contested confirmation hearing on the issue feasibility under § 1129 of the Code should be relaxed, particularly in “first time around” cases. Counsel should proffer plans with alternative provisions, which may come into effect based on the debtor’s post-confirmation performance and other conditions. A plan that takes future development and defalcations into account via “fallback” provisions can more readily be considered feasible at confirmation.

3. Permit Prepetition Security Interests to Substitute for Prepetition Retainers

Counsel for smaller business debtors should be afforded the flexibility to structure the payment of their legal fees without taking large retainers prepetition. Where it is otherwise reasonable, counsel’s prepetition security interest in unencumbered or under-encumbered assets of the estate should be respected in bankruptcy unless it presents a genuinely adverse interest to the estate. The First Circuit Court of Appeals sanctioned this approach in 1987, and a number of lower courts nationwide have followed its lead. Carve-outs from secured

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100 See In re Martin, 817 F.2d 171, 181–83 (1st Cir. 1987) (holding that a case-by-case analysis is necessary to determine whether a security interest in estate property is an interest “adverse to the estate” within the meaning of 11 U.S.C. § 327(a)).

creditors’ collateral seem to be almost routine in larger cases and should continue to be used.\textsuperscript{102}

4. Use § 305(a)(1) Abstention Powers More Liberally

Bankruptcy courts should use their abstention powers under section 305(a)(1) of the Code more liberally after the filing of an involuntary petition, particularly when there is likely no benefit to creditors in disturbing an out-of-court workout pursuant to an assignment for the benefit of creditors, a receivership, or a composition agreement. Preference issues are of little concern in many small business bankruptcies, as the debtor has usually been working on a C.O.D. or C.B.D. basis with its suppliers long before the involuntary petition is filed.

5. Negotiate Forbearance Agreements and Moratoria with Creditors Before Filing

Debtors increasingly have the ability to negotiate forbearance agreements with secured creditors. They may also seek a voluntary moratorium from trade creditors, albeit for limited periods of time, outside of bankruptcy. Grace periods recommended by prepetition creditor committees have been particularly successful. Assuming there is a gestation period before the filing of a Chapter 11 case, debtor’s counsel may be able to work out a payment plan acceptable to a small, but active, unofficial committee. This often can be the foundation for a formal plan of reorganization, which can be filed simultaneously with the Chapter 11 petition.\textsuperscript{103} This certainly has a tendency to shore up creditor confidence, and it may prevent serious erosion in business from predatory competitors.

6. Small, Closely Held Corporations May Reorganize Under Chapter 13

It may be feasible in some cases for a “micro” business debtor, operating as a closely held corporate entity, to dissolve the corporation and assume the business debt as a sole proprietor. It is then pos-
sible for the individual to use the less onerous Chapter 13 provisions for a plan. This has been an effective tool in several cases in the District of Maine.

7. Limit the Use of Independent Accountants for Creditors’ Committees

Courts have the ability to limit the number of professionals in smaller cases. Is there always a need for a committee in a small business case to use its own accountant or financial advisors when the total liabilities are small? A court has the ability under § 105(a) to order the debtor’s accountant to provide to a creditors’ committee all information generated for the debtor or the U.S. trustee.

8. Judges Should Exercise Discretion When Approving Counsel’s Fees

A court has the ability by local rule to increase the threshold on the amount of fees that must be individually categorized in a Chapter 11 fee application. The cost of preparing categorized applications is perhaps out of proportion to the benefits, if any, to be obtained in small cases. Certainly, judges have the ability to pass judgment on the skill of the professionals involved in a case and to make decisions that are reasonable and fair to counsel when the services and expenses are detailed in the fee application.

9. Standardization of Disclosure Statements Utilizing Local Rules

When disclosure statements are required, it would be helpful to adopt a standard form under local rules, which will greatly eliminate the usual contentiousness (much of which is petty) and the need for

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104 See 11 U.S.C. § 1325 (2000), amended by BAPCPA §§ 107, 213, 306, 309, 318, 716, 119 Stat. at 33–35, 53, 80, 83, 93–94, 129. In Chapter 13, creditors do not vote on the plan. Instead, the court determines whether the Chapter 13 filing and proposed plan were in good faith, whether the plan is feasible, and whether the plan satisfies the “best interests” test by providing all claimants with property of a value (over time) at least equal to what they would receive in a hypothetical liquidation.

105 See, e.g., In re Bois, No. 0-22751 (D. Me. filed Oct. 14, 2005); In re Smith, No. 02-20292 (D. Me. filed Mar. 4, 2002); In re Kinsey, No. 97-20160 (D. Me. filed Feb. 7, 1997); In re Dion, No. 96-21408 (D. Me. filed Sept. 12, 1996); In re Beaudoin, No. 96-02224 (D. Me. filed Sept. 1, 1996).

106 See 11 U.S.C. § 327(a) (requiring court approval to employ professionals in a case).

107 See 11 U.S.C. § 105(a) (permitting the bankruptcy court to “issue any order . . . that is necessary or appropriate to carry out the provisions of” the Bankruptcy Code).

hearings and re-hearings on the issue of adequacy of disclosure under § 1125(a)(1) of the Code. BAPCPA anticipates development of standard forms.\textsuperscript{109}

10. Encourage Solicitation of Plan Approval Prepetition

In small cases, courts should now be able to make it easier for debtors to solicit acceptances of a plan prepetition. A court has the ability to review the nature and extent of pre-filing solicitation and can order the debtor to provide notice to creditors of misleading or incorrect information.\textsuperscript{110} It can punish lawyers for their roles if abuses occur.\textsuperscript{111} To minimize the potential for abuse, debtors should be required to maintain records and copies of all solicitation materials.

III. Expansion of Chapter 12 to Include All Small Business Debtors

Chapter 11’s one–size-fits-all paradigm does not produce efficient results when applied to “small businesses,” however that term may be defined. Reasonable minds differ, however, as to what can be done to ensure the proper functioning of the system in the future.

Apparently the National Bankruptcy Review Commission and the 109th Congress believed that the key to meaningful reform was to erect barriers to ensure that only the worthiest small business debtors make it past the early stages of a Chapter 11 case.\textsuperscript{112} Unfortunately, this approach focuses merely on curbing perceived abuses of the existing system and fails to address the fact that Chapter 11 is generally inhospitable to even the most deserving of small business debtors.

Public companies and small businesses are like apples and oranges, and we need an entirely separate chapter (Chapter 10) to deal with small business bankruptcies. But Congress has consistently rejected this proposal. This rejection comes partially out of fear that having two business chapters with different substantive rules would provoke the same kind of wasteful litigation that Congress sought to prevent when it collapsed Chapters X and XI of the 1898 Bankruptcy Act into Chapter 11 of the Code, enacted through the Bankruptcy Reform Act of 1978.

\textsuperscript{109} BAPCPA § 433, 119 Stat. at 110–11.
\textsuperscript{111} Fed. R. Bankr. P. 9011.
Alternatively, rather than enact a new chapter, Congress could increase the debt ceilings for Chapter 13 and Chapter 12 so that more sole proprietors and farming corporations, respectively, can avail themselves of their provisions. Indeed, Congress made just such an adjustment in 1994 as part of its general small business bankruptcy reform. But casting a wider net with the hope of rescuing more (but not all) small business debtors from the perils of Chapter 11 leaves us with a rather schizophrenic system that draws very meaningful distinctions along rather arbitrary lines—specifically, the debtor’s choice of business entity. Thus, under the current regime, the rule could be stated as follows: a debtor who does business as a sole proprietor may use Chapter 13 or Chapter 11 unless the debtor has too much debt, in which case he or she must use Chapter 11, but a debtor who does business in corporate form (or as a partnership) must use Chapter 11, unless it is a farm (or fishing enterprise) without too much debt, in which case it may use Chapter 12.

The future of small business bankruptcy lies not in raising the debt ceilings for Chapters 12 and 13, but rather in substantively expanding Chapter 12, with some modification, to include closely held business corporations and partnerships. This approach makes sense for several reasons.

The overwhelming majority of ABI members who responded to the 1996 survey reported that excessive delays and excessive professional fees were the most serious impediments to the successful use of Chapter 11 by small business entities.113 A majority of the ABI respondents opposed the appointment of an independent financial advisor in reorganization cases to analyze and provide information to the court and creditors concerning the debtor’s financial condition and viability. Finally, ABI members strongly supported the “cramdown” power and the “new value exception” to the absolute priority rule.114 In fact, eighty percent of those polled—debtors’ and creditors’ attorneys alike—supported the proposition that the bankruptcy court should be able to confirm a plan even though no impaired class accepts it.115

Chapter 12, a close cousin to Chapter 13, offers an economical alternative to Chapter 11. Consider the following:

1. Chapters 12 and 13 are tried and tested. The checks and balances between debtor and creditor interests seem to work well, and

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113 See Am. Bankr. Inst., supra note 84.
114 Id.
115 Id.
there have been few complaints of substantial abuse by any constituency.

2. Initially, problematic issues, such as what constitutes “disposable income” under sections 1225 and 1325 of the Code or what constitutes “property of the estate” under sections 1207 and 1306, are now fairly well-settled under caselaw. The availability of this body of caselaw interpreting the provisions of Chapters 12 and 13 should allay some of the fears that drove Congress to reject the enactment of Chapter 10—namely, that a new chapter would add unnecessary complexity to the Bankruptcy Code, and would generate more than its fair share of litigation as the contours of the new chapter were explored by parties and their counsel.

3. Chapter 13 trustees are already experienced in dealing with business cases involving sole proprietors. Chapter 12 trustees already have substantial experience administering business cases involving family farming corporations, many of which concern business operations that are far more complex than those of most small corporate debtors. Thus, whether the U.S. Trustee’s office appoints a standing trustee to administer Chapter 12 small business cases or appoints a panel trustee in each small business case, the trustees ought to be able to handle the new responsibility with limited additional training and with help from business analysts from the U.S. Trustee’s office.

4. As previously discussed, and as U.S. trustees and administrators can attest, little creditor interest exists in small business cases. Only a small number of cases evoke sufficient interest to form an active creditors’ committee. From experience, creditors believe (with good reason) that the ultimate “pay out” in a case simply will not justify any investment of their time. In a small business Chapter 12 case, the trustee would look after the interests of creditors. Under appropriate circumstances, the trustee could oust the debtor from possession and seek conversion or dismissal, or some other remedy on behalf of the creditors.

5. The absence of an active creditors’ committee in smaller cases historically imposed a substantial burden on the U.S. trustee to monitor these cases in the public’s interest. BAPCPA increases this burden significantly. Given that the U.S. trustee already bears such a burden, the additional responsibility created by an increase in the number of Chapter 12 cases should not be significant.

6. Even when disclosure statements are approved and plans are filed in small business Chapter 11 cases today, relatively few unsecured creditors bother to cast ballots either for or against a plan. Depriving creditors of the vote in a small business Chapter 12 proceeding logi-
cally should not bring cries of alarm, especially given the amount of oversight provided by the U.S. trustee.

7. As noted by the NBRC, most small business Chapter 11 cases fail, although they typically die a lingering death.\(^\text{116}\) As they filter through the system, substantial administrative fees and expenses are paid to the professionals. When the well runs dry, the cases die from dehydration. When they finally convert to Chapter 7, the unsecured creditors rarely receive a dividend. Because creditors do not vote on Chapter 12 plans, a Chapter 12 small business case would not generate the kind of administrative expenses (for example, creditors’ committee counsel and plan solicitation materials) that are common in Chapter 11. This, combined with the accelerated timeline of Chapter 12, would mean that more assets would be available to creditors if the Chapter 12 reorganization failed and was followed by a Chapter 7 liquidation.

8. The absolute priority rule in a small business case offers little real protection to creditors. This is true even using the budding practice evolving from the dictum provided by the Seventh Circuit Court of Appeals in the 1997 case *In re 203 North LaSalle Street Partnership*.\(^\text{117}\) Is it relevant to creditor interests whether the reorganization plan of an electrician with four employees offers others an equal chance to purchase the “equity” of the debtor corporation? Realistically, the market for this equity is “virtually nonexistent” because most companies have little or no value after their owner-managers have been ousted by the hypothetical high bidder.\(^\text{118}\)

These facts suggest that closely held corporations and other business entities are good candidates for Chapter 12 using conservative debt thresholds such as those applicable to Chapter 13 debtors. So, for instance, a corporation or other business entity would qualify for Chapter 12 relief if its noncontingent, liquidated, unsecured debts were less than $307,675 and its noncontingent, liquidated, secured debts were less than $922,975.\(^\text{119}\) This criterion creates a bright-line test for eligibility.

A significant number of all potential reorganization cases might qualify for Chapter 12 treatment. Although a debtor probably would not choose Chapter 11 over Chapter 12 (except for purposes of delay, which BAPCPA seems to have eliminated), Congress should make

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\(^{117}\) See 126 F.3d 955, 963–67 (7th Cir. 1997).

\(^{118}\) LoPucki, *supra* note 9, at 758.

Chapter 12 mandatory for corporate and other business entities with the exception of sole proprietorships, which would still be able to use Chapter 13. A two- or three-year sunset provision would create closure if the Chapter 12 provisions failed to provide the speedy, equitable and efficient results intended.

Congress did not contemplate general business entities when it enacted Chapter 12. Consequently, allowing general business entities to seek Chapter 12 relief would require some modification to prevent debtors from abusing the present statutory scheme. For instance:

1. A corporation or other business should not be able to dismiss a case as of right under §1208(b). The court should allow dismissal only “for cause” and after notice and a hearing.

2. Small business entities should be entitled to a discharge or a permanent injunction against enforcement of prepetition dischargeable debt upon successful completion of plan payments. Granted, a Chapter 11 discharge kicks in at the moment of confirmation because the debtor needs to finalize its debt structure forevermore. But small businesses traditionally do not have the same pressure for constant financing and refinancing. Moreover, actual receipt of plan payments should be viewed as the quid pro quo for the relinquishment of creditor voting rights. Thus, there should be a delay in the granting of a discharge in small business cases until the debtor has completed payments under the plan.

3. A business should have sixty days to file a plan and another sixty days to obtain its confirmation. The court should extend these deadlines only for cause shown.

4. A business debtor should be required to file a mini-disclosure statement with the court at least fifteen days before the confirmation hearing. The disclosure statement should include monthly cash flow and profit and loss projections for one year following the date set for confirmation of the plan. This would afford the creditors a reasonable opportunity to formulate objections to the debtor’s proposed plan before the confirmation hearing, and it would serve as the quid pro quo for excluding creditors from voting and oversight of the debtor through committee membership.

5. Chapter 12 should not require a business debtor to pay secured creditors and post-confirmation business debts through the Chapter 12 trustee, even though payments emanate from future in-

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120 C.f. 11 U.S.C. § 1221 (providing ninety days to file a plan).
come generated by the debtor in the normal course of business. This would involve amending § 1222(a)(1).

6. A fair-market standard should govern valuation of a business entity’s real estate. That would produce an equitable result, given that undersecured creditors in Chapter 12 would lose both their right to make the § 1111(b) election and any opportunity to vote against the debtor’s plan or to propose a plan of their own.

7. Chapter 12 should empower the U.S. trustee, with leave of court, to pursue claims against principal officers or other insiders of a corporate or general partnership debtor.

8. Congress should expand the U.S. trustee’s right to commence an action against third parties to three years after confirmation of the debtor’s plan.

9. A business debtor should not be able to invest in new equipment, machinery, business vehicles, or other capital assets during the pendency of the case without the U.S. trustee’s prior authorization. In the event the parties fail to reach an agreement, the courts should review the U.S. trustee’s decision to withhold authorization de novo.

10. Single-asset real estate entities, as defined under § 101(51B), should not qualify for Chapter 12 relief.

11. Congress must relax § 327(a)’s strict disinterestedness requirements for debtor representation in small entity cases. The Code should not disqualify a professional from representing a debtor merely because of existing, unpaid prepetition fees and expenses. Prior representation of a creditor in an unrelated matter against the debtor also should not disqualify the professional from such representation. Absent an actual conflict of interest, a professional should be permitted to represent a corporate or other business debtor in Chapter 12 cases. Disqualification should not be automatic.

12. Congress should amend § 1201(a) to prevent a Chapter 12 business entity from having the ability to convert to Chapter 11.

13. Congress should amend § 1208 to provide that, after conversion or dismissal, a Chapter 12 small business entity may not file another case under this chapter for a period of three years from the date of the confirmation or dismissal.

14. Congress should amend § 303(a) and (b) to permit involuntary Chapter 12 petitions against closely held corporations and other debtors engaged in business.
This proposal, in much the same form, was presented to—and almost summarily rejected by—the NBRC. The Commission concluded that Chapter 11 was “the most legitimate way to address creditors’ rights.” The bulk of its reasoning appeared in a footnote:

The absolute-priority rule and plan-voting concept are important tools which legitimize Chapter 11 by protecting creditors, in reality or by perception, from unfair treatment by debtors. The Commission believes that these creditor protections, albeit largely illusory, are fundamental to the Bankruptcy Code’s careful balance between debtor and creditor rights. Furthermore, the Commission favors maintaining these creditor safeguards to recommending adoption of plan confirmation based on “disposable income” payments, which would likely (i) clog the courts with complex, fact-sensitive litigation about income projections of businesses, and (ii) generate strong opposition in Congress, as did similar legislation proposed as part of the Chapter 10 amendments in 1994.

It is difficult to imagine how “illusory” protections can, at the same time, be “fundamental” to the balance of debtor-creditor rights. It is also difficult to imagine how a body of creditors that is admittedly apathetic toward the bankruptcy process would become energized in Chapter 12 so as to “clog the courts” with litigation concerning debtors’ income projections. Moreover, no such litigation epidemic has arisen with respect to family farmers in Chapter 12, notwithstanding the inherent difficulty of projecting farm income (which depends, among other things, upon weather conditions over which the farmer has no control). And although Congress might bristle at the suggestion of taking away the creditor vote and absolute priority rule in small business cases, Congress has demonstrated a willingness to dispense with those “fundamental” creditor protections when the circumstances demanded it, as with family farmers and family fishermen. Hopefully, before the plight of small businesses in Chapter 11 reaches a crisis level, Congress will see fit to provide meaningful relief by expanding Chapter 12 to include those who admittedly have had little political clout to protect their own interests.

122 Id.
123 Id. at 616 n.1573 (emphasis added).
Conclusion

Financially distressed small businesses are likely to find it more difficult than ever to reorganize successfully under BAPCPA. BAPCPA imposes a plethora of new burdens on the small business debtor. To achieve a fair, meaningful result for clients, counsel will have to employ innovative, proactive strategies, including pre-filing formation of informal creditors’ committees and plan negotiations. The ambiguities and uncertainties created by the new legislation, coupled with the burdens it imposes, demonstrate the need to renew efforts to inform Congress of the economic benefits of small business reorganization, and the need to provide utilitarian avenues for it, including an amended, expanded Chapter 12 procedure. Chapter 12’s streamlined process has worked successfully for family farmer reorganizations, maintaining appropriate checks and balances on creditor and debtor interests without imposing unnecessary complication and expense. There is no reason to believe that a Chapter 12-like process could not well serve distressed small businesses and their creditors.
**THE EVOLVING BANKRUPTCY BENCH: HOW ARE THE “UNITS” FARING?**

Ralph R. Mabey*

**Abstract:** Life on the bankruptcy bench has evolved in recent years. This Article examines these changes from the perspective of bankruptcy judges themselves. Randomly selected bankruptcy judges were surveyed on a variety of topics including law clerks, job satisfaction, case management, bankruptcy appellate panel service, prior career, and publication of opinions. This Article compiles and analyzes the results of those surveys, and concludes that, overall, bankruptcy judges are satisfied and appear resilient to the changes and frustrations facing the bench.

**INTRODUCTION**

The “units”1 that are the bankruptcy bench are evolving. In recent years, the composition of the bankruptcy bench has changed dramatically: consumer bankruptcy case filings have increased; the once-ubiquitous hierarchical distinctions between district court judges and their bankruptcy court colleagues have blurred considerably; greater numbers of permanent (or “career”) law clerks are being hired; bankruptcy judges are performing dual judicial roles as trial judges and appellate judges; and many bankruptcy court chambers are now paperless. This Article assays some of these changes by the

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1 Section 151 of title 28 provides:

In each judicial district, the bankruptcy judges in regular active service shall constitute a unit of the district court to be known as the bankruptcy court for that district. Each bankruptcy judge, as a judicial officer of the district court, may exercise the authority conferred under this chapter with respect to any action, suit, or proceeding and may preside alone and hold a regular or special session of the court, except as otherwise provided by law or by rule or order of the district court.

numbers and from the perspective of bankruptcy judges. Bankruptcy courts and bankruptcy judges are continually being asked to adapt. To do so, they are sacrificing some of the traditional accoutrements of the bench in favor of increased efficiency and productivity.

After first describing the general state of the current bankruptcy bench, this Article reports some findings of an informal survey of a group of bankruptcy judges. These findings center on the use of law clerks, judicial job satisfaction, case management techniques, bankruptcy appellate panel service, judges’ prior careers, and the publication of opinions.

I. The Nuts and Bolts of the Bankruptcy Bench

There are ninety bankruptcy court districts and 372 statutorily authorized bankruptcy judgeships within those districts, twenty-eight of which are presently designated “temporary” judgeships. This total includes the additional bankruptcy judgeships authorized in the Bankruptcy Judgeship Act of 2005, under which the Federal Judicial Code is amended: (i) to authorize appointments for additional temporary bankruptcy judgeships in California, Delaware, Florida, Georgia, Maryland, Michigan, Mississippi, Nevada, New Jersey, New York, North Carolina, Pennsylvania, Puerto Rico, South Carolina, Tennessee, and Virginia; (ii) to extend temporary bankruptcy judgeship positions authorized for the northern district of Alabama, the districts of Delaware and Puerto Rico, and the eastern district of Tennessee; (iii) to provide for one additional (permanent) bankruptcy judge each for the eastern district of California, the southern district of Georgia, the eastern district of Michigan, the southern district of Mississippi, the district of Nevada, the district of New Jersey, the eastern district of New

2 Unless otherwise indicated, citations in this Part are taken from profiles of the bankruptcy bench materials generously provided by Francis F. Szczebak, Chief of the Bankruptcy Judges Division of the Administrative Office of the United States Courts. Administrative Office of the Courts, Materials Discussing Bankruptcy Bench (Apr. 15, 2005) (on file with author) [hereinafter AO Materials].

3 Temporary judgeships are temporary to the district, not to the bankruptcy judge. A temporary judgeship is one in which a vacancy occurring five or more years after the appointment of an individual bankruptcy judge resulting from the death, retirement, resignation, or removal of the bankruptcy judge shall not be filled. See AO Materials, supra note 2; see also Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1225(b), 119 Stat. 23, 196–98 (to be codified at, and amending, 28 U.S.C. § 152(a)) [hereinafter BAPCPA].

In addition, there are a fluctuating number of retired bankruptcy judges serving on recall. See AO Materials, supra note 2.
York, the northern district of New York, the southern district of New York, the eastern district of North Carolina, the eastern district of Pennsylvania, the middle district of Pennsylvania, the district of Puerto Rico, the district of South Carolina, the western district of Tennessee, the eastern district of Virginia; (iv) to provide for two additional bankruptcy judges for the southern district of Florida; (v) to provide three additional bankruptcy judges for both the central district of California and the district of Maryland; and (vi) to provide four additional bankruptcy judges for the district of Delaware.\(^4\)

Of the bankruptcy judges, approximately 22\% are female.\(^5\) The ages of the bankruptcy judges range from thirty-eight to seventy-nine, with two retired judges, each of whom is eighty-nine, presently serving on recall.\(^6\) The longest serving bankruptcy judge has thirty-six years of service.\(^7\)

Most of the bankruptcy judges were bankruptcy practitioners in their prior careers.\(^8\) A handful were state court or magistrate judges.\(^9\) About 115 bankruptcy judges, 35\% of the bench, have left the bench in the last ten years: seventy-eight retired; twelve resigned; eight were appointed to Article III judgeships; seven died while in office; and ten were not reappointed.\(^10\)

The annual salary for bankruptcy judges is currently $149,132.\(^11\)

The bankruptcy courts’ clerks’ offices are staffed with 5000 deputy clerks.\(^12\) The number of deputy clerks for each district is determined by


\(^5\) For comparison purposes, in 1985, although there were fewer bankruptcy judges overall, there were only fifteen female bankruptcy judges. AO Materials, supra note 2.

\(^6\) Id.

\(^7\) See id. The longest continuously serving bankruptcy judge is the Honorable John L. Peterson, United States Bankruptcy Judge, United States Bankruptcy Court for the District of Montana. Judge Peterson retired in 1999 as the Chief Judge in Montana, but he continues to serve as a bankruptcy judge in that district on recall status. See Judge Peterson Wins Jameson Award, Mont. Law. Mag., Sept. 2003, available at http://www.montanabar.org/montanalawyer/september2003/peterson.html.

\(^8\) AO Materials, supra note 2.

\(^9\) Id.

\(^10\) Id.


\(^12\) AO Materials, supra note 2.
a work measurement formula based upon the district’s caseload.\textsuperscript{13} For a while, the number of deputy clerks increased at a rate proportional to the increase in bankruptcy filings.\textsuperscript{14} In 2004, however, due to budget constraints, 1350 staff members were eliminated from bankruptcy court, district court, and probation and pretrial services offices.\textsuperscript{15}

Over the course of the last twenty-four years, total bankruptcy filings have increased from 331,265 in 1980 to more than 1.5 million in 2004.\textsuperscript{16} Chapter 11 business bankruptcy filings have declined in recent years, going from about 21,400 in 1986, to 20,800 in 1991, to 10,600 in 2001, to 8500 in 2003, to 9200 in 2004.\textsuperscript{17} This data will provide baseline comparisons for the stark changes expected from the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Section 158(a) of title 28 provides that district courts have jurisdiction to hear appeals from final judgments and other orders of the bankruptcy court.\textsuperscript{18} Section 158 further provides that the judicial council of a circuit “shall [absent contrary findings] establish a bankruptcy appellate panel service composed of bankruptcy judges of the districts in the circuit who are appointed by the judicial council . . . to hear and determine, with the consent of all the parties, appeals under subsection (a) of [Section 158].”\textsuperscript{19} Appeals from bankruptcy courts to the district court under Section 158 have steadily declined over sixteen years from 4300 in 1988 to about 2800 in 2004, attributable, in part, to the establishment of bankruptcy appellate panels in four of the circuits.\textsuperscript{20}

Section 157 of title 28 provides for withdrawal of certain proceedings from the bankruptcy court under certain circumstances.\textsuperscript{21} From

\textsuperscript{13} Id.
\textsuperscript{14} Id.
\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} AO Materials, \textit{supra} note 2. A chart showing total filings across various categories and chapters is found in Appendix B.
\textsuperscript{19} Id. § 158(b).
\textsuperscript{21} See 28 U.S.C. § 157(d). Section 157(d) of title 28 provides:

The district court may withdraw, in whole or in part, any case or proceeding referred under this section, on its own motion or on timely motion of any party, for cause shown. The district court shall, on timely motion of a party, so withdraw a proceeding if the court determines that resolution of the proceed-
1988 to 2004, the number of proceedings withdrawn from a bankruptcy court to a district court has varied widely.\textsuperscript{22} For example, in 1988, the number of proceedings withdrawn was about 1700 (the highest number in the sixteen year period), whereas, in 2001, the number was 431 (the lowest number in the sixteen year period).\textsuperscript{23} In 2004, the number of proceedings withdrawn was roughly 1300.\textsuperscript{24} The explanation for the variance is not clear, but the 2004 fluctuation may be tied to the strategies pursued in a few large cases.

II. The Survey

To get a sense of life on the bankruptcy bench and the perspectives of the bankruptcy judges themselves, we prepared an informal survey (the “Survey”) centered on the following areas: (i) law clerks; (ii) judicial job satisfaction; (iii) case management; (iv) bankruptcy appellate panel service; (v) prior career; and (vi) publication of opinions.\textsuperscript{25} The results from the Survey are set forth below in narrative form and organized according to these main areas.

A. The Survey Methodology

The bankruptcy judges who participated in the Survey were randomly selected. We compiled a list alphabetized by last name of the bankruptcy judges as of May 31, 2005. We then drew two numbers between one and fifty—the first representing the starting point for the random selection process and the other representing the increment between selections. We selected thirty-seven for the former and thirteen for the latter, meaning that we started the random selection pro-

\begin{footnotesize}
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\item \textsuperscript{22} A chart showing appeals and withdrawals is found in Appendix C.
\item \textsuperscript{23} AO Materials, supra note 2.
\item \textsuperscript{24} Id.
\item \textsuperscript{25} While this survey is far from comprehensive, perhaps it will provide the groundwork for a more comprehensive survey in the future. As far as the author is aware, no one has recently undertaken a comprehensive survey of members of the bankruptcy bench. The Federal Judicial Center (the “FJC”) has underway a judicial evaluation study. Telephone Interview by Adelaide Maudsley, with Beth Wiggins, Federal Judicial Center (Apr. 15, 2005). Participation by bankruptcy judges in the FJC study is voluntary. See id. The FJC survey is targeted at mid-term bankruptcy judges (those about five to eight years into their term) and seeks to gauge how they are doing, what improvements might need to be made, and whether they are on track for reappointment. See id. The FJC undertook the study partly in response to the number of bankruptcy judges who were not reappointed. See id.
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\end{footnotesize}
cess with the bankruptcy judge numbered thirty-seven on the alphabetical list and then proceeded to select every thirteenth bankruptcy judge thereafter. Through this random selection process, we compiled a list of thirty-nine bankruptcy judges for participation in the Survey, anticipating that that would yield approximately a 10% sample. We then sent the Survey, accompanied by a cover letter, to these randomly selected bankruptcy judges soliciting their participation.26

The cover letter provided, among other things, that the results of the Survey would be published but that participants’ names and responses would remain confidential. The Survey and the cover letter were sent to the initial survey participants by electronic mail, where known, and otherwise by facsimile or mail. Two of the initial survey participants declined to participate in the Survey, largely because of scheduling conflicts, in which instance the participation of the next bankruptcy judge listed in alphabetical order by last name was solicited. Thus, the final participation pool of thirty-seven Survey Participants was comprised of two alternate survey participants and twenty-four initial survey participants.

The Survey Participants completed twenty-four Surveys. Most of the Surveys were completed by telephone interview conducted by the author over approximately a three-week period. The remaining Surveys were completed by Survey Participants without a telephone interview and returned to our offices by facsimile or mail. In two instances, a Survey Participant filled out the Survey first and also participated in a telephone interview. Not all of the Survey Participants answered all of the questions on the Survey. Many of the Survey Participants answered the yes-or-no or scale questions on the Survey but did not provide additional comments.

B. The Survey Results

1. Law Clerks

Each bankruptcy judge is authorized a chambers staff of one law clerk and one judicial assistant, with the option of a second law clerk in lieu of a judicial assistant. Circumstances, such as participation on a Bankruptcy Appellate Panel or an unusual caseload, form the basis for an occasional additional law clerk. Irrespective of their caseload, the Survey Participants had varying opinions about the optimal number of

26 A copy of the Survey and cover letter sent to the initial survey participants is on file with author.
staff members and their combination. Forty percent of the responding
Survey Participants stated that two law clerks is optimal; 27% stated that
one law clerk is optimal; 20% stated that one to two clerks is optimal;
7% stated that one law clerk plus one administrator is optimal; and 7%
think that two law clerks plus one administrator is optimal. The major-
ity of Survey Participants—78%—are satisfied with the number of law
clers permitted, while the remaining 22% feel the need for more.

a. Permanent vs. Term?

As becomes apparent in the results detailed and discussed below,
there is a strong trend among bankruptcy judges toward hiring “per-
manent” or “career” law clerks. Of the 438 law clerks presently serving
bankruptcy judges, 246 are “permanent” law clerks and 193 are
“term” law clerks.

Academics have commented on this trend, or at least seen it com-
ing in other courts, and have suggested that it may transform law clerks
into “assistant judges” or even “junior judges.” In a comprehensive

27 AO Materials, supra note 2. For statistical purposes, the Administrative Office of the
Courts considers any law clerk who stays for four or more years to be a “permanent” law
clerk. See id. Permanent law clerks are also sometimes referred to as career law clerks.
28 Id. For statistical purposes, the Administrative Office of the Courts considers any law
clerk who does not qualify as a “permanent” law clerk to be a “term” law clerk. Term law
clers typically serve for one to two years. Id.
29 Victor Williams, A Constitutional Charge and a Comparative Vision to Substantially Ex-
pand and Subject Matter Specialize the Federal Judiciary: A Preliminary Blueprint for Remodeling
Our National Houses of Justice and Establishing a Separate System of Federal Criminal Courts, 37
Wm. & Mary L. Rev. 535, 592–93 (1996). Williams adds:

The increased . . . use of permanent law clerks to work as “assistant judges”
rather than as “assistants to the judges,” becomes more tempting in times of
docket overload. Indeed, the employment of permanent law clerks has been
rising at an alarming rate. A 1994 Judicial Conference memorandum refer-
cencing a report produced for the Judicial Conference’s Judicial Resources
Committee by the National Academy of Public Administration Association,
expresses concern that our overworked federal judges may be tempted to ab-
dicate genuine decisional responsibilities to a “shadow judiciary” of perma-
nent law clerks. “Permanent” law clerks have a qualitatively different institu-
tional position than traditional clerks, who, for largely educational purposes,
commit to a one- or two-year term in a judge’s chambers at a relatively modest
salary. Career law clerks also differ substantially from the increasing number
of law students who volunteer as “interns.” Although judges depend heavily
on temporary law clerks for “drafting” orders and decisions, the increasing
numbers of permanent law clerks often become players in the decisionmak-
ning process, having first-line contact with attorneys and often conducting in-
formal conferences. In such roles, career law clerks often are correctly seen
by the federal bar as “junior judges” with commensurately generous salaries.
study of law clerks in California appellate courts in 1980 (the “Oakley Study”), two commentators, John B. Oakley and Robert S. Thompson, saw fundamental, ideological differences between permanent law clerks and term law clerks.\textsuperscript{30}

The Oakley Study focuses on the comparative virtues and vices of term law clerks versus permanent law clerks and judges’ perceptions and beliefs about the impact of law clerks upon judicial decisions.\textsuperscript{31} The Oakley Study was motivated by a “fear that the endangered species status of the traditional law clerk in the California courts of appeal presented a significant threat to legal ecology, foreboding unfortunate consequences to the quality of appellate justice in California.”\textsuperscript{32}

Oakley and Thompson comment extensively on the “traditional” role of a law clerk in the judicial process and defend this ideal as integral to notions of justice and the judicial process.\textsuperscript{33} Oakley and Thompson articulate the traditional role as follows:

\begin{quote}
[t]he common element that emerges from a review of the literature of law clerking from the days of Horace Gray [the first judge to employ law clerks] to the present is the dialectic between the brashness of youth and the restraint of age, between the theories of the classroom and the pragmatism of bench and bar—a dialectic that is repeated year after year as brilliant but naïve law clerks work in earnest intimacy with indulgent but independently minded judges. . . . [T]he central feature of every reported clerkship has been its limited tenure in relation to that of the judge, with this fundamental fact serving to keep the roles of clerk and judge in proper perspective.\textsuperscript{34}
\end{quote}

The Oakley Study examined clerkship practices in California federal and state courts, including the California Courts of Appeal, the California Supreme Court, the Ninth Circuit Court of Appeals, and California federal district courts.\textsuperscript{35} Oakley and Thompson interviewed about sixty-

\begin{flushright}
Id.
\end{flushright}

\textsuperscript{31} See id. at 7.
\textsuperscript{32} Id. (footnote omitted).
\textsuperscript{33} See id. at 36–39.
\textsuperscript{34} Id. at 33–34.
\textsuperscript{35} See Oakley & Thompson, supra note 30, at 48.
three judges and several law clerks. Based on their survey results, Oakley and Thompson created a profile for each of these courts and compared them to the profiles of the other courts. California state court judges generally used permanent law clerks, whereas the Ninth Circuit and federal district judges exclusively used term law clerks. In analyzing state court judges’ broad use of permanent clerks, Oakley and Thompson determined that the preference for permanent law clerks over term law clerks hinges on four factors: (1) caseload pressures; (2) workload per law clerk; (3) clerkship prestige; and (4) perceptions of law clerk productivity. Based on these four factors, Oakley and Thompson concluded that state courts had a “negative coefficient of short-term law clerk use,” whereas federal courts had a positive coefficient.

In their recommendations for fostering term law clerk usage, Oakley and Thompson argue that there are possible attendant dangers and consequences of employing only permanent law clerks:

[i]n our ideal form, the law clerk is meant to fiddle with the law, to advocate innovation, to introduce to its inner sanctums the ideas of those outside. This gives the law needed play and capacity for change. So long as law clerks come and go in judicial chambers . . . their stimulus is no threat to the integrity of the law. But to let them run parallel to the commissioned judiciary risks either the devolution of judicial power upon non-judicial officers or the evolution of stimulating law clerks into bureaucrats dedicated to continuity rather than variation.

In our Survey, the bankruptcy judges were asked about their clerkship practices and preferences, the traditional law clerk ideal as articulated by Oakley and Thompson, and the possible dangers or consequences of employing permanent law clerks. Of the Survey Participants who responded to the question whether they agree or disagree with the traditional, short-term, law clerk ideal, 38% agreed, while 62% disagreed.
Of the large majority of Survey Participants who disagreed, several bankruptcy judges said that whether dangers of undue deference, boredom, and stale routine (attributes Oakley and Thompson associate with permanent law clerks) exist depends on the particular law clerk and the particular bankruptcy judge. Some of these judges further said that their permanent law clerks have fresh outlooks, are not bored or stale, and that, in all events, the bankruptcy judges themselves do not unduly rely on their permanent law clerks. One bankruptcy judge stated that term law clerks are not more intellectually assertive and vivacious because bankruptcy is specialized and because bankruptcy courts often do not get the same quality of applicants as the federal district courts.\(^44\)

Of the Survey Participants who agreed with the traditional, short-term, law clerk ideal, some expressed a concern that permanent law clerks present a risk of overdependence. Several of the bankruptcy judges who agreed with the traditional law clerk ideal, however, also acknowledged that whether the dangers of undue deference, boredom, and staleness exist depends upon the particular law clerk and the bankruptcy judge.

Of the Survey Participants who responded to the question whether they prefer permanent law clerks or term law clerks, 64% prefer permanent law clerks, while 36% prefer term law clerks. All of the Survey Participants who prefer term law clerks expressed a firm or a moderate preference for term law clerks. These bankruptcy judges explained that term law clerks are eager and bring new perspectives and questions. They said that term law clerks are less likely to get bored and burned out and that term law clerks “keep things from getting stale.”\(^45\) Some of these bankruptcy judges also expressed that they felt an “obligation” to provide clerkship opportunities to young lawyers. One judge stated that he did not want a clerk whose “pinnacle” was a law clerk position; rather, he wanted a “hungry” law clerk.\(^46\)

Of the twelve Survey Participants who prefer permanent law clerks, 45% expressed a firm preference for permanent law clerks; 45% expressed a moderate preference; and 9% expressed a weak

\(^{44}\) Survey No. 19. For purposes of this Article, each Survey received from a Survey Participant was randomly assigned a number from 1–24. That number is used herein to protect the identity of each Survey Participant.

\(^{45}\) Survey No. 9.

\(^{46}\) Survey No. 1.
preference. The primary reason underlying the firm and moderate preferences for permanent clerks is that permanent clerks’ greater knowledge and experience made permanent law clerks more efficient and productive. One judge stated that “knowledge, experience, productivity and continuity vastly outweighs any benefits from young inexperienced and transient lawyers.”

Several of the Survey Participants noted that given the specialized nature of the job, permanent law clerks are valued for their knowledge and experience. Permanent law clerks usually have practiced law and, in many instances and more helpfully, bankruptcy law. Sixty-nine percent of the permanent law clerks employed by the Survey Participants previously worked as attorneys, and 56% had prior experience as bankruptcy practitioners.

The results of the Survey suggest that bankruptcy judges have two primary, related reasons for employing permanent law clerks, both of which are generally consistent with those proposed in the Oakley Study: (1) the specialized nature and quantity of the work; and (2) the large amount of time (said to be six to eighteen months) required to train new bankruptcy law clerks. Given these primary reasons underlying the Survey Participants’ preferences for permanent law clerks, one conclusion that may be drawn is that these bankruptcy judges place a high value on law clerk productivity.

The contrast between the Survey Participants who prefer term law clerks (45%) and those who employ permanent law clerks (70%) suggests some bankruptcy judges prefer term law clerks, but choose to employ permanent law clerks. One bankruptcy judge expressed feeling “guilty” for employing a permanent clerk but did so to accommodate the permanent law clerk’s lifestyle desires. Other Survey Participants indicated that they may have one permanent law clerk and one term law clerk to lessen or obviate some of the unproductive time that necessarily attends the training of a new clerk. Some bankruptcy judges feel constrained to hire permanent law clerks in spite of their preference for term law clerks because they value continuous productivity.

The Survey results suggest that if more bankruptcy judges had two law clerks, more would choose at least one traditional, short-term law clerk because these law clerks’ staggered terms would then assure continuity and productivity. The comments of the Survey Participants also point to a comparatively recent phenomenon: for family and life-
style reasons, more bright young lawyers seek out and prefer permanent law clerk positions to the long and stressful hours of law practice.

b. **Quality of Clerkship Candidates**

The number of clerkship applications received by each of the Survey Participants varies widely, reflecting the fact that many of the Survey Participants employ permanent law clerks. Thirty-three percent of the Survey Participants receive fewer than ten applications per year; 50% receive ten to fifty applications per year; and 17% receive more than fifty applications per year.

When asked about the quality of clerkship applicants on a scale of one to ten, with ten being the highest and best qualified, 7% of the Survey Participants rate applicants between four and five, 43% rate applicants between six and seven, and 50% rate applicants between eight and nine. Most of the Survey Participants require law clerks to be in the top 25% of their law school class. Most of the Survey Participants do not require law review, journal, or moot court experience. Other requirements mentioned for applicants include having taken a bankruptcy class, writing experience, solid references, integrity, and a prior bankruptcy court externship. Most Survey Participants are usually able to hire their first choice among clerkship applicants.

c. **Duties of the Law Clerk**

Law clerks’ duties and responsibilities vary from bankruptcy judge to bankruptcy judge. According to the Survey Participants, law clerks’ primary responsibilities include the following: (i) drafting opinions; (ii) preparing bench memoranda; (iii) observing court proceedings; and (iv) preparing the calendar. Other duties include: (a) serving as a law clerk for the Bankruptcy Appellate Panel on which the bankruptcy judge also sits; (b) serving as a bailiff; (c) supervising externs; (d) reviewing proposed orders; and (e) taking notes during court proceedings.

Ninety-two percent of the Survey Participants require law clerks to take part in drafting opinions. Sixty-seven percent of these bankruptcy judges’ law clerks contribute “considerably” to written opinions; 25% contribute “some” to written opinions; and 8% contribute “slightly” to written opinions.

Seventy percent of the Survey Participants require law clerks, at least on occasion, to prepare pre-argument or bench memoranda. Sixty-two percent of the bankruptcy judges’ law clerks undertake preparation of pre-argument memoranda “several times a month”; 30% “rarely” undertake preparation of pre-argument memoranda; and 8%
“never” undertake preparation of pre-argument memoranda. Ninety-six percent of the Survey Participants discuss research issues, case status, and related matters with their law clerks “frequently” to “constantly.”

Thirty-three percent of the Survey Participants’ law clerks spend 50% to 75% of their time researching novel issues of law; 17% spend more than 75% of their time researching novel issues of law; 25% spend between 25% and 50% of their time researching novel issues of law; and 29% spend less than 25% of their time researching novel issues of law.

d. Externs

We asked the Survey Participants about their use of externs. Thirty-three percent of the Survey Participants make “light” use of externs; 33% make “moderate” use of externs; and 33% “extensively” use externs. Of those who make light use of externs, their primary reason for providing externship opportunities is to aid the extern. Bankruptcy judges who make moderate to extensive use of externs do so because it aids the extern, but also because it aids the bankruptcy judge, the law clerk, and the bar generally. There is, of course, a direct relationship between the use of externs and the bankruptcy judge’s underlying motivation for doing so—bankruptcy judges tend to make greater use of externs if conditions in the bankruptcy judge’s chambers are such that the externs materially aid the bankruptcy judge or the law clerk.

2. Job Satisfaction

Several of the Survey questions asked the Survey Participants to assess their individual job satisfaction and that of the bankruptcy bench generally on a scale of one to ten, with ten being the highest satisfaction rate. An overwhelming majority of the Survey Participants indicated that their job satisfaction is high—either an eight, nine, or ten, with approximately 46% selecting ten.49 A majority of the Survey Participants indicated similar job satisfaction ratings among the bankruptcy bench generally, with 25% indicating a ten, 33% indicating a nine, and 21% indicating an eight. In many of the Surveys, there was a correlation between the scale rating the Survey Participant indicated for himself or herself and the scale rating the Survey Participant indi-

49 Two of the Survey Participants reported their job satisfaction as an “11” when they were interviewed. For statistical purposes, 11s have been recorded as 10s. Survey Nos. 23, 10.
icated for the bankruptcy bench generally. Several Survey Participants indicated, for example, that their colleagues were just as satisfied with the job of being a bankruptcy judge as they were and probably for many of the same reasons. One Survey Participant indicated a low job satisfaction (four on the one to ten scale) but made clear that earlier in his or her long career that job satisfaction rate was much higher. 50

One of the questions in the Job Satisfaction section of the Survey asked Survey Participants if they had observed troubling differences in treatment between bankruptcy and Article III judges. 51 Most of the Survey Participants indicated that there are no troubling differences between the Article III and the bankruptcy judges in their respective districts, though they were aware of troubling differences in treatment in other districts. A few of the Survey Participants indicated that the distinction between Article III and bankruptcy judges has blurred for the better during their tenure on the bankruptcy bench.

The Survey Participants were asked if they knew bankruptcy judges who had recently left the bench and the reasons therefor. Almost all Survey Participants responded affirmatively, citing salary considerations, retirement, and not being reappointed as the most common reasons those bankruptcy judges left the bench. Several Survey Participants commented that many retired bankruptcy judges have been recalled and are presently back on the bankruptcy bench. Others commented that bankruptcy judges make so much less annually than private practitioners that a number of excellent judges found it necessary to leave the bankruptcy bench to earn more to pay for their children’s college educations.

The final series of questions in the Job Satisfaction section of the Survey asked the Survey Participants what they found to be most satisfying and most frustrating about their jobs as bankruptcy judges. Almost uniformly, the Survey Participants indicated that a primary source of satisfaction is the collegiality and excellence of the bench, a competent bankruptcy bar, and, in some instances, their chambers and clerks’ office staffs. The Survey Participants also draw satisfaction from the importance of their job in resolving disputes and assisting litigants. Addi-

50 Survey No. 13.
51 Article III judges include district court judges appointed pursuant to Article III, Section 1 of the Constitution of the United States. U.S. Const. art. III, § 1. Bankruptcy judges, by contrast, are appointed pursuant to 28 U.S.C. § 152 and are not considered Article III judges but rather “serve as judicial officers of the United States district court established under Article III of the Constitution.” BAPCPA, Pub. L. No. 109-8, § 1223(d), 119 Stat. 23, 198 (to be codified at, and amending, 28 U.S.C. § 152(a)(1)).
tionally, the Survey Participants stated that they enjoy the independence service on the bankruptcy bench brings, and they find their work intellectually challenging and stimulating. One Survey Participant indicated that being a bankruptcy judge is the best job in the law;\textsuperscript{52} another said that being a bankruptcy judge is the best job a lawyer can have.\textsuperscript{53}

When asked to identify sources of frustration in being a bankruptcy judge, the answers provided varied widely. Some found increasing and already heavy caseloads frustrating, while others are frustrated by insufficient resources committed to bankruptcy courts.

Related to these frustrations was a sense that Congress has been unresponsive to the bankruptcy bench on important issues. This frustration seems to take two forms. Some Survey Participants indicated that Congress has ignored, or even repudiated, the bankruptcy bench’s views and expertise respecting law reform and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Other Survey Participants indicated that Congress has ignored the bankruptcy bench’s needs for salary increases and benefits.

Although many of the Survey Participants commented that a competent bankruptcy bar was a source of satisfaction, several found ill-prepared attorneys and sloppy lawyering frustrating, particularly in the consumer bankruptcy area and in trial presentations. Two Survey Participants noted anecdotally their perception that bankruptcy judges do not find Chapter 13 bankruptcy practice satisfying and that handling of routine matters in any bankruptcy chapter can become a source of frustration. A small number of Survey Participants indicated that isolation from the outside world is a source of frustration, as are increased demands for technological proficiency for older bankruptcy judges.

3. Case Management

We asked the Survey Participants about their caseloads; their transitions to electronic filing and the Case Management and Electronic Case Files system (“CM/ECF”), the standardized national electronic docketing and case management system; and attendant case management issues.

When asked whether their caseloads were heavy or light or somewhere in the middle, about half of the Survey Participants indicated that their caseloads are conveniently manageable. About 12.5% indicated that their caseloads were extremely heavy; 21% indicated

\textsuperscript{52} Survey No. 20.

\textsuperscript{53} Survey No. 24.
that their caseloads were heavy; and about 12.5% indicated that their caseloads were light. Correspondingly, more than half (about 58%) of the Survey Participants indicated that additional bankruptcy judges are not needed in their respective districts, while 37.5% indicated that additional bankruptcy judges are needed.

Almost all bankruptcy court districts have transitioned to electronic filing and to some form of the CM/ECF system. Individual bankruptcy judges and their chambers have followed suit. In fact, about 87.5% of the Survey Participants have fully embraced CM/ECF or a similar electronic case management system.

When asked about the impact of the CM/ECF system on their chambers and staff, about 62.5% of the Survey Participants indicated that CM/ECF has decreased the burden on their chambers and staff, while about 25% indicated that CM/ECF has increased the burden on their chambers and staff. When asked why, the Survey Participants provided mixed opinions and a variety of answers. Some Survey Participants stated that under the CM/ECF system, the staff in the clerk’s office does much less now because the clerk’s office does not maintain paper files, thereby shifting the burden to the bankruptcy judges’ chambers to check for, sort, and organize pleadings. Others stated the opposite—that the staff in the clerk’s office actually does more under the CM/ECF system because the docketing clerks are constantly watching for newly filed pleadings, correcting the electronic filing errors of attorneys, and notifying the bankruptcy judges’ chambers of docket activity.

Several Survey Participants said that the increased burden derives from chambers staff having to catch and correct docketing mistakes and errors of attorneys and other electronic filers that were previously screened and fixed by the docketing clerks in the clerk’s office. Some Survey Participants attribute the increased burden of CM/ECF on their chambers and staff to a learning curve. While CM/ECF has initially burdened their chambers and staff, this group is hopeful that all will become more adept and efficient at using it, eventually making the process less burdensome. A few of the Survey Participants indicated that they are still trying to assess the impact, if any, of the CM/ECF system on their chambers and staff, while a few others indicated that the CM/ECF system has had no significant impact on their chambers and staff.

When asked whether the CM/ECF system makes reviewing and maintaining pleadings more or less convenient, the Survey Participants overwhelmingly (83%) found the system more convenient. When asked why, the Survey Participants almost uniformly indicated that
CM/ECF advantageously and conveniently allows bankruptcy judges and law clerks to access pleadings and proposed orders anytime, anywhere. One Survey Participant stated the benefit of being able to access proposed orders for review and signature from the study at home or the hotel business center while traveling. The Survey Participants suggested that the CM/ECF system is, however, more convenient for some things and not others. For example, one Survey Participant suggested that signing proposed orders electronically is very easy when no changes or interlineations are required but less so when they are. In several instances, those Survey Participants who found the CM/ECF system less convenient attribute it to their age or lack of technical proficiency.

When asked whether their chambers are paperless, 42% of the Survey Participants said yes. Moreover, most of those Survey Participants have paperless chambers by choice. Many of the Survey Participants indicated that they do not require courtesy copies of pleadings. Rather, they simply access the pleadings electronically, print out those they need to review or have in hard copy, and then subsequently discard them. A number of chambers still require attorneys to submit courtesy copies of some pleadings. One Survey Participant suggested that there is no place to keep hard copies of pleadings anymore because the clerk’s office does not maintain paper files, so chambers might as well, or perhaps have to, become paperless.

When asked whether recent cuts in bankruptcy clerk staff due to budget constraints have affected their chambers, most of the Survey Participants said no, although a number noted that the reduction in clerk staff requires each staff member to do more. Implicit in many of their responses was that because the CM/ECF system has shifted the burden to their chambers and staff, cuts in the clerk’s office do not necessarily directly affect the bankruptcy judges. When asked whether these recent cuts in bankruptcy court staff have affected the responsibilities of law clerks, most of the Survey Participants said no. A few Survey Participants, however, indicated that the budget constraints have led to law clerks having “to pick up the slack” in some areas.54

We also asked Survey Participants how the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”) affected the bankruptcy bench.55 Our question was, of course, well in advance

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54 Survey No. 6.
of the effective date of most of the Act’s provisions. Consequently, many of the Survey Participants indicated that they had not yet seen any noticeable impacts. One notable difference reported by several Survey Participants was an increase in filings, particularly in the consumer area and likely in response to the Act’s stricter rules and limitations on consumer filings. Many Survey Participants echoed the sentiments of the one Survey Participant who commented that there has been “mass confusion” in trying to understand the Act, its implications, and its poorly drafted and sometimes conflicting provisions.\footnote{Survey No. 1.}

Other Survey Participants said that review of the Act had consumed much of their time in the last several months and that their law clerks and clerk’s offices have spent many hours trying to adjust their practices and procedures and local rules to accommodate the Act’s changes. One Survey Participant indicated that the Act has affected already the Chapter 13 bar and Chapter 13 trustees who are concerned about the Act’s new liability and affirmation requirements.

4. Bankruptcy Appellate Panel Service

We asked the Survey Participants about service on the bankruptcy appellate panel (the “BAP”).\footnote{The bankruptcy appellate panel (the “BAP” as it is commonly called) is the appellate court of the bankruptcy court. In many bankruptcy court districts, appeals from bankruptcy court are taken to the BAP unless the appealing parties elect to have the appeal heard by the district court. See 28 U.S.C. § 158(b) (2000). Not all districts have a BAP to which appeals may be taken. See supra note 20.} Most of the Survey Participants (about 79%) are not presently serving on the BAP but many (about 38%) have been designated to serve on the BAP at one time or another. When asked how BAP service affects their service as a bankruptcy judge, several of the Survey Participants indicated that it required adjustments to their bankruptcy court trial and hearing schedule and that it substantially added to their workload. Some of the Survey Participants suggested that those bankruptcy judges who serve full-time on the BAP should have the option of employing an additional law clerk. One Survey Participant indicated that service on the BAP was “like having a second job.”\footnote{Survey No. 2.}

Nevertheless, the Survey Participants uniformly stated that service on the BAP has made them better bankruptcy judges. According to some Survey Participants, sitting on the BAP has made them more aware of the need for a complete, accurate, and detailed trial record.
It has caused them to be more careful and deliberate in their fact-finding and to explain more fully the reasons for their decisions. Several Survey Participants acknowledged that they find the collaborative effort and consensus-building required for service on the BAP challenging and very different from what they are used to as single, independent bankruptcy judges but, at the same time, beneficial because it makes them more patient and more effective in writing decisions.

5. Prior Career

About 83% of the Survey Participants were bankruptcy practitioners before taking the bankruptcy bench. Of the 17% of the Survey Participants who were not bankruptcy practitioners, almost all came from a business law background, as commercial litigators or corporate transactional lawyers. One Survey Participant served as a magistrate before becoming a bankruptcy judge and another served as a federal prosecutor.

When asked how their prior professional experience has affected their performance as bankruptcy judges, the Survey Participants suggested that their prior professional experience has helped them in their handling of business bankruptcy cases. As a result of their prior experience, the Survey Participants are familiar with the players, the issues, and the terminology. Other Survey Participants suggested that their prior professional experience as bankruptcy practitioners was invaluable because they came to the bench well-familiar with the Bankruptcy Code, workings of the bankruptcy court, the bankruptcy court personnel, and the procedural rules. One Survey Participant felt that because bankruptcy law is such a specialized area with its own rules and terminology, one could not be a bankruptcy judge without prior bankruptcy experience. Still other Survey Participants commented that their experience as trial lawyers was beneficial because they knew how to present evidence and examine witnesses. One Survey Participant commented that his or her prior experience as a consumer bankruptcy lawyer gave him or her a practical sense of what kinds of expectations and limitations may be reasonably imposed on consumer debtors.59

59 Survey No. 19.
6. Publication of Opinions

The Survey Participants each publish an average of five or six opinions per year, and have published an average of twenty-six opinions over the last five years.

The Survey asked how the Survey Participants decide whether an opinion should be published. The majority of Survey Participants use two primary criteria in determining whether an opinion should be published: (i) whether the opinion addresses a novel issue of law; and (ii) whether the opinion is helpful to the bar because, for example, the opinion advises the bar as to how the bankruptcy judge will treat a common issue. Two of the Survey Participants indicated that they do not publish opinions that would be embarrassing to a lawyer. Two of the Survey Participants indicated that they published more at the beginning of their careers because it was important to let the bankruptcy bar know where they stood on certain issues.

Of the Survey Participants who responded to the question about whether bankruptcy judges should publish more or less, an overwhelming 87% of the Survey Participants thought that bankruptcy judges should publish less. This answer may not take account of the many new legal issues to be decided under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Conclusion

In the main, the job of a bankruptcy judge is an agreeable one. Short-term law clerks are, lamentably, dying out. Salaries do not keep pace. Congress does not listen. Some lawyers fumble the ball. Too many opinions are being published. But the public service aspects of the job, the collegiality, the intellectual satisfaction, and the independence seem to outweigh the negatives. And, in general, bankruptcy judges appear resilient in the teeth of change—a harbinger for the application of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

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60 There was some mild confusion over the meaning of the term “published.” In most jurisdictions, all opinions are published on the bankruptcy court’s website. Sometimes Lexis or Westlaw simply takes an opinion from the bankruptcy court’s website, although the opinion was not separately submitted for publication. For purposes of this Article, a “published” opinion is one that is published in the Bankruptcy Reporter.
# Appendix A: Salaries of Bankruptcy Judges

<table>
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<tr>
<th>Effective Date</th>
<th>Amount</th>
<th>Authority of Action</th>
</tr>
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<tbody>
<tr>
<td>October 1, 1956</td>
<td>$15,000</td>
<td>P.L. 84-518</td>
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<tr>
<td>Retroactive to 7/1/1964</td>
<td>$22,500</td>
<td>P.L. 88-426</td>
</tr>
<tr>
<td>April 1, 1969</td>
<td>$30,000</td>
<td>P.L. 90-206 JCUS 3/69</td>
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<td>November 1, 1972</td>
<td>$31,650</td>
<td>P.L. 92-210 JCUS 3/72</td>
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<td>October 1, 1975</td>
<td>$33,200</td>
<td>P.L. 94-92 JCUS 9/75</td>
</tr>
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<td>March 1, 1976</td>
<td>$37,800</td>
<td>P.L. 94-217 (fixed by Congress)</td>
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<td>March 31, 1977</td>
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## Appendix B: Bankruptcy Filings by Chapter and Nature of Debt
### Calendar Years 1980–2004

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### Appendix C: Appeals to District Court and Withdrawals of Reference Actions 12 Months Ended 9/30/1988-2004

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Abstract: This Article discusses the continuing contraction of business reorganization under the Bankruptcy Code. It argues that it is wrong to assume that there is no need for a business reorganization law in a modern, service-oriented economy that has well-developed capital markets. The Article first analyzes and contrasts bankruptcy law in the United States under the Chandler Act of 1938, which fostered the concept of reorganization and rehabilitation of distressed business entities, and under the Bankruptcy Reform Act of 1978, which built upon lessons learned under the Chandler Act and pursuant to which bankruptcy reorganization became an appropriate and necessary vehicle to preserve and protect the values of major business organizations. The Article then traces the economic, legal, political, and ideological changes that threaten the viability of corporate rehabilitation, including the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Finally, this Article responds directly to anti-Chapter 11 theorists, arguing: (1) reorganization remains relevant to preserving going-concern values in today’s economy, (2) Chapter 11 has significant value as a transparent, neutral, multi-party forum to address the insolvency of a business, even when a marketplace exists for the debtor’s assets, and (3) the privatization of the insolvency process is both unworkable and undesirable.

Introduction

The concept of debtor reorganization and rehabilitation is in peril. The marvel of modern reorganizations of financially distressed businesses that was ignited by the railroad equity receiverships of the nineteenth century and codified by twentieth-century legislation is fading. As the twenty-first century progresses, the use of Chapter 11 of
the Bankruptcy Code\textsuperscript{1} as a primary reorganization and rehabilitation tool for businesses is under relentless attack—an attack led by those who want to revert back to strict enforcement of contracts and the primacy of creditor rights. Fundamental changes in the economy, accompanied by a shifting and more conservative intellectual approach, are now leading to cries that Chapter 11 is obsolete and irrelevant in a modern economy.

The concept of an even-handed process to deal with financial distress, insolvency, and the interests of all involved parties, although only almost a century old in its modern form in the United States, has a history that goes back to biblical times. It has been subject to constant revision to reflect shifting societal goals, the consequences of failure, and the perception of the debtor as a real party in interest. Thus, the innovative use of equity receiverships to reorganize railroads that created the paradigm for modern reorganization principles occurred during the Industrial Revolution, a period when rapid industrialization caused significant social and economic upheaval as the United States transformed from an agrarian to a manufacturing and industrial economy. The preservation of going-concern values and jobs became more important than the enforcement of contractual rights and the liquidation and dismemberment of a debtor’s assets to benefit particular creditors.

Today, Chapter 11 critics can point to recent statistics to bolster their argument that Chapter 11 has outlived its usefulness. During the ten-year period from 1994 to 2003, the total number of bankruptcy cases filed increased by an average of 8.53\% per year.\textsuperscript{2} Yet, during the same period, the number of Chapter 11 cases filed decreased by an average of 4.13\% per year.\textsuperscript{3} From a different perspective, in 1994, 1.77\% of total bankruptcy cases filed were Chapter 11 cases.\textsuperscript{4} In 2003, the percentage dropped to 0.57\%.\textsuperscript{5} These statistics raise the question whether there is a growing recognition that Chapter 11 is losing its attraction as

\begin{footnotesize}

\textsuperscript{2} 2004 \textit{Bankruptcy Yearbook & Almanac} 5 (Christopher M. McHugh & Thomas A. Sawyer eds., 2004) [hereinafter \textit{Bankruptcy Yearbook]}.

\textsuperscript{3} \textit{Id.}

\textsuperscript{4} \textit{Id.}

\textsuperscript{5} \textit{Id.}
\end{footnotesize}
a process to rehabilitate and resuscitate a distressed business entity.\textsuperscript{6} The qualitative statistics are also revealing. Professor Lynn M. LoPucki has reported that, between 1982 and 1990, over 80\% of Chapter 11 cases resulted in reorganizations.\textsuperscript{7} A downward trend began in 1996, when this statistic fell to 63\%, and, for 2000 and 2002, to 51\%.\textsuperscript{8} Professors Douglas G. Baird and Robert K. Rasmussen have concluded: “Corporate reorganizations have all but disappeared. Giant corporations make headlines when they file for Chapter 11, but they are no longer using it to rescue a firm from imminent failure. Many use Chapter 11 merely to sell their assets and divide up the proceeds.”\textsuperscript{9}

Has the structure of our economy changed so fundamentally that the concept of bankruptcy reorganization as we know it has ceased to be relevant? If not, what explains these statistics? To address these questions properly, one must review the history and development of bankruptcy law and reorganization in America and the modern developments in the Chapter 11 arena. Part I of this Article traces the historical roots of bankruptcy law in America since the Great Depression—the catalyst for the Chandler Act, which represented the first lasting codification of national bankruptcy reorganization law intended to deal with the failure of large businesses.\textsuperscript{10} Part II analyzes the passage of the Bankruptcy Reform Act of 1978, emphasizing the legislative goal of encouraging debtor rehabilitation.\textsuperscript{11} Part III assesses today’s changing economy and other modern developments affecting business reorganizations.\textsuperscript{12} Part IV analyzes the implications of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.\textsuperscript{13} Finally, Part V of this Article addresses the points raised by the anti-Chapter 11 theorists and highlights the current issues affecting the viability of bankruptcy reorganization today.\textsuperscript{14}

\textsuperscript{6} See id.
\textsuperscript{7} Francoise C. Arsenault, Going, Going Gone—Upward Trend in Section 363 Sales, Turnarounds & Workouts, Dec. 15, 2004, at 4.
\textsuperscript{8} Id.
\textsuperscript{10} See infra notes 15–78 and accompanying text.
\textsuperscript{11} See infra notes 79–139 and accompanying text.
\textsuperscript{12} See infra notes 140–90 and accompanying text.
\textsuperscript{13} See infra notes 191–227 and accompanying text.
\textsuperscript{14} See infra notes 228–87 and accompanying text.
I. THE STATE OF BANKRUPTCY LAW BEFORE THE BANKRUPTCY REFORM ACT OF 1978

Credit is an integral part of the economic security and well-being of our society.\textsuperscript{15} Insolvency laws that provide a level of certainty with respect to the treatment of debtors and creditors when dealing with inevitable failures or defaults of businesses are critical to instilling confidence and encouraging the extension and use of credit in our society.

The need for such laws was recognized early in the nation’s history. Thus, it was contemplated that the protection of debtors’ rights and the exercise of creditors’ rights would be established through the enactment of a uniform national bankruptcy law. Article I, section 8, clause 4 of the U.S. Constitution provides Congress with the power to “establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.”\textsuperscript{16} James Madison pronounced, “[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 States, that the expediency of it seems not likely to be drawn into question.”\textsuperscript{17}

Notwithstanding the constitutional authority to enact national bankruptcy laws, the road to lasting federal bankruptcy legislation was a bumpy, intermittent one. Congress rarely reached consensus throughout the late eighteenth and nineteenth centuries as to bankruptcy legislation. 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.\textsuperscript{18} In contrast, Northerners favoring a strong central government supported bankruptcy legislation as necessary to promote commercial enterprise, to encourage the extension of credit, and to protect creditors and personal liberties.\textsuperscript{19}


\textsuperscript{16} U.S. Const. art. I, § 8, cl. 4.

\textsuperscript{17} The Federalist No. 42, at 271 (James Madison) (Clinton Rossiter ed., 1961).

\textsuperscript{18} See David A. Skeel, Jr., Debt’s Dominion: A History of Bankruptcy Law in America 26 (2001).

\textsuperscript{19} See Ron Chernow, Alexander Hamilton 308, 326 (2004); Skeel, supra note 18, at 26; James A. McLaughlin, Book Review, 49 Harv. L. Rev. 861, 862, 864 (1936) (reviewing Charles Warren, Bankruptcy in United States History (1935)).
Consequently, the evolution of bankruptcy law has been the product of distrust of federal courts and the economic “bust-and-boom” cycle.\textsuperscript{20} Periods of economic downturn resulted in calls for bankruptcy legislation and relief, while periods of recovery resulted in the repeal of such legislation prior to the twentieth century.\textsuperscript{21} The Great Depression of the 1930s was the catalyst for the passage of the Chandler Act of 1938 (the “Chandler Act”), which amended the Bankruptcy Act of 1898 and provided for a lasting codification of the bankruptcy reorganization principles that had evolved during the equity receivership reorganizations of railroads.\textsuperscript{22}

A. Passage of the Chandler Act of 1938

During the “Roaring Twenties,” there was a widespread belief that a booming economy and heightened living standards would continue to increase indefinitely. When the world monetary system collapsed and a general panic among bankers and businesses ensued with the onslaught of the Great Depression, the viability of the economy came into question. Popular mistrust and hostility toward the business barons of Wall Street grew exponentially. These pressures first provided the catalyst for the reform and government intervention that ultimately resulted in the New Deal and then shaped the resulting legislation to deal with the economic depression.

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 and falling production ensued, and unemployment increased at a drastic rate. The United States and other nations fell deeper and deeper into the Great Depression, widely considered to be the worst and longest economic collapse in the history of the modern industrial world. Workers were unemployed because companies would not hire them, and companies would not hire employees because there was no market for goods as workers did not have income to purchase goods. In 1933, at the nadir of the Great Depression, over fifteen million Ameri-

\textsuperscript{20} Skeel, \textit{supra} note 18, 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).

\textsuperscript{21} Id.

cans—one quarter of the nation’s workforce—were unemployed, and shares of equity interests maintained only 20% of their pre-crash value.\(^{23}\)

Just as economic panics before have spawned national legislation, the Great Depression caused the nation to consider remedial bankruptcy legislation. The survival of distressed businesses and their related employment opportunities became a major objective of Congress. Initially, during the early 1930s, emergency legislation was enacted to provide an alternative to liquidation of distressed business entities under the protection of the district courts sitting as bankruptcy courts (for example, sections 77 and 77b of the Bankruptcy Act of 1898).\(^{24}\) The emergency legislation, intended to enable the reorganization of business entities, was followed by the realization that a more comprehensive statutory scheme was necessary to meet the economic crisis of the Great Depression.\(^{25}\)

Guidance came from the experiences of the railroad equity receiverships. The railroad equity receivership was a business structure fashioned to meet the crisis resulting from the widespread failure of the railroad industry after the Civil War.\(^{26}\) As David Skeel has noted, “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% of the nation’s track was in receivership.”\(^{27}\)

Railroads, the construction of which were heavily subsidized by the federal government, were seen as a central part of a new national economy because of their ability to move goods and people over long distances within a short period of time. By their nature, the assets of a railroad crossed multiple state lines. Consequently, in the event of default, the railroad faced the threat of individual creditors obtaining state court judgments and causing the dismemberment of the railroad’s assets to satisfy such judgments. Many of the fledgling railroads were net consumers of cash and undercapitalized. Similar to the contemporary failures involving telecom companies, the railroad promoters underestimated the cost of construction, geographical obsta-


\(^{24}\) See Skeel, supra note 18, at 73–74.

\(^{25}\) See id. at 74.

\(^{26}\) Id. at 48–70.

\(^{27}\) Id. at 51–52.
icles, and the time of construction and completion, and overestimated the projected volume of passenger and freight traffic. The result was liquidity deficiencies and defaults in their respective obligations.

In response to the threat that the railroads would cease operations, and drawing upon their equitable authority to appoint receivers to administer properties when appropriate, progressive federal district courts forged the concept of using equity receiverships to assume control of a 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. The process involved the debtor railroad, the significant creditors, and the federal district court working together to effectuate the continuation of the railroad in the public interest. At the same time, the affected parties in interest, through the use of protective committees and receivers appointed by the federal court, negotiated the reorganization and recapitalization of the railroad.

The process generally began with the filing of a “creditor’s bill,” which formally asked the court to appoint a receiver, a judicially appointed person entrusted with receiving and preserving property subject to a judicial proceeding. The filing of a creditor’s bill acted as a modern-day “automatic stay.” The process followed with the technical 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 a new entity and distribute new securities to the stockholders pursuant to the plan.

Two central modern bankruptcy concepts emerged from the railroad receivership paradigm: (1) the notion of preserving going-concern value for economic stakeholders by allowing the debtor’s op-

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28 See id. at 57.
29 Skeel, supra note 18, at 57.
30 Id. at 57–59.
31 Id. at 58.
32 Id.
33 Id.
34 Skeel, supra note 18, at 58.
35 Id. at 58–59.
36 Id. at 57–59.
erations to continue as an ongoing business, and (2) the retention and active participation of the railroad’s management in the operations of the railroad and the development of a business plan to support a reorganization. Prior to the railroad failures, 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 such enormous value.” Instead of adopting this traditional view, federal courts in the railroad receivership era reacted to the necessity of preserving value and serving the public interest and crafted novel ideas that served as the paradigm for modern reorganizations. Creditors and courts embraced the concept that the debtor’s (i.e., existing management’s) knowledge, expertise, and familiarity with its business were inherently valuable in large, complex, corporate restructurings. The participation of the debtor in the railroad equity receiverships became nearly indispensable.

This debtor-in-possession concept was memorialized in 1884 with Wabash, St. Louis, and Pacific Railway (“Wabash”), which was one of the first voluntary equity receiverships and one of the most celebrated. Until Wabash, receivership had been purely a creditors’ remedy, initiated only after a creditor’s request and a foreclosure action against collateral security by one or more classes of creditors. In the case of Wabash, representatives of the railroad (Wall Street investors) themselves sought and obtained judicial authority to commence a receivership and to be appointed as the receivers, in an effort to continue to operate and manage the railroad prior to the railroad defaulting in the payment of interest. As Skeel observed, “Wabash 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.”

The railroad receivership courts afforded railroad managers, investment bankers, and reorganization lawyers substantial leeway in

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38 Skeel, *supra* note 18, at 57.
40 See Chamberlain, *supra* note 37, at 140.
42 Skeel, *supra* note 18, at 64.
43 Id.
44 Id.
their prosecution of the cases. Managers would oversee the business operations, while the bankers and attorneys would negotiate the reorganization with the creditor constituencies through the device of protective committees. Cognizant of the expanding power the investment bankers and lawyers exercised as they became more efficient at the receivership process, 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.\textsuperscript{45}

The equity receivership process, however, was not without its detractors. Critics complained that bankers would routinely allocate themselves generous underwriting fees upon the issuance of new securities as part of the reorganization plan, and attorneys and other professionals would receive very substantial fees with minimal oversight before anyone else in the case was paid.\textsuperscript{46} Moreover, critics contended that attorneys were often compromised by their relationship with managers and looked the other way in the presence of fraud or mismanagement.\textsuperscript{47}

As the Great Depression continued, Congress considered legislative action to preserve the nation’s industrial and commercial base. The newly formed Securities and Exchange Commission (the “SEC”) commissioned a study to review the use of federal consent receiverships to reorganize distressed business and to develop a legislative proposal in connection therewith.\textsuperscript{48} The result was the enactment of the Chandler Act.\textsuperscript{49} It codified the principles developed in railroad reorganization cases as the basis for rehabilitating and reorganizing distressed businesses.\textsuperscript{50} It provided for a single, nationwide forum to deal with business failures and the interests of the economic stakeholders.\textsuperscript{51} The Chandler Act encompassed the proposals of the SEC based upon its study of federal consent receivership cases and the use of protective committees by enacting Chapter X of the Bankruptcy Act, entitled “Corporate Reorganizations.”\textsuperscript{52} Chapter X was intended to provide the

\textsuperscript{45} See Shapiro v. Wilgus, 287 U.S. 348, 356 (1932); Harkin v. Brundage, 276 U.S. 36, 52 (1928); Skeel, supra note 18, at 105.
\textsuperscript{46} See Skeel, supra note 18, at 110–11.
\textsuperscript{47} See id.
\textsuperscript{48} Miller & Ryland, supra note 39, at 211.
\textsuperscript{50} See id.; Miller & Ryland, supra note 39, at 213–14.
\textsuperscript{51} See Act of June 22, 1938, ch. 575, 52 Stat. at 840.
\textsuperscript{52} Id. at 883; Miller & Ryland, supra note 39, at 213–14.
vehicle for the reorganization of large, publicly owned corporations, and to avoid the evils that had been associated with the Wall Street-controlled equity receiverships and that had been uncovered by the SEC study.\(^{53}\) In addition, the Chandler Act included the enactment of Chapter XI—"Arrangements"—of the Bankruptcy Act.\(^{54}\) Chapter XI, intended to deal only with unsecured credit of smaller debtors, endorsed the concept of a debtor-in-possession, in lieu of a receiver or a trustee, to administer the debtor’s estate during the Chapter XI process.\(^{55}\) The Chandler Act drew on both the populist mistrust of the Wall Street community and attorneys who controlled many of the receivership cases of the nineteenth and twentieth centuries and the populist sentiment associated with the New Deal reform legislation endorsed by substantial Democratic majorities in the House of Representatives and the Senate.\(^{56}\)

**B. Chapter X**

Chapter X provided the statutory framework for a comprehensive reorganization of a financially distressed corporation. It was intended to deal with all aspects of the corporation’s business and capital structure. Under Chapter X, relief was available both on a voluntary and involuntary basis. Because Chapter X was intended to deal with large publicly owned corporations, it provided that the administration of a Chapter X case, in large measure, would be under the direct supervision of a U.S. district court judge rather than a referee in bankruptcy.\(^{57}\) It provided for (a) the mandatory appointment of one or more trustees in reorganization, if the liabilities of the corporation exceeded $250,000; (b) the appointment of an “examiner” if no trustee was mandated; (c) the strict application of the fair and equitable (absolute priority) rule that required an elaborate process to determine the enterprise value of the debtor’s business; (d) the ability to impair the rights of secured and unsecured creditors, as well as equity-interest holders; (e) the availability of the “cram down” power to confirm a plan of reorganization over dissenting classes of creditors or equity-interest holders; (f) a statutory and extensive role for the

\(^{53}\) Miller & Ryland, *supra* note 39, at 214.

\(^{54}\) Act of June 22, 1938, ch. 575, 52 Stat. at 905.

\(^{55}\) Miller & Ryland, *supra* note 39, at 214.


SEC; (g) an extended process for the development and proposal of a plan of reorganization; (h) a first right on the part of the reorganization trustee to propose a plan of reorganization; (i) a requirement that the district court determine that a proposed plan was worthy of consideration before solicitation of acceptances could proceed; (j) no statutory committees of creditors or equity-interest holders; and (k) a broad comprehensive discharge.58

In answer to the perceived corruption that occurred in some of the equity receivership reorganization cases and its effect on the operation of protective committees that had been uncovered by the SEC study, Chapter X introduced the principle of disinterestedness.59 Reorganization fiduciaries such as trustees and appointed professionals were required to document their disinterestedness as a condition to employment and by implication, to allowances and the payment of compensation.60 Management and, in effect, the board of directors were displaced by the mandatory appointment of a reorganization trustee, and there was a significant loss of control by traditional power groups.61 Skeel characterized this power shift as follows: “Out were private negotiation and the wiles of Wall Street, in was pervasive governmental oversight.”62 The SEC rigidly exercised oversight as to the requirement of disinterestedness.63 As a result of the extensive statutory provisions and prerequisites to the proposal of a plan of reorganization, its acceptance, and ultimately, its consummation, Chapter X cases extended over a long period of time.64 The combination of the above factors had the effect of discouraging corporations from entering into Chapter X cases.

59 See Miller & Waisman, supra note 22, at 169–70.
60 Id. at 169.
61 See id.; see also Skeel, supra note 18, at 119–20 (“The act gave the trustee explicit authority to take over the business activities of the bankrupt firm; and the new law took the power to formulate a reorganization plan out of the hands of the creditors and vested it in the trustee. Creditors and other parties could, in theory, make suggestions to the trustee; but the trustee, and the trustee alone, was the one who would develop the terms of any reorganization.”) (citation omitted).
62 See Skeel, supra note 18, at 122.
63 Id.
64 Id. at 171 (“The effect of SEC’s tardiness was to exacerbate the delay that already characterized cases that were handled in Chapter X. This made Chapter XI look even better to bankruptcy lawyers and the bankruptcy court.”); Harvey R. Miller & Alan N. Resnick, Commentary on Professor Warren’s Paper: Absolute Priority, 1991 Ann. Surv. Am. L. 49, 50 (1992).
Management, fearful of being displaced, would delay the commencement of bankruptcy cases. Often, during this process, the deterioration of the debtor’s business would continue unabated and sometimes result in the loss of the ability to reorganize and rehabilitate. In 1938, more than 500 corporations commenced cases under Chapter X. By 1944, that number had dropped to sixty-eight. During the 1950s and 1960s, the number of Chapter X cases each year fluctuated around one hundred. The effect of the rigid requirements of Chapter X encouraged distressed business corporations and their professionals to consider the availability of relief under Chapter XI of the Chandler Act. Chapter XI did not mandate the appointment of a reorganization trustee and often permitted the debtor’s management to stay in control of the affairs of the debtor as a debtor-in-possession. In Chapter XI cases, equity-interest holders often were able to retain their interests. In addition, Chapter XI provided no statutory role for the SEC.

C. Chapter XI

As the economy of the United States expanded following the Second World War and credit became more accessible, the occurrence of bankruptcy filings increased. Given the unattractiveness of Chapter X, those experiencing credit defaults explored the possibility of resorting to relief under Chapter XI of the Chandler Act. Chapter XI contemplated a plan to arrange the debtor’s unsecured debts and liabilities in an attempt to enable the debtor to satisfy those obligations. It did not necessarily displace management. Most importantly, debtors had a virtually unlimited exclusive right to file a plan of arrangement. The alternative to a plan of arrangement was liquidation with potentially significant loss of value. This power acted as a de facto “cram down” and was used by debtors and their professionals to drive the terms of a plan of arrangement or to extend the term of a Chapter XI case. In addition, the “fair and equitable” rule that had

65 See Miller & Waisman, supra note 22, at 169–70.
66 Skeel, supra note 18, at 125.
67 Id.
68 Id.
69 Id.
70 Id. at 125–27.
71 Skeel, supra note 18, at 125–27.
73 Skeel, supra note 18, at 125–27, 161–63.
74 See id. at 163.
originally been a part of Chapter XI was repealed in 1952. As a consequence, a plan of arrangement could provide for equity-interest holders to retain their interests despite a less-than-full recovery by creditors.

Chapter XI was designed to provide an efficient, expeditious, and economical vehicle for a small, generally privately owned business enterprise or an individual that desired to modify and discharge unsecured debts. It did not provide any specific authority to effectuate the rights of secured creditors or, theoretically, equity-interest holders.

As distressed business corporations and their professionals sought to avoid Chapter X, they explored and pursued means to expand the scope of Chapter XI to reorganize and rehabilitate the corporations’ business. The SEC zealously fought the use of Chapter XI for publicly owned corporations, to protect, first, public stockholders and, thereafter, public bondholders. The Supreme Court, however, held that publicly owned corporations could use Chapter XI for the purpose of reorganization if that form of bankruptcy served the “needs” of the corporation. The creativity and ingenuity developed in connection with the application of the provisions of Chapter XI to large, complex business entities had the effect of transforming Chapter XI from a debtor-relief chapter intended for small “mom and pop” businesses with small amounts of unsecured liabilities, to a reorganization vehicle used by Fortune 500 corporations.

II. The Bankruptcy Reform Act of 1978 and the Emphasis on Rehabilitation

The Bankruptcy Reform Act of 1978 (the “1978 Act”), which enacted the current Bankruptcy Code, was signed by President Jimmy Carter on November 6, 1978 and took effect on October 1, 1979. The 1978 Act was both the first bankruptcy legislation not enacted on the

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75 Id. at 124, 167.
76 Id. at 125–27.
77 See Gen. Stores Corp. v. Shlensky, 350 U.S. 462, 466 (1956) (“A large company with publicly held securities may have as much need for a simple composition of unsecured debts as a smaller company. And there is no reason we can see why c. XI may not serve that end. The essential difference is not between the small company and the large company but between the needs to be served.”).
78 See Skeel, supra note 18, at 127.
heels of domestic economic turmoil and the first comprehensive reform of federal bankruptcy law since the passage of the Chandler Act. A decade in the making, the final version of the 1978 Act was the culmination of separate drafting efforts by a congressional commission, the House of Representatives, the U.S. Senate, and the National Association of Bankruptcy Judges. A primary catalyst for this flurry of activity to revamp bankruptcy law was a 1971 study conducted by the Brookings Institution, which called upon Congress to rethink the bankruptcy process completely. Although the Brookings Institution study was primarily focused on consumer (individual) bankruptcies following the explosion of consumer credit during the 1960s, the National Bankruptcy Review Commission, appointed in 1970, included many of the Brookings Institution’s recommendations to overhaul the business reorganization process under the Bankruptcy Act of 1898 (as amended by the Chandler Act) in its report.

The 1978 Act codified a new Chapter 11 of a new title 11 of the U.S. Code, which remains the general template for corporate reorganizations and represents the combination of certain aspects of chapters X, XI, and XII of the Chandler Act. Congress intended Chapter 11 to eliminate the controversy that often surrounded a debtor’s choice of a particular chapter: “[a] single chapter for all business reorganizations will simplify the law by eliminating unnecessary differences in detail that are inevitable under separately administered statutes. . . .” and “will eliminate unprofitable litigation over the preliminary issue as to which of [chapters X or XI] apply.” It was also designed to respond to the widely held grievance that “existing law did not have adequate mechanisms to facilitate corporate rehabilitation in a straightforward, predictable way.”

The new Chapter 11 combined the flexibility and debtor control that characterized Chapter XI with many of the public protection features central to Chapter X.
A. Encouraging Rehabilitation Through Debtor Protections

Among the principal objectives of the 1978 Act were to make bankruptcy a more appealing option than it had been in the past and address the “great stresses . . . in the bankruptcy system” that had arisen as both the number of bankruptcy filings, as well as their complexity, increased. Offering court-supervised reorganization procedures, the 1978 Act was designed to provide “bankrupt businesses another opportunity to succeed.” Two issues predominated the adoption of the more flexible, streamlined, and rehabilitation-friendly Chapter 11: (1) whether to mandate trustees for large debtors and (2) the appropriate role of the SEC. The resolution of both issues reflected Chapter 11’s strong presumption in favor of the debtor-in-possession concept. Under the 1978 Act, trustees may be appointed only for cause, reflecting Congress’ view that, absent fraud or incompetence, reorganization would be best effectuated by allowing the debtor to continue to operate its business as debtor-in-possession. Even if a trustee is appointed, the court may, at any point before confirmation, terminate the trustee’s appointment and restore the debtor-in-possession to management and operation of the business. As for the SEC, Chapter 11 provided no specific statutory role other than the ability to participate as a party-in-interest. Chapter 11 thus eliminated SEC oversight of the reorganization process.

Other provisions further enhanced the “comfort zone” that Chapter 11 provided to debtors and management and encouraged filing before a debtor’s financial position deteriorated beyond the point that rehabilitation would no longer be feasible. Such enhancements included: (a) the automatic stay of action against the debtor, its properties, and properties in the possession of the debtor upon commence-
ment of a Chapter 11 case;\textsuperscript{94} (b) the broad financing power available to debtors;\textsuperscript{95} (c) the debtor’s expanded authorization to reject executory contracts;\textsuperscript{96} (d) a more comprehensive definition of property of the estate;\textsuperscript{97} (e) 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;\textsuperscript{98} (f) the expansion of the debtor’s administrative powers;\textsuperscript{99} and (g) 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, subject to termination, contraction, or extension for cause.\textsuperscript{100}

B. Protection of Non-Debtor Interests

Congress was mindful of the interest of other parties affected by business failures. The legislative history of the 1978 Act demonstrates that Congress believed that “[t]he purpose of a business reorganization case [under Chapter 11] . . . is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders.”\textsuperscript{101} With the understanding that “[r]eorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the values of the estate should be apportioned among creditors and stockholders. . . .,”\textsuperscript{102} the 1978 Act also provided safeguards to protect the interests of creditors and public investors. Such provisions reflected Congress’ intent to balance the interests of all parties involved in the Chapter 11 reorganization process.

Non-debtor protections included in the 1978 Act provide that: (a) the commencement of a Chapter 11 case may be voluntary or involuntary;\textsuperscript{103} (b) secured creditors are entitled, if requested, to adequate protection of their interests in property of the estate;\textsuperscript{104} (c) the goal of a Chapter 11 restructuring is to achieve a consensual plan of

\textsuperscript{94} 11 U.S.C. § 362.
\textsuperscript{95} See id. § 364.
\textsuperscript{97} See id. § 541.
\textsuperscript{98} Id. §§ 542–43.
\textsuperscript{99} See id. §§ 361–366.
\textsuperscript{100} Id. § 1121.
\textsuperscript{103} 11 U.S.C. §§ 301, 303 (2000).
\textsuperscript{104} Id. §§ 361, 363.
reorganization accepted by certain requisite majorities of various classes of voting-impaired creditors and equity holders;\(^\text{105}\) (d) 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, and upon a finding that the statement contains “adequate information” to enable creditors and equity holders the opportunity to cast an informed vote;\(^\text{106}\) (e) the office of the U.S. trustee (initially as an experimental program and now as a permanent program) will oversee the administration of Chapter 11 cases;\(^\text{107}\) (f) the debtor must provide due process protections, such as notice and a hearing, to creditors prior to obtaining the entry of orders and judgments;\(^\text{108}\) and (g) the plan must fully comply with confirmation requirements, including an expanded feasibility standard and a best-interests-of-creditors test.\(^\text{109}\)

Congress also appreciated that the revival of an otherwise failing business served interests of non-creditors, including older employees, customers, suppliers, and property owners.\(^\text{110}\) As Harvard Law School Professor Elizabeth Warren has observed, “[c]ongressional comments on the Bankruptcy Code are liberally sprinkled with discussions of policies to ‘protect the investing public, protect jobs, and help save troubled businesses,’ of concern about the community impact of bankruptcy, and of ‘the public interest’ beyond the interests of the disputing parties.”\(^\text{111}\)

\(^{105}\) See id. § 1126.

\(^{106}\) Id. § 1125.

\(^{107}\) Id. § 307.


\(^{109}\) See 11 U.S.C. §§ 1123, 1129 (2000); In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890, 265 F.3d 869, 877 (9th Cir. 2001); see also Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.), 843 F.2d 636, 649 (2d Cir. 1988) (stating that the 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 Chapter 7 liquidation”).

\(^{110}\) Warren, supra note 87, at 787–87.

C. Judicial Interpretation of the Bankruptcy Code

From the outset, the Bankruptcy Code was understood to be a flexible document, with its provisions to be shaped and interpreted to meet the needs of the Congressional policy of furthering rehabilitation. Early caselaw illustrates the manner in which policy considerations behind the 1978 Act encouraged a pragmatic view and application of the Bankruptcy Code.

In United States v. Whiting Pools, Inc., the Court of Appeals for the Second Circuit, relying upon the policy considerations of the 1978 Act as well as on sections 541 and 542 of the Bankruptcy Code as statutory predicates, expanded the power of the debtor to obtain a turnover order under section 542(a) of the Bankruptcy Code. The debtor in Whiting Pools, pursuant to section 542 of the Bankruptcy Code, sought to require the Internal Revenue Service (“IRS”) to turn over property that it had levied shortly before Whiting filed for bankruptcy. Whiting was in the business of selling, installing, and servicing swimming pool equipment, and the IRS, acting pursuant to Internal Revenue Code § 6331, seized and took control of all of Whiting’s tangible property, including equipment, vehicles, inventory, office equipment, and supplies, all of which were “absolutely necessary to an effective reorganization of the debtor.”

The IRS argued that the plain meaning of section 542 did not mandate turnover in this case because, at the commencement of the case, the debtor’s interests in the property were only those set out in the IRS levy statute, namely a right to notice of the seizure/sale, redemption prior to sale, and a right to surplus proceeds. The Second Circuit disregarded the IRS’s “mechanical interpretation,” determining that “the Government’s reading of the Bankruptcy Code would seriously affect the chances of success in many reorganization cases.”

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In light of legislative history indicating that reorganizations were to be encouraged under the new Code, we doubt that Congress intended such a result.” The court instead found that a narrow definition of property of the estate would have a “far-reaching effect on reorganizations by denying to debtors or trustees in reorganization not only the power to obtain the turnover of property of the debtor levied upon by the IRS, but also that repossessed prior to bankruptcy by secured creditors or held by pledgees after a default.”

The Supreme Court affirmed the Second Circuit’s holding, thereby upholding the debtor’s right to regain possession and use of property necessary to its ongoing business and generally prioritizing the ability of a debtor to restructure successfully over the ability of the federal government to collect taxes. The Court echoed the Second Circuit’s concern for a flexible approach to interpreting the Bankruptcy Code in order to facilitate reorganization: “By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors’ claims, and to produce a return for its owners.”

The Court also emphasized the breadth of the definition of “property of the estate” in the context of the legislative history of the 1978 Act, stating that “[b]oth the congressional goal of encouraging reorganizations and Congress’ choice of methods to protect secured creditors suggest that Congress intended a broad range of property to be included in the estate.”

In NLRB v. Bildisco & Bildisco, the Supreme Court again emphasized the policy goals of the Bankruptcy Code: “[t]he fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of eco-

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119 Id. at 150, 152 & n.13 (citing 123 CONG. REC. H. 11,697 (daily ed. Oct. 27, 1977)).
120 Whiting Pools, Inc., 674 F.2d at 150.
123 Id. at 203–04. Interestingly, the Supreme Court also interpreted the IRS levy statute to narrow the IRS’s interest in the property to that of a right to legal custody and nothing more, rejecting the IRS’s contention that the debtor’s interests in the property were only, for instance, a right to notice of the seizure/sale or a right to surplus proceeds. See id. at 210–11 (“In fact, the tax sale provision itself refers to the debtor as the owner of the property after the seizure but prior to the sale. Until such a sale takes place, the property remains the debtor’s and thus is subject to the turnover requirement of § 542(a).”) (citation omitted). It is possible that the Supreme Court was attempting to narrow the Second Circuit’s reliance on a broad definition of “property of the estate” by instead narrowly interpreting the IRS’s rights to the debtor’s property under the IRS levy statute to fall outside of a less broad definition. Nevertheless, this is unlikely given the Supreme Court’s lengthy discussion of the Bankruptcy Code’s policy objectives. See id. at 204.
economic resources.” In a controversial holding, the Court rejected the argument that collective bargaining agreements are not executory contracts and, therefore, are beyond the scope of the rejection powers of section 365 of the Bankruptcy Code. The Supreme Court declined to require a debtor to demonstrate that a reorganization would otherwise fail in order to reject a collective bargaining agreement, a formulation adopted by the Second Circuit in *Brotherhood of Railway v. REA Express, Inc.* The Supreme Court held that, although rejection of collective bargaining agreements should be governed by a stricter standard than the business judgment standard applied to other executory contracts because of the special nature of a collective-bargaining contract and the “law of the shop” it creates, the *REA Express* standard was too stringent and therefore “fundamentally at odds with the policies of flexibility and equity built into Chapter 11 of the Bankruptcy Code.” The Court thus held that a debtor could rescind a labor contract immediately upon the commencement of a Chapter 11 case. Unfortunately, the public debate sparked by the *Bildisco* decision triggered an immediate congressional response. Congress promptly passed an amendment to the Bankruptcy Code setting forth specific procedures and substantive requirements for the rejection of collective bargaining agreements. Section 1113, the amendatory provision of the Bankruptcy Code that nullified the *Bildisco* holding, provides for an expedited form of collective bargaining, the failure of which is the only avenue for a debtor to reject the labor contract.

Another case illustrating the doctrine of flexibility is *In re Ionosphere Clubs, Inc.*, which is often credited as the seminal case regarding critical-vendor payments and, accordingly, is frequently cited in support of critical-vendor motions. The issue before the court was

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125 Id. at 521–23.
126 See id. at 525–27.
129 See id.
131 *In re Century Brass Prods., Inc.*, 795 F.2d 265, 272 (2d Cir. 1986); see 11 U.S.C. § 1113.
133 A critical-vendor motion seeks authorization to pay claims of “critical vendors,” as identified by the debtor and approved by the court. Critical vendors are those who “supply services or material essential to the conduct of the [debtor’s] business,” such that their
whether the debtor, Eastern Airlines, was required to pay the prepetition wage, salary, and medical benefit claims of all employees, rather than only the claims of active, non-striking employees the debtor considered to be critical for continued operations.134 According to the International Association of Machinists, the prepetition wage and salary claims of both active and striking employees were priority claims under section 507(a)(3) of the Bankruptcy Code and thus should be treated in the same fashion.135

The court, however, held that “[a] rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization”136 and the “paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated . . ., [which] is the rehabilitation of the debtor.”137 In denying relief for non-critical employees and allowing the debtor to make payments solely to active, non-striking employees, the court relied on the equitable power provided by section 105 of the Bankruptcy Code, as well as on section 363(b), which empowers a bankruptcy court to authorize a debtor to expend funds outside the ordinary course of business.138 According to the court, its use of section 105 in this context went to the very purpose of the Bankruptcy Act’s grant of equitable powers to the bankruptcy court, which was “to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.”139

As these cases make clear, rehabilitation and reorganization were the policy goals underlying the enactment of the Bankruptcy Code. In the early years following the 1978 Act, judges did not hesitate to in-

134 In re Ionosphere Clubs, Inc., 98 B.R. at 174–75.
135 Id. at 175.
136 Id. at 178 (quoting In re Chateaugay, 80 B.R. 279, 287 (Bankr. S.D.N.Y. 1987)).
137 Id. at 176.
138 Id. at 178.
139 Id. (quoting In re Chateaugay, 80 B.R. at 287).
interpret the Bankruptcy Code and exercise their perceived equity powers to achieve and implement that policy.

III. THE DECLINING EMPHASIS ON REHABILITATION

A. The “Clawback” by Creditors and Parties in Interest

The passage of the 1978 Act ushered in a new era of special-interest legislation designed to meet the needs of a variety of parties. Congress responded to pressures from various special interests by passing specific provisions to protect a particular special-interest group. Thus began the contraction of debtor protections to achieve the congressional policy of rehabilitation and reorganization. Ultimately, the enactment of such special-interest provisions motivated other groups to obtain statutory amendments to protect their interests and the “clawback” protections and powers extended to the debtors.

Purportedly to maintain affordable access for airlines to lease and finance acquisitions of aircraft, section 1110 of the Bankruptcy Code provides aircraft manufacturers, lessors, and financiers with additional protections. Section 1110 is a provision paralleled to section 1168, which originated in section 77(j) of the 1978 Act, and was passed in response to the Supreme Court’s ruling in Continental Illinois National Bank v. Chicago, Rock Island & Pacific Railway, that a creditor’s right to foreclose on a particular railroad asset could be enjoined to preserve going-concern value. Section 1110 of the Bankruptcy Code provides an exception to the automatic stay provision of section 362, allowing financiers to bypass the stay to receive current payments or recover the financed aircraft-related equipment. Supposedly, two negative consequences would arise if the section 1110 exception did not exist: (1) airlines would face prohibitive increases in the cost of aircraft leases—driven by lessors’ and financiers’ need to account for such risk—and (2) airlines would be unable to acquire new aircraft readily to service additional markets, compete with other airlines, or upgrade aging equipment. It has been argued that, as a result of the section 1110 protections and despite the chronic financial problems plaguing the airline sector, a competitive market

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141 294 U.S. 648 (1935).
for aircraft-related financing developed that benefited the airline industry and the public. The empirical evidence to support this argument, however, is inconclusive.

Certain financial institutions receive special protection under the Bankruptcy Code. Safeguards are designed to provide incentives for such institutions to enter into transactions with financially troubled companies, to preserve the liquidity of the nation’s financial markets, and to remove the uncertainties of bankruptcy as a limiting factor in the formation and execution of such transactions. For example, the Bankruptcy Code grants financial institutions that conduct derivative transactions the right to set off mutual claims despite the automatic stay and permits them to exercise otherwise unenforceable ipso facto provisions.\textsuperscript{145}

Commercial property owners also receive special protections under the Bankruptcy Code.\textsuperscript{146} While section 365 of the Bankruptcy Code generally allows a debtor to delay its decision to assume or reject an executory contract until confirmation of its plan of reorganization, section 365(d)(4) limits the time within which a debtor may assume a lease of nonresidential property to sixty days from the date of commencement of the Chapter 11 case, subject to extension for cause.\textsuperscript{147} In addition to the sixty-day limitation of section 365(d)(4), shopping center lessors have received further protections pertaining to the assumption of leases within their shopping centers, in the form of adequate assurance of performance provisions.\textsuperscript{148} Such protections, codified in section 365(b)(3), are justified by proponents by the interdependencies among tenants of shopping centers and the resulting impact that each tenant has on others.\textsuperscript{149}

Equipment lessors are also protected by section 365(d)(10) of the Bankruptcy Code, adopted in 1994, under which a debtor is obligated to make all payments required under a lease of personal property arising sixty days after the commencement of the Chapter 11 case.\textsuperscript{150} This provision is designed to protect such a lessor from a debtor who retains the lessor’s property and attempts to limit the les-


\textsuperscript{147} Id. § 365(d)(4).

\textsuperscript{148} See id. § 365(b)(3).


\textsuperscript{150} See 11 U.S.C. § 365(d)(10).
sor’s administrative expense claim through section 503(b)(1), which allows for administrative expenses that are the “actual, necessary costs and expenses of preserving the estate.”

B. The Creditor-in-Possession

The increasing influence of creditors has fundamentally changed the reorganization process, with wide-ranging and far-reaching effects both prior to and during a company’s decision to commence a Chapter 11 case. This Section identifies and analyzes two contributing causes: (1) distressed-debt trading and (2) debtor-in-possession financing.

Distressed-debt trading has grown to proportions never contemplated when the 1978 Act was enacted. It has meaningfully transformed the relationship between debtors and creditors. In the 1970s and 1980s, that relationship was generally symbiotic. Prior to globalization and technological advancements such as the Internet, suppliers, purchasers, and lenders often shared long-standing commercial relationships and, as a result of geographic limitations, were confined to the same areas and local economies. The interdependent nature of fortunes encouraged support when a local enterprise commenced a reorganization case, as it was in the best interests of suppliers and lenders to continue providing materials, products, and support.

The globalization of the economy and the growth of financial markets have fueled distressed-debt trading, a phenomenon that has upset the symbiotic relationship between a debtor and its creditors. Unsophisticated suppliers who are unwilling to navigate the recovery of their claims through the Chapter 11 process now easily liquidate their claims by selling them for cash at a discount to distressed-debt traders. Creditor financial institutions no longer feel con-

151 See id. § 503(b)(1); Ayer et al., supra note 149, at 54.
152 The onset of large-scale debt trading is generally attributed to the 1991 amendment to Federal Rule of Bankruptcy Procedure 3001(e). Before 1991, claimants had greater access to information that enabled them to make informed decisions on whether they should sell their claims. By contrast, the current version of Bankruptcy Rule 3001(e) no longer requires the disclosure of the “terms of the transfer” and “the consideration therefor,” which were viewed as frustrating the goal of providing a liquid market for the sale of claims. Today, Bankruptcy Rule 3001(e) simply requires the transferee to provide evidence of the transfer to the court. Fed. R. Bankr. P. 3001(e); Harvey R. Miller, Chapter 11 Reorganization Cases and the Delaware Myth, 55 VAND. L. REV. 1987, 2015–16 (2002).
153 Even to the extent that trade creditors do not sell their claims and are willing to work patiently with the debtor to ensure its rehabilitation, trade creditors’ role in Chapter 11 cases appears to be waning. For example, one would expect Winn-Dixie, a grocery retailer with goods comprising its main cost of doing business, to have a large proportion of trade debt. Instead, the trade debt accounted for only roughly twenty percent of Winn-Dixie’s debt at the
strained by relationships with management and may choose not to carry large defaulted loans, which must be marked to market with attendant financial statement charges to the lender. Accordingly, financial institutions often seek liquidity and lower risk, and thus sell the debt notwithstanding any prior relationship with a particular debtor.

Distressed-debt traders have different motivations from commercial creditors providing goods and services or lenders. They buy claims of all types at substantial discounts. Rather than nurture long-term relationships, distressed-debt traders purchase debt claims to reap material profits and, in certain situations, to obtain control of the debtor and dominate the administration of the reorganization case through membership on the creditors’ committee. In either case, the perspective of the distressed-debt trader is that time is of critical importance in order to maximize the return on investment. The sooner a trader or a group of traders can force a debtor to emerge from Chapter 11, the sooner the traders’ claims can be monetized—regardless of any other factor, including whether or not the debtor had been fully rehabilitated when it was pressured to exit the Chapter 11 reorganization process. This paradigm may be a material contributing factor to the recidivism rate and Chapter 11 debtors’ eventual return to the bankruptcy court.

Distressed-debt traders, primarily hedge funds, constitute a sophisticated set of players in the Chapter 11 arena who continue to grow increasingly familiar with Chapter 11 and who are unwilling to sacrifice recovery for the sake of the debtor’s rehabilitation. Distressed-debt traders’ entry into the reorganization process has transformed Chapter 11 reorganizations from primarily rehabilitation to the fulfillment of laissez-faire capitalism focused on the realization of substantial profit-taking.

In tandem with the growing dominance of the distressed-debt traders/hedge funds, lenders, including hedge funds who increasingly have supplanted banks and other financial institutions, have also grown increasingly sophisticated in gaining influence and control over a debtor through debtor-in-possession financing (“DIP financing”). DIP financing agreements generally take the form of a revolving credit facility, with

commencement of its Chapter 11 cases. See generally In re Winn-Dixie Stores, Inc., No. 05–11063 (RDD) (Bankr. S.D.N.Y. Feb. 21, 2005) (first-day affidavit of Bennett L. Nussbaum reporting total liabilities of $1.9 billion, but accounts payable of only $410 million as of January 12, 2005, approximately five weeks before the Chapter 11 filing).
amounts borrowed due on a regular and relatively short-term basis. They typically include regular reporting requirements to allow the lenders to evaluate the debtor’s performance frequently and to determine whether the loan should be rolled over. Because debtors that file for Chapter 11 protection increasingly have balance sheets that are encumbered by large amounts of secured debt—meaning they have a real need to turn to DIP financing, negotiations over DIP loan agreements have become more and more one-sided, with lenders’ leverage substantially enhanced by pre-Chapter 11 liens and security interests. Such leverage has enabled DIP lenders to impose increasingly severe covenants and conditions on the debtor and its activities to the point that control of the Chapter 11 case has been taken away from the bankruptcy court.

For example, a DIP lender may insist that the debtor hire a chief restructuring officer (“CRO”). CROs are typically vested with executive decision-making power and direct access to the debtor’s board, but they can talk to the lenders without reporting back to the board. Many DIP loan provisions can constrain management flexibility and pressure the debtor into selling its assets. A DIP lender may insist upon, for example, highly restrictive cash flow covenants in the loan agreement. Other examples include drop-dead dates, events of default, negative covenants, and consent requirements that may go so far as to prohibit the filing of a Chapter 11 plan without the prior written consent of the lenders.

The Chapter 11 process is increasingly dominated by the “creditor-in-possession,” which may explain recidivism rates that have been

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154 See generally id.
155 See generally id.
158 Id. at 13.
159 For example, the management of United Airlines was compelled to terminate much of its workforce and renegotiate its collective bargaining agreement in order to comply with the cash flow requirements of the company’s DIP agreement. Id. at 13–14.
calculated to be as high as 42% in some districts.\textsuperscript{161} Despite the feasibility requirement of section 1129(a)(11) of the Bankruptcy Code, the bankruptcy judge is dependent upon the parties to present the necessary facts, upon which the judge will either confirm or deny a plan. Courts do not have the means to assess independently a plan’s feasibility when presented and supported by the debtors and the creditors. To a large degree, the bankruptcy judge is a captive of the parties, even when a group of creditors exerts a disproportionate influence on the process.

Management is often unable to counterbalance the influence of creditors in Chapter 11. At the outset, management, fearing a loss of control in the current environment, is often reluctant to commence a Chapter 11 case, often waiting only until the last moment to use Chapter 11, which could be after the debtor has a realistic chance of being rehabilitated. Conversely, once a Chapter 11 case has commenced, management often has every incentive to cooperate with lenders. Perhaps senior management is simply reading the proverbial “writing on the wall.” At the outset of many cases, it is often obvious that creditors will eventually own the reorganized debtor. Managements desiring a future role with the reorganized debtor will, therefore, have an incentive to appease their future owners.\textsuperscript{162} Other times, lenders are able to change the debtor’s management team to their advantage. An empirical study found that, during times of financial distress, there is a 52% likelihood of senior management turnover in any year in which the debtor declares bankruptcy or engages in an out-of-court restructuring.\textsuperscript{163} The same study found that lenders were responsible one out of every five times such management changes occurred.\textsuperscript{164}

Accordingly, creditors (increasingly in the form of distressed-debt traders), consistent with the adage that time is money and facing little resistance, often pressure a debtor to emerge quickly from Chapter 11 and push the debtor to formulate and present hastily a plan of reorganization. All too often this occurs before the remedial work has

\textsuperscript{161} Harvey R. Miller & Shai Y. Waisman, The Creditor in Possession, \textit{Bankr. Strategist}, Nov. 2003, at 1, 2, 6, 7.
\textsuperscript{162} See Miller et al., supra note 157, at 17.
\textsuperscript{164} Id.; see Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. Pa. L. REV. 669, 737 (1993) (finding that creditors participated in eighteen of forty CEO firings in large publicly traded firms that filed for Chapter 11).
been done, so the reorganized debtor fails once again. The result is Chapter 22, sometimes Chapter 33, to use proverbial characterizations.165

C. The Increasing Prevalence of Section 363(b) Sales

The prevalence of asset sales under section 363(b) of the Bankruptcy Code in the context of Chapter 11 is attributable to many factors besides increasingly powerful creditors. Robust capital markets facilitate the pooling of massive amounts of capital by groups of investors, typically in the form of alternative investment vehicles such as private equity and leveraged buyout funds, hedge funds, and vulture funds, in order to purchase or control companies of sizes previously not thought possible (for example, RJR Nabisco, Kmart, Toys “R” Us, Sungard). Additionally, with the ability of such funds to cooperate, few companies are outside the realm of acquisition possibility based on size. Assets are increasingly fungible, implying that the number of potential buyers of assets of any Chapter 11 debtor is growing. The Bankruptcy Code itself creates incentives to engage in asset sales; because section 363 offers the ability to convey assets “free and clear,” a debtor sometimes may file for Chapter 11 to implement a sale of all or substantially all of its assets under section 363(b) without any intention to attempt a rehabilitation of the business.167 This unique ability to cleanse the assets of a distressed company attracts potential purchasers because it potentially removes the uncertainty of successor liability, fraudulent transfer claims, and lien issues that often accompanies asset purchases. Chapter 11 thus facilitates the creation of a market for the sale.

Notwithstanding the foregoing factors, the creditor-in-possession phenomenon has certainly contributed to the increasing prevalence


167 Baird & Rasmussen, supra note 9, at 751–52 (citing the bankruptcies of Trans World Airlines and Enron).
of bankruptcy sales. Creditors often prefer Chapter 11 as a mechanism to facilitate asset sales rather than as a tool for reorganization, given that immediate sales produce a greater certainty of return. Distressed-debt traders, for example, often consider an extended Chapter 11 process to be undesirable, given that their primary concern is achieving a quick return on their investments. DIP lenders, which are often senior secured creditors, also may favor asset sales in Chapter 11, given that they face limited upside potential but significant downside risk from an extended Chapter 11 case.

D. The Political Environment

Since the mid-1990s, there has been a judicial trend toward strictly construing and emphasizing the plain meaning of the language of the Bankruptcy Code in its application, as opposed to what is pejoratively described as legislating from the bench.\(^\text{168}\) This trend emphasizes predictability, rights, and legislative fiat. Creative applications of the principles and policies of the Bankruptcy Code to further a debtor’s rehabilitation, its proponents argue, cannot be extended by a bankruptcy court in the absence of express statutory provisions empowering the court to provide such relief. This trend stands in stark contrast to the flexibility and practicality of the bankruptcy courts that initially interpreted and applied the Bankruptcy Code. The result has been judicial decisions that ignore the predominant rehabilitation policy objective that underlies the 1978 Act. This conservative but currently popular view of the judicial function may hamper the ability of a debtor to reorganize effectively and also ignores the fact that a reorganization case is a socioeconomic legal process that requires flexibility and creativity to achieve the legislative objectives.

_Perlman v. Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)\(^\text{169}\)_ is a prime example of the unfortunate consequences of the strict constructionists. In that case, the Court of Appeals for the Ninth Circuit held that the proper interpretation of section 365(c)(1) of the Bankruptcy Code is the plain meaning of its language, which establishes a so-called hypothetical test to govern the assumption of executory contracts.\(^\text{170}\) The decision prevents a debtor, as a debtor-in-


\(^{169}\) 165 F.3d 747 (9th Cir. 1999).

\(^{170}\) See id. at 749–50.
possession, from assuming a non-assignable executory contract, even when the debtor has no intention of assigning the contract. The decision blithely ignores the legal construct that the debtor and the debtor-in-possession constitute the same entity and, therefore, the entity whose performance the counterparty had voluntarily agreed to accept. Rather, the decision enables the counterparty to take advantage of the occurrence of Chapter 11 to repudiate the agreement and obtain a windfall. As a result, the debtor’s estate is deprived of the value of the executory contract to the detriment of all of the debtor’s creditors other than the counterparty. By focusing on the plain meaning of the Bankruptcy Code instead of the underlying policy of rehabilitation, this decision seriously impairs the ability of Chapter 11 debtors to reorganize by depriving them of the economic benefit of assuming executory contracts with favorable terms if such contracts are not hypothetically assignable.

Similarly, in United Phosphorus, Ltd. v. Fox (In re Fox), the Bankruptcy Appellate Panel of the Court of Appeals for the Tenth Circuit held that creditors may not bring derivative suits on behalf of the bankruptcy estate. In so holding, the panel focused on the literal language of section 548 of the Bankruptcy Code, which authorizes the trustee to avoid transfers. In choosing not to follow the Third Circuit’s decision in another case, Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, the Fox panel discounted what it at least acknowledged as better policy: “Cybergenics discusses many reasons why it would be good policy for parties other than the trustee to bring derivative complaints, and it is hard to disagree with the reasons set forth by the majority.” The court continued, though, to decline the invitation to be guided by such policy considerations:

We, however, believe this reasoning is best considered by Congress, and it is not up to us to create a remedy for creditors it has not granted to them, especially when that right is

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171 See id. at 750.
172 See 11 U.S.C. § 365(c) (2000) (“The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties . . . .”) (emphasis added).
173 Perlman, 165 F.3d at 753.
174 305 B.R. 912 (B.A.P. 10th Cir. 2004).
175 Id. at 916.
176 See id. at 914–15.
177 330 F.3d 548, 580 (3d. Cir. 2003).
178 Fox, 305 B.R. at 916.
given exclusively to the trustee. Here, the statute is absolute and allows us no discretion to vary from what it says.\footnote{Id. (citation omitted).}

Instead, the B.A.P. adhered to the plain meaning rule and the Supreme Court’s admonition in \emph{Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A.},\footnote{530 U.S. 1 (2000).} that a plain and unambiguous statute should not be embellished.\footnote{Fox, 305 B.R. at 916.}

In \emph{In re Armstrong World Industries, Inc.}, the court laid out perhaps one of the strongest-worded rebukes of judicial flexibility.\footnote{See 320 B.R. 523, 540 (D. Del. 2005).} After extensive negotiations, the debtor filed its fourth plan of reorganization.\footnote{Id. at 525.} At issue and a key part of this plan was the consent by the asbestos personal injury claimants to share a portion of their proposed distribution with equity holders.\footnote{Id. at 526.} The bankruptcy court issued proposed findings of fact and conclusions of law along with a proposed confirmation order, and certain unsecured creditors who had previously indicated support of the debtor’s plan filed objections with the district court.\footnote{See \emph{id.} at 531.} The district court denied confirmation of the plan, holding that it violated the fair and equitable (absolute priority) rule, by allowing equity holders to receive the debtor’s property on account of their ownership interest before unsecured creditors had been paid in full.\footnote{Id. at 536.} The court warned: “Bluntly put, no amount of legal creativity or counsel’s incantation to general notions of equity or to any supposed policy favoring reorganizations over liquidation supports judicial rewriting of the Bankruptcy Code.”\footnote{In re Armstrong World Indus., Inc., 320 B.R. at 540; see United States v. Sutton, 786 F.2d 1305, 1308 (5th Cir. 1986) (“While the bankruptcy courts have fashioned relief under Section 105(a) in a variety of situations, the powers granted by that statute may be exercised only in a manner consistent with the provisions of the Bankruptcy Code. That statute does not authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.”).}

The growing influence of creditors, particularly secured creditors, and the increasing emphasis both on enforcing parties’ contractual and statutory rights and on strictly interpreting the plain language of the Bankruptcy Code, has found unity and intellectual justification in aca-
demic circles under the name of “contractualism.” 188 Under a contractual model, there is no need for a court-supervised insolvency process because the most suitable private party, through contract, is allocated decision-making responsibility. 189 Upon default by the borrower (or even before), control shifts to such party per agreement and this party makes business decisions such as when to shutter the business. The contractual model eschews governmental oversight and entrusts private parties with the responsibility of allocating control rights efficiently. From this perspective, the control that secured creditors and DIP lenders procure through restrictive terms and conditions of loan agreements is acceptable, even desirable. Some argue that contractualism is already in place. 190

IV. THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

Representing the most comprehensive set of reforms to the Bankruptcy Code in more than twenty-five years, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 191 (the “Abuse Act”) is designed to improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensuring fairness to both debtors and creditors. 192 The Abuse Act pertains to both consumer and business bankruptcy and includes provisions intended to reduce systemic risk in the banking system and financial marketplace, as well as a separate chapter addressing transnational insolvencies, both in response to trends in the globalization of business management and operations and in order to provide greater legal certainty for trade and investment. 193

President Bush signed the Abuse Act into law on April 20, 2005, and most provisions took effect on October 17, 2005. 194 The Abuse


189 See, e.g., Baird & Rasmussen, supra note 9, at 781 (citing Webvan as a paradigmatic example). One can analogize to the control obtained by DIP lenders over a debtor through the DIP loan agreement, which, if sufficiently overreaching, allows the DIP lenders the right effectively to run the debtor’s operations.

190 Westbrook, supra note 188, at 829.


Act represents the culmination of nearly eight years of proposed legislation. The House of Representatives has passed bankruptcy reform legislation on eight occasions since the 105th Congress,\textsuperscript{195} and the Senate has passed legislation on four occasions and has held numerous hearings on the subject of bankruptcy reform.\textsuperscript{196} Notwithstanding President Clinton’s veto of such legislation during the 106th Congress, bankruptcy reform legislation survived and now has found enactment with bipartisan, bicameral support, the lobbying for which was largely financed by credit card issuers and banks.\textsuperscript{197}

The legislative history of the Abuse Act indicates several motivations for reform: (1) an increase in the number of consumer bankruptcy filings and alleged associated creditor losses, as well as adverse financial consequences for the economy as a whole; (2) the use of loopholes and other abusive practices; and (3) the lack of a clear mandate for debtors to repay their debts to the best of their abilities.\textsuperscript{198} However, whether the Abuse Act does in fact respond to such “significant developments”\textsuperscript{199} has been questioned. According to the Senate testimony of Professor Warren, “The overarching problem with this bill is that time and the American economy have passed it by. . . . [T]he events of the past eight years have dramatically changed the economic and social environment in which [the bill must be considered].”\textsuperscript{200} The legislative history demonstrates that this balance was a matter of discussion; in the context of consumer bankruptcy legisla-


\textsuperscript{196} The Senate passed legislation in each of the 105th, 106th and 107th sessions of Congress, as well as a conference report in the 106th Congress. Id. at 6, reprinted in 2005 U.S.C.C.A.N. at 93.

\textsuperscript{197} See, e.g., Timothy Spence, Bankruptcy: Senators Pursue Credit-card Reform, MIAMI HERALD, May 22, 2005, at E4 (“Banks and credit card companies, which lobbied for the law, say it would stop people who live beyond their means and then shirk their debts by declaring bankruptcy.”).


tion, the House Report dated April 8, 2005 states: “these reforms contemplate replacing the current law’s presumption in favor of the debtor with a mandatory presumption of abuse that would arise under certain conditions.”

Initial political commentary on the Abuse Act has focused mainly on its creditor-friendly consumer aspects because the legislation modifies the provisions governing individual bankruptcies more so than business bankruptcies, and these changes are visible to the American public. Not to be lost in the attention given to the consumer provisions, however, is the effect the Abuse Act will likely have on Chapter 11 reorganizations and the delicate balance between the interests of the debtors and creditors.

In some ways, the modifications to the Bankruptcy Code appear to be a continuation of the creditors’ clawback of creditor prerogatives and the special-interest legislation that followed the 1978 Act. Creditors, as repeat players in the Chapter 11 game, have a continuing interest in the system. It is the business of banks, credit card issuers, and utilities, for example, to deal with defaulting debtors inside and outside of Chapter 11 on a regular basis and, therefore, these players have a vested interest in the nation’s insolvency laws. They are positioned and incentivized to lobby and obtain passage of special-interest legislation. They have been largely successful. In contrast, the interests of debtors are not consistently represented in our pluralist system. Debtors cannot form an effective lobby because of their transient interaction with the insolvency system and their more limited resources and diverse interests. As noted above, the passage of significant bankruptcy legislation to encourage rehabilitation has been sporadic historically. Legislation has been spurred by outcry during the troughs of the economic boom and bust cycle, with the 1978 Act being the notable exception.

An illustrative example is the Abuse Act’s modification of section 365(d)(4) of the Bankruptcy Code, the provision that governs a debtor’s statutory period to assume or reject an unexpired lease of nonresidential real property. The Abuse Act extends the debtor’s time period to assume or reject the lease from sixty to 120 days, but

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deprives the court of the ability to grant extensions of the time period for cause shown.\textsuperscript{204} Previously, courts had routinely extended the time period, prompting outcries and lobbying from landlords. Now, after one ninety-day extension, any further extension will require the prior written consent of the lessor.\textsuperscript{205} If such lease is assumed and eventually rejected, the lessor would be entitled to an administrative expense for money owed under such lease for a period of two years, without regard to actual damages suffered by the lessor.\textsuperscript{206} Similarly, section 366 of the Bankruptcy Code, the provision that governs the treatment of utility companies, protects utility creditors at the expense of the debtor. The Abuse Act extends the time within which a debtor must provide adequate assurance of payment to thirty days, but enhances utility companies’ positions by restricting what qualifies as adequate assurance.\textsuperscript{207} Adequate assurance must be “satisfactory” to the utility and, while the Abuse Act does not clarify what “satisfactory” means, it specifically excludes administrative expense priority.\textsuperscript{208} Additionally, a utility company will now be able to recover or setoff against a prepetition deposit without court approval.\textsuperscript{209} Other examples of the creditor clawbacks in the Abuse Act include: (1) the narrowing of the automatic stay with respect to U.S. Tax Court proceedings,\textsuperscript{210} setoffs relating to contracts for financial instruments and repurchase agreements,\textsuperscript{211} and certain governmental activities such as exclusion from participation in Medicare;\textsuperscript{212} (2) extending the time period for creditors to seek reclamation of goods;\textsuperscript{213} (3) granting administrative expense status for goods provided twenty days prior to the commencement of a Chapter 11 case;\textsuperscript{214} and (4)

\textsuperscript{204} See id.
\textsuperscript{205} Id.
\textsuperscript{206} See id.
\textsuperscript{207} See BAPCPA § 417, 119 Stat. at 100 (to be codified at, and amending, 28 U.S.C. § 366).
\textsuperscript{208} See id.
\textsuperscript{214} See BAPCPA § 1227, 119 Stat. at 200 (to be codified at, and amending, 28 U.S.C. § 503).
strengthening the ability of creditors to cause a Chapter 11 case to be converted or dismissed.\textsuperscript{215}

These examples of special-interest clawbacks in the Abuse Act, however, do not tell the entire story. In certain ways, the circumstances surrounding the passage of the Abuse Act are reminiscent of the New Deal environment that produced the Chandler Act. Echoing the New Deal mistrust of Wall Street, the recent flurry of high-profile fraud scandals that have caused many small investors to lose significant amounts of money and the length and expense of many Chapter 11 cases have prompted criticism of the Chapter 11 process. The resentment by organized groups of debt traders, landlords, lessors, and others of the purported entrenchment of management and professionals, not unlike the pre-Chandler Act criticism of the professionals’ relationship with managers prior to the commencement of receiverships, has been quite vocal. For example, the Abuse Act adds new section 503(c) to the Bankruptcy Code, which places considerable limits on retention bonuses.\textsuperscript{216} Under the new section 503(c), retention bonuses can be paid only if: (i) the payment is essential to retaining the person because that person has a “bona fide job offer from another business” with equal or greater compensation and (ii) the services provided by that person are “essential to the survival of the business.”\textsuperscript{217} Moreover, the new law caps retention bonuses to an amount equal to ten times the amount of similar payments given to non-management employees for any purpose (during the year in which such payment is made) or, if no similar payments were made, no greater than 25% of the amount of any similar payments to such insider for any purpose (during the year in which such payment is made).\textsuperscript{218} Certainly responding to the numerous recent fraud cases, the Abuse Act modifies section 1104 of the Bankruptcy Code to require that the U.S. Trustee move for appointment of a Chapter 11 trustee if there are reasonable grounds to suspect current board members, the CEO, or the CFO of fraud, dishonesty, or criminal con-


\textsuperscript{216} See BAPCPA § 331, 119 Stat. at 102–03 (to be codified at, and amending, 28 U.S.C. § 503).

\textsuperscript{217} See id.

\textsuperscript{218} See id.
duct in the management of the debtor or the debtor’s public financial reporting.\textsuperscript{219}

Perhaps the most significant change to the landscape of Chapter 11 reorganizations is the Abuse Act’s effective shortening of the debtor’s exclusive periods to file a plan of reorganization and obtain acceptances.\textsuperscript{220} Under section 1121 of the Bankruptcy Code as modified by the Abuse Act, extensions of the exclusive periods to file a plan and obtain acceptances are now limited to eighteen and twenty months, respectively, from the commencement of the debtor’s Chapter 11 case.\textsuperscript{221} Previously, bankruptcy courts granted, for cause and under the appropriate circumstances, several extensions that allowed the debtor to control the bankruptcy process for years.\textsuperscript{222}

The wisdom of the change to section 1121 of the Bankruptcy Code is debatable. Although the amendment appears to have been prompted by the length of recent, high-profile Chapter 11 cases such as Owens Corning\textsuperscript{223} and Global Crossing,\textsuperscript{224} it is unclear that debtors languish under the protection of Chapter 11 because of their lack of diligence in formulating an emergence strategy and filing a plan of reorganization. Many of these cases can be explained by special circumstances. For example, asbestos cases tend to be prolonged because of the unique nature of asbestos claims and the problems associated with estimating thousands of latent claims, devising a plan, and binding the claimants. Similarly, Global Crossing’s Chapter 11 case lasted almost two years largely because the debtor’s initial plan to sell assets to Hutchison Whampoa and Singapore Telemedia was scrutinized by the Committee on Foreign Investment in the United States.\textsuperscript{225}


\textsuperscript{222} E.g., In re UAL Corp., No. 02–48191 (ERW) (Bankr. N.D. Ill. 2002); In re LTV Steel Co., Inc., No. 00–43866 (WTB) (Bankr. N.D. Ohio 2000); In re Johns-Manville Corp., No. 82–11656 (BRL) (Bankr. S.D.N.Y. 1982).

\textsuperscript{223} In re Owens Corning, No. 00–3837 (JKF) (Bankr. D. Del. 2000).

\textsuperscript{224} In re Global Crossing Ltd., No. 02–15749 (REG) (Bankr. S.D.N.Y. 2002); see, e.g., Schroeder, supra note 202, at A2 (citing Owens Corning Corp.’s operating in bankruptcy since late 2000 as an example of the motivation to speed up business bankruptcies).

\textsuperscript{225} See Dennis K. Berman, The Economy: Bush Is Expected to Approve Global Crossing Deal, WALL ST. J., Sept. 9, 2003, at A2 (“The anticipated White House endorsement should end a 20-month saga for Global Crossing, which filed for Chapter 11 bankruptcy-court protection in early 2002, but has struggled to win U.S. government approval for a plan by Singa-
Notably, based on the year of emergence, the average length of Chapter 11 reorganizations has actually been declining over the last twenty years on the whole.\textsuperscript{226} Furthermore, it remains to be seen whether the average length of Chapter 11 cases will decrease because of the new limits on exclusivity extensions. There is the possibility that Chapter 11 cases may take longer, be more litigious, and, consequently, be more expensive as creditors now have less of an incentive to begin working with the debtor immediately. Further, management may delay commencing a Chapter 11 case even longer, leading to increased recidivism. What is clear, however, is that this change to section 1121 of the Bankruptcy Code strengthens the creditors’ leverage by giving them the option of being recalcitrant and waiting out the debtor’s exclusive periods in order to file their own plan.\textsuperscript{227}

V. DOES CHAPTER 11 REMAIN RELEVANT?

A. Going-Concern Value—A Thing of the Past?

Clearly the concept of comprehensive reorganization as contemplated by the 1978 Act is under intense scrutiny. The well-documented changes to the structure of our economy, including the shift from a manufacturing-oriented economy to a service-oriented one, the growth and globalization of financial markets, and the increasing significance of intangible assets and intellectual capital, to name a few, are significant and real. The current economy thus stands in contrast to the post-Industrial Revolution economy dominated by manufacturing and industry from which the railroad reorganization paradigm emerged, and it challenges the assumptions behind modern-day reorganization.

Professors Baird and Rasmussen are among those at the forefront of the argument predicting the demise of 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 com-

\textsuperscript{226} See \textit{Bankruptcy Yearbook}, supra note 2, at 71. From 1982 through 2003, the average length of a Chapter 11 reorganization was 16.5 months. In 2000, 2001, 2002, and 2003, the average length was 14.0, 13.5, 13.8, and 18.2 months, respectively. \textit{Id.} It should be noted, however, that this trend may be a result of the increasing prevalence of bankruptcy sales and the influence of creditors.

mencement 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.\footnote{See generally Baird & Rasmussen, supra note 9.} Intangible assets now comprise half of the value of non-financial firms in the United States, and firms that see Chapter 11 by their nature, do not tend to have intangible assets of significance.\footnote{Id. at 766.} Moreover, the hard assets of firms in a service economy not dominated by industry and manufacturing are fungible assets—general office space, desks, chairs, and word processors.\footnote{Fungible assets stand in contrast to dedicated or firm-specific assets. “Railroad assets are the archetypal examples of dedicated assets in American bankruptcy law, as individual rails, which together form a track, maintain little value separately, but are far more valuable collectively.” Miller & Waisman, supra note 22, at 192.} These assets do not retain greater value staying with a debtor, but can be used just as well by other firms.\footnote{Id. at 763–66.} Accordingly:

To the extent we understand the law of corporate reorganizations as providing a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, we may safely conclude that its era has come to an end.\footnote{Id. at 753.}

Are the assets of today’s businesses less dedicated than the assets of a railroad? 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 economy are office space, desks, and chairs. The conclusion, however, that firms using Chapter 11 today lack going-concern value remains unproven and runs contrary to experience.\footnote{Id. at 788; Miller & Waisman, supra note 22, at 191–92.} 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. This fact demonstrates that today’s market is rejecting the notion that debtors using Chapter 11 have little or no going-concern value. The integrity of the business as an ongoing operation, rather than as the separate assets, is what results in the enhanced sale prices.\footnote{See Miller & Waisman, supra note 22, at 192 n.176 (citing 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. 2001); In re Trans World Airlines, Inc., No. 01–056 (P JW) (Bankr. D. Del. 2001)).}
Why do businesses still maintain going-concern value despite the increasingly fungible nature of corporate assets? The answer lies in how assets are conceptualized. Baird and Rasmussen are correct in the sense that fungible assets do not have greater value residing within a particular business. This is only true, however, when the assets have not yet been deployed. Businesses incur costs in acquiring, installing, and otherwise deploying assets for use. Similarly, starting a business from scratch is expensive and time-consuming and entails a large degree of entrepreneurial risk. Accordingly, office space, chairs, desks, and word processors, although fungible in the absolute sense, are dedicated in a truer sense.

Stated differently, firms do differentiate between transactions inside the firm and outside the firm. Although, as Baird and Rasmussen note, the ability to conduct business through contracts outside the firm is increasingly common today, the flurry of recent mergers and acquisitions activity and the move toward consolidation across many industries suggest that there are benefits that cannot be obtained by simply contracting with the marketplace. For example, businesses maintain going-concern value as a result of centralized management, overlapping systems, and other benefits of economies of scale. As Baird and Rasmussen admit, transaction costs keep certain activities within the organization: “There is no special magic beyond transaction costs in accounting for any particular collection of assets assembled within a single firm.”

In addition, firms have going-concern value even in the absence of transaction costs. Going-concern value is primarily realized through a firm’s intangible ability to use its assets more efficiently than its competitors. The conclusion of Baird and Rasmussen that all firms using Chapter 11, by their unsuccessful nature, lack such ability is overly simplistic. Today’s firms are often multinational and diversified. A firm may file for Chapter 11 despite having highly profitable lines of busi-

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236 See Baird & Rasmussen, supra note 9, at 773–75.
237 Professor LoPucki has a similar response to Baird and Rasmussen. He argues that substantial value exists in the relationships of a firm’s completely fungible assets. See Lynn M. LoPucki, The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen’s The End of Bankruptcy, 56 Stan. L. Rev. 645, 653 (2003). Both arguments recognize that, in spite of the increased efficiency and competitiveness of the various markets of our economy, transaction costs still exist.
238 Baird & Rasmussen, supra note 9, at 770.
239 Id. at 754.
240 Id. at 763–64.
ness or divisions. A company may be competitive in its industry, yet require Chapter 11 protection for reasons not directly related to the company’s competitive position.

B. Why Chapter 11 Remains Relevant

As defaulting businesses continue to have going-concern value, Chapter 11 remains relevant to preserving that value, whether through a traditional reorganization or a bankruptcy sale. Chapter 11 has enduring value as a transparent and neutral multiparty forum. It brings all parties in interest to the table to make decisions regarding whether to pursue a reorganization or sale and how to marshal and allocate the proceeds thereafter. As we have stated before, “[t]he 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.”

Chapter 11 provides a multiparty forum for a debtor to rehabilitate in an orderly fashion under the supervision of the court, to the extent that rehabilitation remains the primary policy goal of the Bankruptcy Code. Anti-Chapter 11 theorists such as Baird and Rasmussen, for example, presuppose that maximization of credit recovery comes ahead of rehabilitation when arguing that Chapter 11 is unnecessary so long as there is a marketplace for the debtor’s assets. Inferring from the prevalence of section 363 sales and the

241 See, e.g., In re Trans World Airlines, Inc., No. 01–056 (PJW) (certain flight routes of TWA were still highly profitable despite overall losses); In re Enron Corp., No. 01–16034 (AJG) (Enron’s trading operations were highly lucrative).

242 Texaco, for example, commenced Chapter 11 cases in the face of a $10.53 billion judgment to Pennzoil. “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.” Skeel, supra note 18, at 1; see, e.g., In re Lionel L.L.C., No. 04–17324 (BRL) (Bankr. S.D.N.Y. 2004) (bankruptcy action commenced because of adverse multi-million dollar judgment in trade secrets dispute); In re Loral Space & Commc’ns, Inc., No. 03–41710 (RDD) (Bankr. S.D.N.Y. 2003) (bankruptcy action commenced in part to utilize section 363 of the Bankruptcy Code and because of losses stemming from a poor investment); In re WorldCom, Inc., No. 02–13533 (AJG) (Bankr. S.D.N.Y. 2002) (bankruptcy action commenced because of fraud allegations); In re Enron Corp., No. 01–16034 (AJG) (same); In re Bethlehem Steel Corp., No. 01–15288 (BRL) (Bankr. S.D.N.Y. 2001) (bankruptcy action commenced because of pension liability); In re Owens Corning, No. 00–3837 (JKF) (Bankr. D. Del. 2000) (bankruptcy action commenced because of asbestos claims).

243 Miller & Waisman, supra note 22, at 196.

244 See Baird & Rasmussen, supra note 9, at 777 (“Even if control rights are not allocated coherently, there is still no need for a collective forum that decides the fate of the firm if the firm can be sold in the marketplace as a going concern.”). It should be noted
creditor-in-possession phenomenon of the current Chapter 11 environment that creditor recovery maximization is the primary aim of the Bankruptcy Code is putting the cart before the horse. Immediately after passage of the 1978 Act, it was unequivocal that the Bankruptcy Code’s primary policy objective was debtor rehabilitation with attendant preservation of jobs. Although some of the changes that have occurred as to the objectives of Chapter 11 since 1978 are attributable to the special-interest legislation including the Abuse Act, a large degree of the creditor-in-possession phenomenon is the result of creditors’ ability to seize control of the process. Rehabilitation remains a predominant, if not the predominant, objective of the Bankruptcy Code itself. In this sense, disproportionate creditor control and influence is an argument for the strengthening of Chapter 11, not for its dismantling.

Chapter 11 has significant value as a neutral forum. To preserve faith in our economic system and rule of law, any insolvency system must be fair and able to respond to changing economic times and tensions to achieve the objectives of the legislation. Chapter 11 is a process designed to resolve, in a rational, practical manner, conflicts between the debtor, creditors, and other economic stakeholders, as well as conflicts between competing and other creditors who often have diametrically opposed interests. Currently, the Chapter 11 process often is skewed in favor of the controlling creditor(s) at the expense of other parties in interest.

Excessive creditor control remains undesirable because such influence may cause the debtor’s operations to be managed solely in the interests of the particular controlling creditor group, thereby foreclosing the debtor’s restructuring options. For example, the provisions of a DIP agreement can constrain the debtor’s flexibility and take away altogether the option of a possible successful reorganization, leaving a sale as the only viable alternative. One court, recognizing this danger, commented on a financing arrangement:

that Chapter 11 remains useful when there is no marketplace for assets and thus a traditional reorganization is the only option. Many Chapter 11 cases involve businesses that do not receive significant interest from prospective buyers for their assets. See, e.g., In re UAL Corp., No. 02–48191 (ERW) (Bankr. N.D. Ill. 2002) (depressed airline industry); In re Bethlehem Steel Corp., No. 01–15288 (BRL) (companies in heavily depressed industries generally do not receive significant buyer interest); In re Owens Corning, No. 00–3837 (JKF) (generally, the successor liability issues of asbestos companies discourage potential interest of prospective buyers); In re Chateaugay Corp., No. 86–11270 (BRL) (Bankr. S.D.N.Y. 1986) (environmental liability issues also potentially discourage prospective buyers).
Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons usable against it for the bankruptcy estate’s benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization, and steal a march on other creditors in numerous ways. The Financing Agreement would pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit of the Bank and the Debtor’s principals who guaranteed its debt.245

Chapter 11 is not only a forum for creditors and equity-interest holders to be represented; it also provides a forum for all stakeholders to be heard. As discussed above, the need for a bankruptcy law during the railroad failures of the late nineteenth century drew special attention in light of the importance of railroads to the rapidly industrializing economy. Courts overseeing the railroad equity receiverships endeavored to craft a solution that would preserve the functioning of the nation’s railroads in light of their importance to parties beyond the railroad’s creditors and shareholders. Similarly, the legislative history of the 1978 Act is liberally sprinkled with discussions of the importance of such economic externalities as employees and the public interest.246

Chapter 11 provides the debtor and courts the opportunity to weigh public policy considerations and to consider economic externalities. If parties are allowed to secure their own financial security without regard to external costs or benefits of potential transactions, important issues will be neglected in the bankruptcy process (for example, maximization of return to all creditors, continued workforce employment, environmental concerns, equity, and the public interest). The risk that employees would be displaced, firms would be dissolved, and the market would be flooded with workers may increase exponentially. Increased unemployment and contraction of income may have dramatic and far-reaching effects upon a local economy in which the debtor operated.

Bankruptcy will raise concerns regarding important national issues such as antitrust, national security, public health, and transportation. Opponents of Chapter 11 have failed to address how such public policy concerns can otherwise be adequately addressed. This problem is heightened where public policy claimants have limited interests and little incentive to participate. Accordingly, Chapter 11 provides a forum to foster debate over public policy, the benefits of which might not otherwise be considered.

C. Why Chapter 11 Remains Relevant to a Sale

Critics of Chapter 11 argue that a reorganization process is unnecessary as long as there is a marketplace to sell assets. If a buyer is willing to pay a market price for assets, there is no need for a costly rehabilitative process. In turn, creditors benefit because they potentially obtain a greater recovery, one of the fundamental aims of reorganization.

Is the increasing prevalence of section 363 sales desirable? Sales, whether to strategic or financial buyers, arguably are beneficial because they can allow the assets to fetch a fair price, as determined by the market, and transfer the assets to a party better suited to deploy such assets. This argument emphasizes the rights of creditors and the maximization of recoveries and places great reliance on the efficiency of the markets to allocate resources. It is appealing because it posits that the optimal economic decision will be made by an invisible hand when each party simply acts only out of its own self interest.

247 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 case, 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.

248 See, e.g., In re Global Crossing, Ltd., No. 02–40188 (REG); In re WorldCom, Inc., No. 02–13533 (AJG).

249 See, e.g., In re United Healthcare Sys., Inc., No. 97–1159, 1997 WL 176574, at *5 (D.N.J. Mar. 26, 1997) (stating that, in evaluating a sale of assets, a district court must look to the overriding consideration of public health); In re Brethren Care of South Bend, Inc., 98 B.R. 927, 934 (Bankr. N.D. Ind. 1989) (stating that, in evaluating the sale of a not-for-profit nursing care facility’s assets, the well-being of the residents of the facility is of particular concern).

250 See, e.g., In re US Airways Group, No. 04–13820 (SSM) (Bankr. E.D. Va. 2004); In re US Airways Group, No. 02–83984 (SSM) (Bankr. E.D. Va. 2002); In re UAL Corp., No. 02 B 48191 (ERW) (Bankr. N.D. Ill. 2002). 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.

251 See, e.g., Baird & Rasmussen, supra note 9, at 777.
Conversely, critics of the increased occurrences of section 363 sales might question the efficiency of our markets and its ability to allocate resources optimally. They may further argue that the prevalence of sales ignores the rehabilitative intent of the 1978 Act, the transaction costs associated with displacing businesses, and the externalities of bankruptcy. As noted above, rehabilitation is an important policy objective of the Bankruptcy Code, and Congress indicated that consideration was to be given to the impact that a bankruptcy would have, for example, on the community of the debtor.

Undoubtedly, there are compelling arguments in favor of sales in contrast to traditional reorganizations. What is unique and significant about Chapter 11 is that it allows the question to be considered in a meaningful manner. Absent a neutral, multiparty forum, secured lenders will likely exert their influence over a debtor and advocate a sale, as their preference is inherently toward the certainty of recovery that a sale can provide. The benefit of Chapter 11 is the ability to consider both options with input from the debtor, all creditors, and other stakeholders such as employees and the public.

Even if one accepts as a given the benefit of sales and the precept of maximizing creditor recoveries, Chapter 11 remains important. One of the important functions of Chapter 11 is creating and allocating value among creditors. To this end, there are many instances when the use of the Chapter 11 process to marshal claims properly and to sell assets free and clear of all claims raises the purchase price, a result that cannot easily be achieved outside the Chapter 11 process. This is perhaps one reason that, though troubled companies are not required to use Chapter 11 as a conduit for a sale of their businesses, it is well understood that Chapter 11 provides a market for such a sale and creates a forum for addressing the future of the business and the liquidation of its assets to pay creditors. The creation of such a market is arguably desirable because it allows the assets to fetch a fair price, as determined by the market, and transfers the assets to a party better suited to put such assets to their best use.

Chapter 11 also helps to ensure that value is allocated equitably between creditors of different levels of seniority. For example, in effecting a sale, senior secured creditors may exercise their influence over the debtor’s management to sell assets under distortedly conservative valuations, to the detriment of junior creditors. Conversely, although less common, a controlling junior creditor may influence

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252 Miller et al., supra note 157, at 21.
management to overestimate the value of the debtor to increase its likelihood of recovery, which can increase the risk of non-recovery for senior creditors. The wide differences in valuations of assets and the imprecise nature of valuation make this outcome possible.

A study by Stuart Gilson, Edith Hotchkiss, and Richard Ruback suggests that such distortion of valuations may be a common result of creditor control. The nature of creditors’ claims as prioritized makes this a natural outcome:

[A] free-rider problem arises from the obvious fact that the secured party managing collateral sales has no incentive to realize more than the amount of its debt. Anything above that amount must be distributed to other secured parties, the bankruptcy trustee, or the debtor—none of whom bear the costs and risks of the sales.

Creditor-influenced undervaluation of assets has been recognized by the bankruptcy courts. In In re Exide Technologies, Judge Carey held that the debtor’s plan significantly undervalued the debtor. The financial advisor to the debtor submitted a valuation of between $950 million and $1.05 billion, while the financial advisor to the creditors’ committee submitted a valuation of between $1.478 billion and $1.711 billion. Both sides used the same three methodologies—comparable company analysis, comparable transaction analysis, and discounted cash flow. Judge Carey ultimately determined the debtor’s valuation to be in the range of $1.4 billion to $1.6 billion. Among other arguments that informed this holding was the argument that controlling senior creditors had influenced the debtor’s valuation so as to enhance senior creditor recoveries to the detriment of unsecured creditors.

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254 See Westbrook, supra note 188, at 845.
256 Id. at 59.
257 Id.
258 Id. at 66.
259 Id. at 58–66. When Exide emerged from bankruptcy in May 2004, the market supported the debtor’s proposal, setting an enterprise value and a market capitalization of $1.03 billion and $544 million, respectively. By November 16, 2005, Exide’s enterprise value and market capitalization had declined to $788 million and $109 million, respectively. Judge Carey ignored the Supreme Court’s admonition that the best way to determine value is by market forces. See Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship, 526 U.S. 434, 456–57 (1999) (citation omitted). The debtor’s proposed valua-
D. Contractualism

The last decade has seen significant debate over privatization of the recovery process or “contractualism.” Baird and Rasmussen argue:

If these [control] rights are allocated sensibly, the shutdown decision will reside in the hands of those with the best information and the appropriate incentives to exercise it correctly. If the transaction costs associated with such contracting are low enough, we once again have no need for a law of corporate reorganizations as traditionally understood.

Although appealing as a solution to the criticism of Chapter 11 process as costly and lengthy, contractualism is not a meaningful alternative to a multiparty, court-supervised forum. It is both undesirable and unworkable.

Contractualism is undesirable because it transforms the problem of the default of a business, a situation affecting a myriad of parties, known and unknown, into a process typically dominated by one party. The contractual model fails to take into account the fact that each party possesses only its own information and its own subjective belief as to what is the “correct” decision. It is precisely these narrow, self-motivated positions that Chapter 11 is designed to test and challenge through an adversarial process. In the real world, decisions are made by the parties that possess control; such parties are not necessarily in a position (or incentivized) to make optimal decisions on behalf of all stakeholders.

Of course, this criticism relates to the more general political and economic debate over the appropriate level of oversight and governmental intervention in our markets, a debate which is beyond the scope of this Article. Perhaps, as a matter of priorities, maximization took into account market forces—namely, “the price that could be realized for a debtor’s assets in a realistic framework, assuming a willing seller and a willing buyer.” In re Exide Techs., 303 B.R. at 59. The debtor’s expert conducted a “private equity process” where offers were solicited from numerous potential purchasers, including private equity firms and one strategic buyer. Id. By contrast, the creditor committee’s proposal was a straightforward, formulaic application of valuation methodology without reference to such market forces. See id. at 60.

260 See Westbrook, supra note 188, at 827–30.
261 Baird & Rasmussen, supra note 9, at 778.
262 For a detailed discussion of why contractualism is not possible without a dominant secured interest encumbering substantially all of the debtor’s assets, see generally Westbrook, supra note 188.
of creditor recoveries as an objective of Chapter 11 is more important than rehabilitation of the debtor. Perhaps liquidation is more appropriate in industries suffering from overcapacity. The precise point is that these issues must be considered. Often the discussion of Chapter 11 focuses on rights, particularly the rights of secured creditors, while ignoring the central question of what is trying to be achieved—rehabilitation versus liquidation. In many of these cases, reorganization is quite possible (and may produce a greater recovery to all creditors), but the controlling interests of senior creditors push the debtor toward an immediate sale. The Chapter 11 model is desirable because it allows the issue to be considered on a case-by-case basis instead of abdicating these important policy considerations to the free market regime under the assumption that private rights and maximization of recoveries will produce socially optimal outcomes.

Contractualism also fails as an alternative to the Chapter 11 process because it is unworkable. Not only do proponents of this model fail to cite a relevant case where parties efficiently allocated rights among interest holders, they also fail to explain in detail exactly how a debtor can privately contract away the operational decisions of a business between such parties as secured lenders, unsecured creditors, trade creditors, tort claimants, and equity-interest holders. Baird and Rasmussen cite high-tech “startup” corporations, like Webvan, as working models of contractualism. Startups, however, are not useful in demonstrating whether a single collective forum can be displaced by a regime of private contract. By their own admission, startups possess little, if any, debt, so there is no conflict between senior and junior claimants. 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 is the typical shareholder. Unlike the railroads of the nineteenth century, startups do not have fragmented debt interests and equity ownership, but instead 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.

The associated increase in parties in interest in troubled firms and the number of parties that need to be noticed in any particular case make contracting control rights among disputing parties exceed-

263 Baird & Rasmussen, supra note 9, at 781.
264 See Skeel, supra note 18, at 58.
ingly difficult. The ability of any one significant party to hold up the process or generate litigation materially increases the potential that such party can hold up the process or create chaos by attempting to collect before others. Although Baird and Rasmussen argue that control rights can be easily and efficiently allocated, the multiplicity of parties in interest makes it difficult. As a consequence, the “shutdown” decision, as they characterize it, is only a small part of the efficient allocation of control rights. Deciding who should acquire the control rights and be empowered to make the “shutdown” decision in the absence of a dominant secured creditor is very challenging.

E. Successful Reorganizations

Amid the increasing number of Chapter 11 cases that result simply in sales and the often-discussed rates of recidivism of debtors, examples of successful, traditional reorganizations still remain.

Federated Department Stores is an example of a highly successful, old-fashioned restructuring. Before its Chapter 11 case, Federated was saddled with $7.5 billion of debt after being purchased in a highly leveraged takeover by Canada’s Campeau Corporation in 1988. Its business was declining, and suppliers had lost confidence. Furthermore, while in Chapter 11, Federated was forced to hold a fire sale of

265 See Baird & Rasmussen, supra note 9, at 781.

266 See, e.g., In re AT&T Latin Am. Corp., No. 03–13538 (RAM) (Bankr. S.D. Fla. 2003); In re Top-Flite, Inc., No. 03–12003 (MFW) (Bankr. D. Del. 2003); In re Budget Group, No. 02–12152 (MFW) (Bankr. D. Del. 2002); In re Velocita Corp., No. 02–35895 (DHS) (Bankr. D.N.J. 2002); In re Loews Cineplex Entm’t Corp., No. 01–40346 (ALG) (Bankr. S.D.N.Y. 2001); In re Bethlehem Steel Corp., No. 01–15288 (BRL); In re ANC Rental Corp., No. 01–11200 (MFW) (Bankr. D. Del. 2001); In re Polaroid Corp., No. 01–10864 (JPW) (Bankr. D. Del. 2001); In re Trans World Airlines, Inc., No. 01–00056 (PJW).

267 See, e.g., Edward I. Altman, Evaluating the Chapter 11 Bankruptcy-Reorganization Process, 1993 COLUM. BUS. L. REV. 1, 6. When considering the rates of recidivism of debtors, it is important to recognize the role and responsibility of the court. Once a plan is presented, the bankruptcy court is without means to assess independently its feasibility and to overcome the impact of the debtors and creditors who have combined to urge confirmation. Moreover, it is debatable whether, even given such means, courts should impart their own views in an adversarial process when the parties in interest have reached agreement. For a more detailed discussion of the role courts play in recidivism, 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 (2001), with Harvey R. Miller, Chapter 11 Reorganization Cases and the Delaware Myth, 55 VAND. L. REV. 1987 (2002).


270 See id.
some of its key assets, including buildings.\footnote{Id.} Despite these problems, Federated was able to use Chapter 11 to restructure.\footnote{See id.} Federated reached a deal to swap $5 billion in debt and other liabilities for new notes and equity, allowing it to emerge triumphantly from bankruptcy protection.\footnote{Id.} In Federated’s first fiscal quarter after emergence, the company recorded an $11.8 million profit.\footnote{DiCarlo, supra note 269.} In 1994, Federated acquired its archrival, Macy’s, pursuant to Macy’s Chapter 11 plan of reorganization.\footnote{Id.} By 1998, Federated’s debt was rated as “investment” grade by the major rating agencies.\footnote{Id.}

Similarly, Zales International Corporation,\footnote{In re Zales Int’l Corp., No. 92–30707 (SAF) (Bankr. N.D. Tex. 1992) (emerging in 1993).} the famous jewelry retailer, is another example of a traditional restructur- ing. While in Chapter 11, Zales evaluated and refocused its business strategy, expanding merchandise selection and improving merchandise quality.\footnote{See Elaine De Simone, Zales Jewelers Make Dazzling Recovery, RETAIL TRAFFIC, Nov. 1, 1998, http://retailtrafficmag.com/mag/retail_zales_jewelers_makes/index.html.} Since emergence, Zales has improved sales, expanded store openings, and put itself in a position to compete for market leadership in its industry.\footnote{See id.} WorldCom, Inc.\footnote{In re WorldCom, Inc., No. 02–13533 (AJG) (emerging in 2004).} is yet another example. After having shed $36 billion in debt and retaining an enviable business customer list, WorldCom emerged from Chapter 11 protection, re-
named as MCI, with $6 billion in cash, to the chagrin of competitors fearful of a price war.\footnote{See MCI Emerges from Bankruptcy, CNN/MONEY, Apr. 20, 2004, http://money.cnn.com/2004/04/20/technology/mci_bankruptcy/.} Notably, earlier this year, MCI was the target of a fierce takeover battle between Verizon and Qwest.\footnote{See, e.g., Dionne Searcey, Protest by MCI Shareholders May Push Qwest to Rejoin Battle, WALL ST. J., May 16, 2005, at B4.}

These examples are not intended to be empirical illustrations that traditional reorganizations remain a significant part of Chapter 11. Instead, they are meant to demonstrate that, if Chapter 11 is used proactively and with rehabilitation in mind, it can be an effective tool for turning around failing businesses. Of course, not all businesses can be turned around because many that resort to Chapter 11 are be-
beyond redemption. There is no solution for the lack of a viable business model. Similarly, businesses cannot be turned around to the extent they delay too long in seeking Chapter 11 relief or to the extent their operations are effectively constrained by creditors. The danger here is the potential that arguments of the demise of Chapter 11 based on the lack of reorganizations in the traditional sense or the high degree of recidivism will become self-fulfilling prophecies.

To encourage reorganization, it is imperative that Chapter 11 be restored as a more neutral forum that gives the debtor and all parties in interest a meaningful ability to reorganize. This imperative seems greater than ever given the increasing power and influence of creditors. Unfortunately, at this time, much of the criticism of the Chapter 11 process appears aimed squarely at the debtor. In that respect, there is a perception that the current length and cost of Chapter 11 cases is the fault of the intransigent debtor. The present course of action of further handicapping the debtor may lead only to more recidivism and fire sales, an unwelcome result. It is not even clear that, under this current creditor-in-possession regime, all creditors, as opposed to senior secured creditors only, do better. The Chapter 11 process requires a reassessment of which parties are currently at the helm, and which parties should be:

The reason that control of the process of recovery has become so important is that [going concern sales or financial restructurings] often require more time and more complex management, both operational and financial, than a simple piecemeal liquidation. At the same time, the range of possible values, from a low value in a simple liquidation to a high value obtained from a creative merger, has become much greater as well. Closely related is the fact that key decisions in this more complex environment turn importantly upon evaluation of risk and a willingness to accept risk.283

Interestingly, the evolution of the reorganization model in the United States is moving opposite to the European model, which is taking a form similar to the Chapter 11 model that prevailed from 1979 through the end of the twentieth century.284 The United Kingdom’s recently enacted insolvency law is a particularly useful example for

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283 Westbrook, supra note 188, at 804–05.
284 See Skeel, supra note 18, at 238–43.
purposes of contrast. It abolished a long-standing system of secured contractualism. The overhaul was designed to reduce the impact of one party over the process. According to Professor Jay Westbrook:

[N]eutrality is a necessary concept in any system for managing a general default in which the policymaker provides for multiple beneficiaries and charges the manager with maximizing value for all of them. A dominant secured party cannot be a neutral manager, and its management creates a serious potential of loss for other beneficiaries.

Conclusion

Bankruptcy law in the United States has evolved significantly over the last century. The twenty-five years following the enactment of the 1978 Act, the changes that the reorganization world currently is undergoing, and the enactment of the Abuse Act raise the question as to whether it has come full circle. Many of today’s changes go to the core of the whole concept and objective of Chapter 11 and are reminiscent of the atmosphere behind the Chandler Act. Chapter X of the Chandler Act, although comprehensive and well-intentioned, failed to encourage reorganization because it was structurally inefficient and perhaps overly complex, thereby requiring the expenditure of excessive time and money. At a time when the concept of reorganization remains relevant, there is a danger of repeating the mistake of discouraging distressed companies from pursuing rehabilitation as originally contemplated by the 1978 Act, a policy goal that seems to have diminished. Despite the contractions of the debtor protections that were provided for in the 1978 Act, there is still a need to provide distressed debtors a reasonable opportunity to rehabilitate themselves for the benefit of all stakeholders and interests and not just a group of sophisticated, aggressive lenders and speculative investors. The economy remains credit-intensive, and there must be relief from oppressive debt that can be provided only by a fair and reasonable reorganization law.

Many of the arguments underlying the assertion of Chapter 11’s demise actually demonstrate the opposite—that there is a need for a reinvigorated, rehabilitation-oriented process. The criticisms of Chapter 11 often focus on the fact that the benefits of Chapter 11 do not
justify its costs, particularly those of professionals’ fees. This concern is not a novel one and appears to stem from the high proportion of professionals’ fees in recent fraud cases. Given this concern, perhaps the more relevant question going forward is whether Chapter 11 should be based on an adversarial process. The American legal and political system is rooted in the adversarial process and the notion of competing parties or factions, but such systems, by their nature, generate considerable litigation and expense. Do the costs of the Chapter 11 process outweigh its benefits? Does the adversarial process remain relevant? These questions must be asked and answered as long as there is a continuing need for reorganization and rehabilitation.


289 See, e.g., In re Drexel Burnham Lambert Group, Inc., 133 B.R. 13, 26 (Bankr. S.D.N.Y. 1991) (“[W]e have been left with the strong impression that for [financial advisors and investment bankers] the debtor is the cash cow to be milked, Chapter 11 the milking parlor, and the Judge the milking stool.”). Likewise, as discussed above, critics of the railroad receiverships complained that bankers and attorneys received substantial fees before anyone else was paid. See Skeel, supra note 18, at 68.

290 Professor Lynn LoPucki has compiled a list of the top ten costliest bankruptcy proceedings. The top two (Enron and WorldCom) are fraud cases, and Adelphia Communications (#6) and Global Crossing (#9) also make the list. See Arndt & Bernstein, supra note 288. Fraud cases, by their nature, likely generate more professional fees than the average bankruptcy case. In particular, significant legal and accounting fees are incurred by investigating and unraveling the fraud that caused the company to seek Chapter 11 protection. These fees often include the deployment or retention of numerous additional professionals to address the additional issues raised by the fraud, including the involvement of additional regulatory agencies and litigating parties.
THE FUTURE OF THE DOCTRINE OF NECESSITY AND CRITICAL-VENDOR PAYMENTS IN CHAPTER 11 CASES

ALAN N. RESNICK*

Abstract: This Article explores the history and justification for the doctrine of necessity in Chapter 11 cases. It discusses the doctrine’s gradual narrowing, due to appellate courts’ reluctance to permit payment of prepetition debts or recognize courts’ authority to authorize such payments. The Article analyzes the effect of recent amendments to the Bankruptcy Code on the doctrine and confirms that there is uncertainty regarding the propriety of payment of certain prebankruptcy debts. The Article proposes that the Code be amended to clarify the extent to which the doctrine of necessity applies in Chapter 11 cases and asserts that courts should recognize different standards depending on the type of debt being repaid. Finally, this Article argues that courts should have discretion to authorize payments in extraordinary circumstances when they follow procedural safeguards.

Introduction

The recognition and application of the doctrine of necessity, especially with respect to the treatment of so-called “critical vendors,” have been the subject of controversy in Chapter 11 reorganization cases in recent years. The doctrine of necessity is a judge-made rule that courts rely upon to justify permitting a debtor in possession in a Chapter 11 case, prior to the confirmation of a plan of reorganization, to pay certain creditors the full amount of their prebankruptcy unsecured claims. This special treatment is, in theory, reserved for

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those vendors and other creditors who are critical to the survival of the debtor because of the goods or services they provide.

Frequently permitted by bankruptcy courts in response to motions made on the first day of the case—sometimes with only a few hours’ notice to the United States trustee and a handful of parties in interest—the appellate courts tend to narrow the availability and scope of the doctrine of necessity in bankruptcy cases. Most recently, Congress enacted the most comprehensive and sweeping bankruptcy legislation in more than twenty-five years, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Act” or “2005 amendments”).¹ Though the recent legislation does not directly address the viability of, or limitations on, the doctrine of necessity, several provisions of the 2005 Act are likely to have an impact on the use of the doctrine in future cases. In addition to these judicial and legislative developments, proposed amendments to the Federal Rules of Bankruptcy Procedure have been published which, in reaction to criticism regarding the lack of notice and process safeguards, will have an impact on the procedural aspects of the doctrine of necessity.

Although predicting the future significance or resolution of any controversial issue in bankruptcy jurisprudence is a foolish endeavor, this Article will nonetheless address the likely future of the doctrine of necessity in Chapter 11 reorganization cases, taking into account recent judicial and legislative developments and the pending amendments to the Federal Rules of Bankruptcy Procedure.

I. WHAT IS THE DOCTRINE OF NECESSITY?

One of the most fundamental principles of American bankruptcy law is the equal treatment of similarly situated creditors. The Bankruptcy Code contains numerous provisions designed to achieve such equality.² For example, only similarly situated creditors may be placed in the same class under a plan of reorganization,³ and the same treat-

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ment must be afforded to each and every member of that class unless a creditor receiving less favorable treatment consents.\textsuperscript{4} Furthermore, if a non-accepting class becomes the subject of a “cram down” request—by which the court may confirm a plan notwithstanding the rejection of a class of creditors—the Bankruptcy Code prohibits the confirmation unless the plan does not “discriminate unfairly” against the non-accepting class.\textsuperscript{5} That standard means that the plan may not treat an accepting class more favorably than the non-accepting class of equal rank unless the court finds that the discrimination is fair under the circumstances. Also, if an insolvent debtor pays an unsecured claim within ninety days before bankruptcy, and the payment enables the creditor to receive more than the creditor would have received from the debtor’s bankruptcy estate if the debtor had not made the payment and had filed a chapter 7 petition, the payment may be recovered by the trustee or debtor in possession as a voidable preference.\textsuperscript{6} The theoretical predicate for providing for the recovery of the preference is, again, the equality of treatment of similarly situated creditors. In addition, the automatic stay under section 362 of the Bankruptcy Code prohibits creditors from obtaining an unfair advantage over others by enforcing collection rights after filing a bankruptcy petition.\textsuperscript{7} All of these provisions of the Bankruptcy Code are designed to give similarly situated creditors the same or substantially similar treatment in bankruptcy.

This principal of treating creditors equally when a debtor is in bankruptcy is violated when an insolvent debtor in possession in Chapter 11 is allowed to pay a creditor, in full, with respect to a pre-bankruptcy general unsecured claim before a plan of reorganization is confirmed. So why permit it? Why should a bankruptcy court order that the debtor may pay prebankruptcy unsecured claims in full for certain creditors, but not for other creditors, leaving the latter group with recoveries of only a few cents on the dollar under a confirmed plan of reorganization? The easy answer is that, in certain situations, it is necessary for the survival of the debtor’s business and for the successful reorganization of the debtor. This, in turn, inures to the benefit of all parties in interest, including employees who keep their jobs, vendors and others who may be dependent on the continuing existence of the debtor for future business, equity holders who may

\textsuperscript{4} Id. \S 1123(a)(4).
\textsuperscript{5} Id. \S 1129(b)(1).
\textsuperscript{6} BAPCPA, Pub. L. No. 109-8, \S 1213(a)(1), 119 Stat. 23, 194 (to be codified at, and amending, 11 U.S.C. \S 547(b)).
reap economic benefits when the business is rehabilitated, and gen-
eral unsecured creditors whose recovery will be based on the going
value concern of the reorganized business, rather than on the scrap
value of assets resulting from forced liquidation at auction sales.

Aside from the fact that, at least until the amendments enacted in
2005,8 there has been no provision of the Bankruptcy Code that ex-
pressly authorizes the payment of prebankruptcy debts before
confirmation of a Chapter 11 plan, critics of the doctrine of necessity
have argued that there is no effective way to determine who, in fact, is
a “critical vendor.”9 Skeptics are particularly concerned about the lack
of adequate procedural protection for other unsecured creditors who
wish to challenge the application of the doctrine of necessity. As any
experienced Chapter 11 practitioner knows, there is usually inade-
quate opportunity to challenge emergency motions made on the first
day of the case that result in court orders on the same day or within a
few days thereafter.

The doctrine of necessity—that is, court-approved payment of
unsecured prebankruptcy claims before a Chapter 11 plan is
confirmed—has its origin in nineteenth-century railroad receivership
cases.10 Two similar doctrines developed at that time. First, railroad
receiverships in the late 1800s recognized an equitable rule of prior-
ity, known as the “six months rule,” which authorized receivers to pay
the unpaid claims of “operating creditors” arising within the six-
month period immediately preceding the receivership case.11 To be
entitled to such payments, a creditor had to show that the obligation

8 Amendments to the Bankruptcy Code made by BAPCPA, which, in general, are ef-
fective in bankruptcy cases commenced on or after October 17, 2005, are discussed later in
this article.
9 Christopher D. Hunt, Note, Not-So-Critical Vendors: Redefining Critical Vendor Orders, 93
tions/Online_ABI_Journal/Archive1/ABL_Journal_Archives.htm (click on “2003,” then
“September,” then follow “FINANCIAL STATEMENTS: The Case Against ‘Critical Vendor’
Motions” hyperlink).
10 See B&W Enter. Inc. v. Goodman Oil Co. (In re B&W Enter. Inc.), 713 F.2d 534, 536
(9th Cir. 1983) (discussing the origins of the doctrine of necessity and the parallel doc-
trine called the six months rule); In re Boston & Me. Corp., 634 F.2d 1359, 1366 (1st Cir.
1980) (discussing same).
11 Russell A. Eisenberg & Frances F. Gecker, The Doctrine of Necessity and Its Parameters, 73
Marq. L. Rev. 1, 4 (1989); Andrew J. Currie & Sean McCann, Hold on to Those Payments, Cri-
world.org/Content/NavigationMenu/Publications/Online_ABI_Journal/Archive1/ABL_Jou-
rnal_Archives.htm (click on “2003,” then “June,” then follow “FEATURE ARTICLE: Hold on
to pay was incurred within six months before the receivership proceeding commenced, in which case it was given an equitable priority over other creditors and was entitled to payment. Such payments were made even before mortgagees were paid. The justification for the doctrine was that it would be inequitable to operating creditors, supplying the necessary services and products for the railroad’s continued existence and revenue generation, if the resulting operating revenue benefited secured creditors, who were not entitled to the operating revenue of the railroad until a receiver was appointed. In essence, the rule gave prebankruptcy unsecured claims of vendors and other operating creditors that arose within six months before the receivership priority in payment over secured creditors.

When the Bankruptcy Act of 1898 was enacted, the six months rule became part of railroad reorganization cases under section 77(b) of the Act. When the Bankruptcy Act of 1898 was repealed and replaced by the Bankruptcy Code as part of the Bankruptcy Reform Act of 1978, the six months rule, though not expressly mentioned, continued under section 1171(b), in the Subchapter of Chapter 11 which deals exclusively with railroad reorganizations. Section 1171(b) provides that

[a]ny unsecured claim against the debtor that would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the date of the order for relief under this title shall be entitled to the same priority in the case under this Chapter.

Similar in concept to, but separate and distinct from, the six months rule, the “necessity of payment doctrine” also developed in nineteenth-century railroad receivership proceedings. Since first enunciated in the 1882 decision of the U.S. Supreme Court in Miltenberger v. Logansport Railway Co., the doctrine became an important part of railroad reorganizations and receiverships. Like the six months rule, the necessity of payment doctrine permitted courts to allow re-

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12 Currie & McCann, supra note 11, at 34.
13 Id.
14 See id.
ceivers to pay certain pre-receivership unsecured creditors. Courts limited the doctrine’s use, however, to secure only the continued delivery of supplies and services essential to the debtor’s continuation in business. Also, unlike the six months rule, the “doctrine of necessity,” as it became known later, is not a rule establishing priority of claims; rather, it is a doctrine giving courts discretion to deviate from the otherwise applicable rules of priority by making early payments to certain creditors to achieve the greater goal of a successful reorganization. Whereas the six months rule directly changes the priority of claims by paying ordinary course claims incurred within the six months prior to a railroad reorganization before secured claims, the doctrine of necessity permits payment of prebankruptcy unsecured claims only when such payment is needed so that trade vendors or other creditors will not refuse to supply critical goods and services after the debtor files for bankruptcy protection.

When first developed, courts applied the doctrine of necessity, like the six months rule, only in railroad reorganization cases for which success was considered vital to the public interest. Consequently, giving preference to some creditors at the expense of others was acceptable because the public depended on continued rail operations. In *Dudley v. Mealey*, a 1945 decision written by Learned Hand and joined by Jerome Frank and Augustus Hand, involving the application of the six months rule, the Court of Appeals for the Second Circuit for the first time extended the six months rule to a non-railroad reorganization case with the goal of encouraging successful reorganization. In particular, the court held that a hotel in a Chapter X case under the former Bankruptcy Act could provide for the grant of priority of claims of prepetition vendors in its reorganization plan. Gradually, other courts expanded the use of the doctrine of necessity to cases that do not involve railroad reorganization, and courts eventually utilized the doctrine to protect the interests of creditors and reorganization efforts more generally.

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19 *Goodman Oil*, 713 F.2d at 537; *In re Boston & Me.*, 634 F.2d at 1382.
20 Currie & McCann, *supra* note 11, at 34.
21 See 147 F.2d 268, 271 (2d Cir. 1945).
22 See id.
II. The Doctrine of Necessity in Cases Under the Bankruptcy Code

Unlike the six months rule, the doctrine of necessity was not codified when the Bankruptcy Code was enacted as part of the Bankruptcy Reform Act of 1978. As such, it could be argued that the absence of any mention of the doctrine demonstrates Congressional intent for its demise upon the Code’s enactment. Thus, bankruptcy courts should not have the authority to permit payment of prepetition unsecured indebtedness, even if the continuing provision of goods and services from certain creditors is critical to the debtor’s reorganization.

It also could be argued, however, that the Bankruptcy Code contains no indication that Congress intended to eliminate the doctrine of necessity and to prohibit critical-vendor payments. Under prevailing statutory construction policies, the absence of any mention of the doctrine does not necessarily mean that it did not survive the enactment of the Bankruptcy Code. The Supreme Court has written that, in the field of bankruptcy, when the Bankruptcy Code is silent regarding the survival of a judge-made rule that existed in cases under the former Bankruptcy Act, the law as it existed before the Code’s enactment should be assumed to continue to be applicable absent a strong reason to the contrary: “[w]e will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.”

Most courts that have expanded the doctrine of necessity beyond railroad reorganization cases have done so relying on the equitable power provided in section 105(a) of the Bankruptcy Code. Section 105(a), which sets forth the general equitable powers of bankruptcy courts, provides in relevant part: “[t]he court may issue any order,

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28 11 U.S.C. § 105(a); see In re Just for Feet, Inc., 242 B.R. 821, 824 (D. Del. 1999) (explaining that even if the doctrine of necessity is not codified in the Code, courts have authorized pre-petition claims when necessary using their equitable powers under § 105(a)).
process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”

Section 1107(a) of the Bankruptcy Code grants a debtor in possession the rights, powers, and duties of a trustee serving in a case under Chapter 11, including the right to operate the debtor’s business, authorized by section 1108. The argument that follows, therefore, is that section 105(a) gives courts the authority to enable a debtor in possession to fulfill its duty to do what is reasonably necessary to keep its existing business operating. Included in this duty is paying prepetition claims when necessary to assure that creditors whose continuing delivery of goods and services are critical to the reorganization effort do not stop dealing with the debtor due to non-payment of prepetition indebtedness.

The brevity of section 105(a) and its legislative history, however, do not provide much insight to the limits of the courts’ equitable powers authorized by this section. Section 105(a) and its legislative history are silent about critical-vendor payments and the ability of the courts to circumvent the priority scheme under section 507 of the Bankruptcy Code. Courts condemning the use of section 105(a) to allow critical-vendor payments point out that the Supreme Court has noted that “whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.” The Bankruptcy Code specifically sets out certain types of claims that are entitled to an administrative expense priority. As one bankruptcy court has noted, “a prepetition unsecured claim cannot be elevated to an administrative expense since the scheme of the 1978 Bankruptcy Code does not allow [a] Court to change the classification of claims set by Congress in the Code.”

30 Id. §§ 1107(a), 1108.
Notwithstanding the uncertainty about the doctrine of necessity’s existence under the Code, bankruptcy courts have often relied on the doctrine and section 105(a) to authorize the payment of prepetition claims.\textsuperscript{36} In many cases, the doctrine has been used, without objection, to justify the payment of prepetition unsecured claims that are entitled to priority under section 507(a) of the Bankruptcy Code.\textsuperscript{37} In fact, probably the most common use of the doctrine of necessity is for the payment of prepetition wages.\textsuperscript{38} For example, if a debtor ordinarily pays its employees their weekly wages on Friday afternoons and files a Chapter 11 petition on Wednesday after the close of business, the debtor would not have the right to pay its employees their earned wages for the week, except for the wages earned postpetition (Thursday and Friday), until a Chapter 11 plan is confirmed.\textsuperscript{39} The debtor could pay wages earned postpetition because those wages constitute administrative expenses,\textsuperscript{40} which may be paid in the ordinary course of business.\textsuperscript{41} The delay in the payment of wages earned prepetition, however, could cause substantial hardship to employees and could damage employee morale. It is important to note that the unpaid wage claims for the prepetition part of that week ordinarily would be entitled to priority under section 507(a) so that such employees would most likely be paid in full after a plan is confirmed, subject to the statutory cap on the wage-claim priority.\textsuperscript{42} To avoid undue hard-


\textsuperscript{38} \textit{In re} Bradlees Stores, Inc., No. 00-16035 (Bankr. S.D.N.Y. filed Dec. 26, 2000).

\textsuperscript{39} Id.


ship on employees that could result in poor employee morale, many
courts have granted motions filed by debtors in possession, usually on
the first day of the case, permitting the payment of prepetition wages
in the ordinary course of business to the extent that such wage claims
would have priority under section 507(a).  

Similarly, the doctrine of necessity has been used, almost rou-
tinely in large Chapter 11 cases, to authorize a debtor in possession to
honor customer claims, such as warranty claims, and other customer
obligations, such as discount programs, the right to return goods,
lay-away plans, and frequent flier programs. The honoring of these
obligations is necessary to continue the debtor’s good will with its cus-
tomers and to instill customer confidence in the debtor’s business.

III. The Limits (or Slow Death) of Section 105(a)

Bankruptcy courts and district courts have often relied on section
105(a) to authorize critical-vendor payments in Chapter 11 cases. When challenged, they often found that the doctrine of necessity gave
them the discretion to permit payments to critical vendors. For exam-
ple, in In re Just for Feet, Inc., the District Court for the District of Dela-
ware, relying on the doctrine of necessity and section 105(a) as au-
thority, held that the debtor, an athletic footwear and apparel retailer,
could pay prepetition claims of certain critical vendors. The debtor
persuaded the court that the debtor’s reorganization efforts would be
seriously harmed if the debtor could not get the necessary goods from

43 See, e.g., In re CEI Roofing, Inc., 315 B.R. 50, 53, 61 (Bankr. N.D. Tex. 2004). See gen-
erally, In re EqualNet Commc’ns Corp., 258 B.R. 368, 370 (Bankr. S.D. Tex. 2000) (discuss-
ing the doctrine of necessity, and noting that employee wage claims are priority claims in
whole or in part, the court wrote that “[t]he need to pay these claims in an ordinary
course of business time frame is simple common sense. Employees are more likely to stay
in place and to refrain from actions which could be detrimental to the case and/or the
estate if their pay and benefits remain intact and uninterrupted”).

44 In re Allis-Chalmers Corp., No. 87-11226 (Bankr. S.D.N.Y. filed June 29, 1987).

45 In re ANC Rental Corp., No. 01-11200 (Bankr. D. Del. Dec. 5, 2001); Debtor’s Mo-
tion Pursuant to § 105(a) of the Bankruptcy Code and the Doctrine of Necessity for an
Order Authorizing but not Directing Debtors in Possession to Honor Prepetition Obliga-
tions Relating to Certain (i) Vendors that Support Marketing and Sales Programs (ii) Cus-
tomer Incentive Programs (iii) Critical Contract Labor and (iv) Employee Related Corpo-
rate Credit Card Programs, In re ANC Rental Corp., No. 01-11200 (Bankr. D. Del. filed
Nov. 13, 2001).


The court commented that the doctrine of necessity remained viable in the Third Circuit, although most of the cases cited by the court in support of the doctrine involved railroad reorganizations.\textsuperscript{51} The court asserted that, despite the automatic stay under section 362 of the Code, “[c]ertain pre-petition claims by employees and trade creditors, however, may need to be paid to facilitate a successful reorganization.” The court further noted that section 105(a) “provides a statutory basis for the payment of pre-petition claims.”\textsuperscript{52}

Although bankruptcy courts and district courts were using the doctrine of necessity and section 105(a) to permit critical-vendor payments, appellate courts in several circuits have been less willing to permit payment of prepetition debt to vendors or to recognize section 105(a) as authority for such payments.\textsuperscript{53} Probably the most dramatic and sympathetic set of facts in any case involving payment of prepetition claims under the authority of section 105(a) was \textit{Official Committee of Equity Security Holders v. Mabey}.\textsuperscript{54} That decision involved thousands of personal-injury claims held by women who were injured by the Dalkon Shield contraceptive device sold by A.H. Robins Co., the Chapter 11 debtor.\textsuperscript{55} The examiner in that case sought court authorization to place $15 million in an emergency treatment fund to provide surgery or in-vitro fertilization to certain victims who were likely to benefit from such medical treatment in connection with their claimed infertility.\textsuperscript{56} The funds would be paid directly to the doctor and hospital providing medical assistance to the injured victims.\textsuperscript{57} The cost of the surgery would be between $10,000 and $15,000 per claimant.\textsuperscript{58} Under a proposed plan of reorganization, Dalkon Shield claimants would be compensated out of a $1.75 billion fund and all other creditors would be paid in full.\textsuperscript{59} Also, the distribution to each Dalkon Shield claimant would be reduced by the amount spent on the surgery, so that the

\textsuperscript{50} Id. at 826.
\textsuperscript{52} Id. at 824.
\textsuperscript{53} See, e.g., \textit{In re} Kmart Corp., 359 F.3d 866, 871, 874 (7th Cir. 2004); Chiasson v. J. Louis Matherne & Assocs. (\textit{In re} Oxford Mgmt., Inc.), 4 F.3d 1329, 1334 (5th Cir. 1993).
\textsuperscript{54} 832 F.2d 299, 299–301 (4th Cir. 1987).
\textsuperscript{55} See \textit{id.} at 300.
\textsuperscript{56} See \textit{id.}
\textsuperscript{57} \textit{Id.}
\textsuperscript{58} \textit{Id.} at 301.
\textsuperscript{59} \textit{Mabey}, 832 F.2d at 301.
amount paid from the $15 million emergency treatment fund would actually be a loan against subsequent distributions. The district court approved the establishment of the emergency treatment fund, subsequently indicating that its authority for the unusual order was section 105(a) of the Code. The Court of Appeals for the Fourth Circuit, however, reversed, stating:

[w]hile the equitable powers emanating from § 105(a) are quite important in the general bankruptcy scheme, and while such powers may encourage courts to be innovative, and even original, these equitable powers are not a license for a court to disregard the clear language and meaning of the bankruptcy statutes and rules.

The court continued:

While one may understand and sympathize with the district court’s concern for the Dalkon Shield claimants, who may desire reconstructive surgery or in-vitro fertilization, the creation of the Emergency Treatment Fund at this stage in the Chapter 11 bankruptcy proceedings violates the clear language and intent of the Bankruptcy Code, and such action may not be justified as an exercise of the court’s equitable powers under § 105(a). The Bankruptcy Code does not permit a distribution to unsecured creditors in a Chapter 11 proceeding except under and pursuant to a plan of reorganization that has been properly presented and approved.

Appellate courts in other circuits have also limited the application of the court’s equitable powers in connection with the payment of prepetition claims. For example, the Ninth Circuit Court of Appeals rejected the notion that a bankruptcy court’s equitable powers support the payment of critical vendors’ prebankruptcy claims. In B&W Enterprises, Inc. v. Goodman Oil Co. (In re B&W Enterprises, Inc.), the court wrote that it is “unwise to tamper with the statutory priority scheme devised by Congress.” After the debtor, a trucking company,

60 See id. at 300.
61 See id. at 301 (referring to the lower court’s order approving the establishment of the emergency fund).
62 Id. at 302.
63 Id.
64 713 F.2d 534, 537 (9th Cir. 1983).
paid prepetition claims of certain trade creditors without obtaining court approval, the Chapter 7 trustee sought to avoid such payments under sections 549 and 550 of the Bankruptcy Code. The bankruptcy court held that the transfer can be avoided and the district court and Ninth Circuit affirmed. The Ninth Circuit reasoned that “[t]here is no indication that Congress intended the courts to fashion their own rules of super-priorities within any given priority class” and that the court’s equitable powers cannot be used to justify such prepetition claims payments.

The Court of Appeals for the Fifth Circuit, in Chiasson v. J. Louis Matherne & Associates (In re Oxford Management, Inc.), held that claims for real estate brokerage commissions, incurred before the commencement of the bankruptcy case, could not be paid to the agents to which they were owed because such payments would violate the priority scheme of the Bankruptcy Code. The court said that “[s]ection 105(a) authorizes a bankruptcy court to fashion such orders as are necessary to further the substantive provisions of the Bankruptcy Code” but could not be used to allow postpetition payments on prepetition claims of general unsecured creditors because making such payments “deviated from the pro rata scheme of distribution envisioned by the Code.”

After the Fifth Circuit’s decision in Chiasson, the Bankruptcy Court for the Northern District of Texas, in In re CoServ, L.L.C., announced that it would approve a debtor’s request for payment of prepetition claims only in very limited circumstances. The court noted that the Fifth Circuit held that section 105(a)’s equitable powers do not extend to a payment of prepetition claims in all situations. The court reasoned that payments of the prepetition claims disrupt the priority scheme of the Bankruptcy Code and, therefore, courts should carefully evaluate allowance of such requests. The court commented that a creditor’s demand for payment of prepetition claims, particularly where the creditor has a contract with the debtor, constitutes “economic blackmail” and may violate the automatic stay imposed by

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65 Id. at 535–36; see 11 U.S.C. §§ 549, 550.
66 Goodman Oil, 713 F.2d at 535–36, 538.
67 Id. at 537.
68 4 F.3d at 1334.
69 Id. at 1333–34.
71 See id. at 495.
72 See id. at 494.
section 362(a). The court then adopted a three-part test for deciding whether prepetition claims should be paid. First, the court must determine whether the payment is indispensable to the debtor’s business, such as when the creditor is a sole supplier of a given product or a creditor with control over valuable property. Second, the court must determine whether nonpayment of the claim risks probable harm or eliminates an economic advantage disproportionate to the amount of the actual claim. Third, the court must decide whether there is any practical or legal alternative to payment of the claim, such as providing a deposit or assuming an executory contract between the debtor and the creditor.

A subsequent bankruptcy case in Texas, *In re Mirant Corp.*, followed *In re CoServ* and applied the same three-part test. The debtor in that case generated and sold electric power and a trade creditor’s refusal to supply necessary goods and services would have seriously impaired not only the debtor’s reorganization, but also the nation’s economy. Recognizing these circumstances, the bankruptcy court gave the debtor the authority to evaluate the propriety of potential critical-vendor payments on an on-going basis under the *In re CoServ* three-part test.

IV. The Kmart Decision

The most recent, as well as notorious, decisions dealing with critical-vendor payments were rendered in *In re Kmart Corp.* and *Capital Factors, Inc. v. Kmart Corp.* On January 22, 2002, Kmart Corporation and certain of its domestic subsidiaries and affiliates filed a voluntary Chapter 11 petition for reorganization. In one of the motions filed on the first day of the case, Kmart sought authority to pay certain prepetition obligations to critical vendors and certain for-

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73 *Id.* (citing *In re Structurlite Plastics Corp.*, 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988)).
74 *Id.* at 498.
75 *In re CoServ*, 273 B.R. at 498.
76 *Id.*
77 *Id.* at 498–99.
79 *See id.* at 428.
80 *Id.* at 429–30.
81 *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004); *Capital Factors, Inc. v. Kmart Corp.*, 291 B.R. 818 (N.D. Ill. 2003).
82 *Kmart*, 291 B.R. at 820.
eign vendors. On the same day, the Bankruptcy Court for the Northern District of Illinois issued an order granting Kmart “open-ended permission to pay any debt to any vendor [Kmart] deemed ‘critical’ in the exercise of unilateral discretion, provided that the vendor agreed to furnish goods on ‘customary trade terms’ for the next two years.” The bankruptcy court relied on section 105 and, implicitly, on the doctrine of necessity in authorizing the critical-vendor payments. In total, Kmart was authorized to pay, at its discretion, in excess of $320 million in prepetition claims to numerous critical vendors, both foreign and domestic, including liquor distributors and advertising companies. Kmart did not include Capital Factors, a factoring company with an unsecured claim of approximately $20 million, as a critical vendor. As a result, Capital Factors objected to Kmart’s first-day motion. The objection was unsuccessful in the bankruptcy court. Capital Factors appealed the critical-vendor payment order to the district court, but failed to obtain a stay of the bankruptcy court’s first-day orders pending appeal. Kmart proceeded to pay out more than $300 million to 2330 “critical” suppliers in payment of their prepetition claims. Approximately 2000 vendors were not deemed “critical” and therefore were not paid, and, eventually, they received a distribution under a plan of reorganization that was worth approximately ten percent of their claims.

On appeal, the district court reversed and remanded the matter back to the bankruptcy court to order the return of all payments made to vendors with respect to prepetition claims. As to the doctrine of necessity, the court asserted that the doctrine derived from railroad reorganization cases and was not codified in the Bankruptcy

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83 Id.
84 In re Kmart, 359 F.3d at 868–69. Over the next two weeks Kmart filed two more motions seeking authority to pay issuers of prepetition letters of credit and prepetition claims of certain liquor vendors. Kmart, 291 B.R. at 820. Both of these motions were approved by the court and became subject to Capital Factors’ later appeal. Id. at 820–21.
85 See Kmart, 291 B.R. at 821–23.
87 Kmart, 291 B.R. at 820.
88 Id.
89 Id. at 821, 823.
90 In re Kmart, 359 F.3d at 869.
91 Id.
92 Kmart, 291 B.R. at 825.
Code. The only way to apply the doctrine of necessity, wrote the court, was through section 105. The district court noted, however, that courts were split on allowing critical-vendor payments based on the doctrine of necessity and on the section 105(a) equitable powers of the bankruptcy courts. The district court noted that the Seventh Circuit stated that “the grant of equitable power in § 105 is limited in that it ‘allows [bankruptcy] courts to use their equitable powers only as necessary to enforce the provisions of the Code, not to add on to the Code as they see fit.’”

The district court cited the Seventh Circuit’s admonition that “[t]he fact that a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be.” It also determined that the bankruptcy court’s order elevated the claims of the critical vendors over those of other unsecured creditors and subordinated the claims of non-critical unsecured creditors. The district court concluded that the bankruptcy court had impermissibly altered the priority scheme set forth in the Bankruptcy Code without articulating any applicable authority to support doing so and, therefore, its critical-vendor order could not be allowed to stand.

In 2004, the Court of Appeals for the Seventh Circuit affirmed the district court’s decision. Judge Easterbrook, writing for the court, wrote that section 105(a) does not give bankruptcy courts discretion to permit the debtor to pay prebankruptcy unsecured claims in violation of the Bankruptcy Code’s rules on priority.

The Seventh Circuit also noted that section 105(a) allows bankruptcy courts to issue orders or judgments that are necessary to carry out the provisions of the Bankruptcy Code, but “does not create discretion to set aside the Code’s rules about priority and distribu-

93 Id. at 822.
94 Id.
95 Id.
96 Id. (alteration in original) (quoting In re Fesco Plastics Corp. Inc., 996 F.2d 152, 156 (7th Cir. 1993)).
97 Kmart, 291 B.R. at 823 (alterations in original) (quoting In re Chicago, Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986)).
98 Id. at 822.
99 See id. at 822–23.
100 In re Kmart, 359 F.3d at 874.
101 See id. at 871.
tion.” The court further pointed out that “the power conferred by § 105(a) is one to implement rather than override.” The equitable nature of the bankruptcy proceedings does not permit the judges to redistribute rights in accordance with their personal views of fairness. “Every circuit that has considered the question has held that this statute does not allow a bankruptcy judge to authorize full payment of any unsecured debt, unless all unsecured creditors in the class are paid in full.” Judge Easterbrook then announced the Seventh Circuit’s agreement with that view.

Judge Easterbrook’s opinion went on to say that “doctrine of necessity is just a fancy name for a power to depart from the Code.” The court stated that the Bankruptcy Code replaced the common-law bankruptcy principles worked out in the railroad reorganization cases. Older doctrines, such as the doctrine of necessity, may still survive only as aids to interpretation of ambiguous language of the Bankruptcy Code, but not as “freestanding entitlements to trump the text.”

The court then considered whether any other provisions of the Bankruptcy Code could be used to authorize the grant of critical-vendor payments. The court rejected the notion that section 364(b) could provide a basis for permitting payment of prepetition debt to critical vendors. Judge Easterbrook noted that section 364 authorizes the debtor to obtain credit but does not say anything about how the money will be distributed or about priorities among creditors. The court specifically rejected the holding in In re Payless Cashways, Inc., where critical-vendor payments were allowed pursuant to section 364. The Seventh Circuit in In re Kmart likewise held that section 503 could not be used to justify critical-vendor payments. The court reasoned that “[p]re-filing debts are not administrative ex-

102 Id.
103 Id.
104 Id. (citing In re Chicago, Milwaukee, 791 F.2d at 528).
105 In re Kmart, 359 F.3d at 871.
106 Id.
107 Id.
108 Id.
109 Id.
110 In re Kmart, 359 F.3d at 872.
112 In re Kmart, 359 F.3d at 872; see 11 U.S.C. § 364.
114 359 F.3d at 872; see 11 U.S.C. § 503.
penses; they are the antithesis of administrative expenses. . . . Treating pre-filing debts as ‘administrative’ claims against the post-filing entity would impair the ability of bankruptcy law to prevent old debts from sinking a viable firm.”

In dicta, Judge Easterbrook left the door open to possible use of section 363(b) to authorize critical-vendor payments in future cases. That section provides that “[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” It could be argued that section 363(b) may be used to authorize the debtor, in exercising its business judgment, to use estate funds to make payments of prepetition claims to certain creditors. Judge Easterbrook wrote that section 363(b) “is more promising, for satisfaction of a prepetition debt in order to keep ‘critical’ supplies flowing is a use of property other than in the ordinary course of administering an estate in bankruptcy.” The Seventh Circuit also cautioned against using section 363(b) authority to disrupt the priority scheme of the Bankruptcy Code, stressing that although section 363(b) may allow certain changes in the priority of creditors, such changes should be kept to a minimum: “it is prudent to read, and use, § 363(b)(1) to do the least damage possible to priorities established by contract and by other parts of the Bankruptcy Code.” The court then refused to rule on whether section 363(b)(1) may be used to justify payment of prepetition unsecured debt to maintain the flow of goods from “critical vendors,” because “this order was unsound no matter how one reads § 363(b)(1).”

The Seventh Circuit then placed strict procedural and evidentiary limits on the use of § 363(b)(1) to pay prepetition unsecured debts, without deciding whether that section of the Code may ever justify such payments:

115 In re Kmart, 359 F.3d at 872.
116 See id.
119 In re Kmart, 359 F.3d at 872.
120 Id.
121 Id.
The foundation of a critical-vendors order is the belief that vendors not paid for prior deliveries will refuse to make new ones. Without merchandise to sell, a retailer such as Kmart will fold. . . . [I]t is necessary to show not only that the disfavored creditors will be as well off with reorganization as with liquidation—a demonstration never attempted in this proceeding—but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued. If vendors will deliver against a promise of current payment, then a reorganization can be achieved, and all unsecured creditors will obtain its benefit, without preferring any of the unsecured creditors.\footnote{122 Id. at 872–73.}

The court also noted that some critical vendors would continue to do business with the debtor postpetition because they are legally obligated to perform long-term contracts and the automatic stay under section 362(a) prevents these vendors from refusing to make postpetition deliveries so long as the debtor pays for new goods.\footnote{123 Id. at 873; see 11 U.S.C. § 362(a) (2000).} One vendor, Fleming Companies, which received the largest payment for prepetition debt among Kmart’s alleged critical vendors because it sold Kmart between $70 million and $100 million of groceries and related goods weekly, was one of those obligated to continue to make deliveries under a long-term contract: “[n]o matter how much Fleming would have liked to dump Kmart, it had no right to do so. It was unnecessary to compensate Fleming for continuing to make deliveries that it was legally required to make.”\footnote{124 In re Kmart, 359 F.3d at 873.}

The court also explained why it would be very difficult for a debtor in possession, when attempting to justify the use of section 363(b)(1) to authorize payment of prepetition debt, to prove that a particular vendor would, in fact, refuse to make future deliveries, even if not obligated to do so under a prepetition contract.\footnote{125 See id.}

Each new delivery produced a profit; as long as Kmart continued to pay for new product, why would any vendor drop the account? That would be a self-inflicted wound. To abjure new profits because of old debts would be to commit the sunk-cost fallacy; well-managed businesses are unlikely to do this. Firms that disdain current profits because of old losses
are unlikely to stay in business. They might as well burn money or drop it into the ocean.\textsuperscript{126}

The Seventh Circuit also addressed the concern that vendors might refuse to deliver goods postpetition out of fear that they would not get paid for those deliveries.\textsuperscript{127} By suggesting ways to address those concerns, the court apparently heightened the debtor’s burden of proof in obtaining an order authorizing the payment of prepetition debt owed to critical vendors.\textsuperscript{128}

Doubtless many suppliers fear the prospect of throwing good money after bad. It therefore may be vital to assure them that a debtor will pay for new deliveries on a current basis. Providing that assurance need not, however, entail payment for prepetition transactions. Kmart could have paid cash or its equivalent. (Kmart’s CEO told the bankruptcy judge that COD arrangements were not part of Kmart’s business plan, as if a litigant’s druthers could override the rights of third parties.) Cash on the barrelhead was not the most convenient way, however. Kmart secured a $2 billion line of credit when it entered bankruptcy. Some of that credit could have been used to assure vendors that payment would be forthcoming for all post-petition transactions. The easiest way to do that would have been to put some of the $2 billion behind a standby letter of credit on which the bankruptcy judge could authorize unpaid vendors to draw. That would not have changed the terms on which Kmart and any of its vendors did business; it just would have demonstrated the certainty of payment. If lenders are unwilling to issue such a letter of credit (or if they insist on a letter’s short duration), that would be a compelling market signal that reorganization is a poor prospect and that the debtor should be liquidated post haste.

Yet the bankruptcy court did not explore the possibility of using a letter of credit to assure vendors of payment. The court did not find that any firm would have ceased doing business with Kmart if not paid for pre-petition deliveries, and the scant record would not have supported such a

\textsuperscript{126} Id.
\textsuperscript{127} See id.
\textsuperscript{128} See id.
finding had one been made. The court did not find that discrimination among unsecured creditors was the only way to facilitate a reorganization. It did not find that the disfavored creditors were at least as well off as they would have been had the critical-vendors order not been entered. . . . Even if § 362(b)(1) [sic] allows critical-vendors orders in principle, preferential payments to a class of creditors are proper only if the record shows the prospect of benefit to the other creditors. This record does not, so the critical-vendors order cannot stand.\textsuperscript{129}

The Seventh Circuit in \textit{In re Kmart}, by rejecting section 105(a) and the doctrine of necessity as a basis for authorizing payment of prebankruptcy claims of unsecured vendors, and by re-focusing the critical-vendor debate on section 363(b), which it interpreted as having a high burden of proof, has clearly and substantially raised the bar for debtors seeking to pay critical-vendor claims early in a Chapter 11 case.\textsuperscript{130} The decision also exemplifies the trend in the appellate courts of limiting bankruptcy courts’ previously broad discretion to authorize a debtor to pay prepetition claims outside of a plan of reorganization.\textsuperscript{131}


\textbf{A. Administrative Priority for Goods Delivered Within Twenty Days Before Bankruptcy}

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has amended the Bankruptcy Code in two significant ways that are likely to impact critical-vendor payments. First, the 2005 Act

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\textsuperscript{129} \textit{In re Kmart}, 359 F.3d at 873–74.
\end{center}

\begin{center}
\textsuperscript{130} See \textit{id.} at 871–73. That does not mean, however, that courts following \textit{In re Kmart} have not authorized payment to critical vendors. In \textit{In re Tropical Sportswear Int’l Corp.}, 320 B.R. 15, 18, 20–21 (M.D. Fla. 2005), the bankruptcy court allowed the debtors, a designer and marketer of clothing, to use estate funds to pay 77.5\% of prepetition amounts owed to certain critical vendors. The court relied on sections 105 and 363(b)(1), and the court’s opinion heavily referenced \textit{In re Kmart} and the evidentiary test proposed by \textit{In re Kmart} in determining whether the critical payments should be allowed. \textit{Id.} at 19–20; see 11 U.S.C. §§ 105, 363(b)(1) (2000).
\end{center}

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\textsuperscript{131} Notwithstanding, courts have distinguished \textit{In re Kmart} in cases involving the payment of prepetition priority wage claims, because there are fewer concerns about affecting the priority scheme of the Bankruptcy Code or unfairly favoring some unsecured creditors over others. See \textit{In re CEI Roofing, Inc.}, 315 B.R. 50, 53–54 (Bankr. N.D. Tex. 2004).
\end{center}
added section 503(b)(9) to the Code to give administrative expense treatment for “the value of any goods received by the debtor within 20 days before the date of commencement of a case under [the Bankruptcy Code] in which the goods have been sold to the debtor in the ordinary course of such debtor’s business.” The result is that such claims have administrative priority under section 507(a)(2) of the Code. Apparently, the rationale for granting priority to such vendors is that within twenty days before bankruptcy, a debtor is likely to know that bankruptcy is imminent and that it will not be able to pay for goods delivered within that time period. Moreover, goods delivered so close to the bankruptcy filing are likely to benefit the bankruptcy estate. This new provision is a radical departure from the general rule that only postpetition expenses are afforded administrative priority. Curiously, section 503(b)(9) gives providers of goods priority over similarly situated providers of services or lenders who gave the debtor value within the twenty-day period.

This new provision is similar in concept to the six months rule used in railroad reorganization cases in at least two ways. First, it is a rule of priority, rather than payment. That is, by giving such claims administrative expense status, the amendment clearly gives such vendors priority over general unsecured creditors and above most other priority claims. Indeed, such vendor claims will have priority over wage and tax claims. In involuntary bankruptcy cases, section 503(b)(9) vendor claims will have priority over claims of unsecured creditors who extend credit in the ordinary course of business during the gap period between the filing of the petition and the earlier of the appointment of a trustee or order for relief. The Code does not,


135 BAPCPA § 1227(b), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 503(b)). With respect to priority of claims allowed under section 502(f) of the
however, specify *when* payment will be made. It remains to be seen whether courts in Chapter 11 cases will allow payment of these vendor claims before confirmation of a plan of reorganization. Under section 503(a) of the Code, any entity with an administrative claim may file a request for payment, and it is within the court’s discretion whether to authorize payment during the case.\(^\text{136}\) In a Chapter 11 case, administrative expenses must be paid in full on the effective date of the plan unless paid earlier, either in the ordinary course of business or with court authorization.\(^\text{137}\) Arguably, prepetition vendor claims are never payable in the ordinary course of business because of the intervening bankruptcy and the automatic stay, even if afforded administrative expense priority. If courts adopt that view, actual payment of section 503(b)(9) vendor claims will require either a court order authorizing payment or a confirmed Chapter 11 plan.

Section 503(b)(9) is also similar to the six months rule in that priority status is granted automatically.\(^\text{138}\) The debtor does not have to demonstrate that the creditor is “critical” or that payment of the claim is necessary for a successful reorganization. In fact, the new section applies in all types of bankruptcy cases—including Chapter 7 liquidation cases—indicating that Congress did not intend to link payment of these prepetition vendor claims to the necessity for effective reorganization.

It is worth noting that section 503(b)(9) refers to the “value” of the goods received by the debtor within the twenty-day period before bankruptcy.\(^\text{139}\) It does not refer to “purchase price” or “claim” arising from the sale.\(^\text{140}\) It can be expected that value will be the same as the purchase price in most cases, especially if any arguable difference in the two amounts is not so material as to warrant litigation over that issue. Nevertheless, the language of the section leaves open the argument that value, in a particular case, may be an amount that is either higher or lower than the purchase price.\(^\text{141}\)


\(^{137}\) *See* 11 U.S.C. § 363(c)(1); *BAPCPA* § 1502(a)(8), 119 Stat. at 216–17 (to be codified at, and amending, 11 U.S.C. § 1129(a)(9)).

\(^{138}\) *See* BAPCPA § 1227, 119 Stat. at 199–200 (to be codified at 11 U.S.C. § 503(b)(9)).

\(^{139}\) *See id.*

\(^{140}\) *See id.*

\(^{141}\) *See id.*
The need to rely on the doctrine of necessity to pay critical vendors will be reduced in future cases because of section 503(b)(9). Critical vendors, as well as non-critical vendors, with claims for goods delivered within twenty days before bankruptcy should be willing to continue to do business with the debtor in possession in a Chapter 11 case, unless there is a concern that the debtor may not have sufficient assets from which to pay administrative expense claims in full. That concern could be alleviated by appropriate provisions in postpetition financing arrangements that will assure sufficient funds to pay administrative expenses.

Alternatively, a request may be made under section 503(a) for immediate payment for goods delivered within the twenty-day pre-bankruptcy period. Determining when an administrative expense is to be paid is within the discretion of the bankruptcy court. As discussed above, courts have been more willing to permit immediate payment of prepetition claims, such as wage claims, when such claims are entitled to priority in treatment and, therefore, are likely to be paid in full later in the case. It could be anticipated that a critical vendor that insists on immediate payment of its section 503(b)(9) claim as a condition to doing business with the debtor in possession will have its claim treated in a manner similar to the treatment of priority wage claims; courts will likely grant the debtor’s request under section 503(a) to make such payment. Clearly, the burden of proof to pay an administrative priority claim will be easier to satisfy than the burden required to pay a nonpriority unsecured claim under section 105(a), section 363(b), or the doctrine of necessity.

B. Expansion of Reclamation Rights of Vendors

The 2005 Act also amended section 546(c) of the Code, which deals with a seller’s right to reclaim goods sold to the debtor in the ordinary course of the seller’s business. The Act could also reduce the demand for court authorization to pay critical vendors.

In cases commenced before the effective date of the 2005 amendments, section 546(c) provides that the avoiding powers of a trustee or debtor in possession are subject to any statutory or com-

142 See id.
144 In re Verco Indus., 20 B.R. 664, 665 (B.A.P. 9th Cir. 1982).
145 BAPCPA § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).
mon-law right of a seller that has sold goods to the debtor, in the ordinary course of the seller’s business, to reclaim those goods if the debtor has received the goods while insolvent.\(^{146}\) Nevertheless, strict time limits apply in such cases.\(^{147}\) To exercise this right in cases commenced before the effective date of the 2005 amendments, the seller must demand reclamation in writing before ten days after the debtor received the goods or, if the ten-day period expired after commencement of the bankruptcy case, before twenty days after receipt of the goods.\(^{148}\) If a timely demand is made, the seller must comply with state law regarding reclamation, which is section 2–702 of the Uniform Commercial Code.\(^{149}\) Under state law, the right of reclamation is subject to the rights of a purchaser in the ordinary course or other good-faith purchaser of the goods.\(^{150}\) In addition, for the right of reclamation to apply, the debtor must have possession of the goods when the demand was made,\(^ {151}\) and the goods must be identifiable.\(^{152}\) If a timely reclamation demand is made, the court has discretion to compel the return of the goods to the seller, or it may deny reclamation and grant the seller’s claim administrative priority, or secure the claim with a lien on property.\(^{153}\)

The 2005 amendments have expanded a seller’s right to reclaim goods. First, rather than requiring the seller to demand reclamation within ten days after receipt of the goods (or twenty days if the ten-day period expires after commencement of the bankruptcy case), section 546(c), as amended, gives the seller reclamation rights if the debtor

\(^{146}\) 11 U.S.C. § 546(c); see also BAPCPA § 406(1),(2), 119 Stat. at 105–06 (to be codified at, and amending, 11 U.S.C. § 546(h)) (designated as 11 U.S.C. § 546(g) before the 2005 amendments). Section 546(c), first added to the Code in 1994, authorizes the court, on motion made within 120 days after the order for relief in a Chapter 11 case, to permit a trustee or debtor in possession, with the seller’s consent, to return goods shipped to the debtor before the commencement of the case, and the seller may offset the purchase price against any prepetition claim of the seller. 11 U.S.C. § 546(g) (2000). The court, however, must find that the return of the goods is in the best interest of the estate. Id.

\(^{147}\) See 11 U.S.C. § 546(c).

\(^{148}\) Id. § 546(c)(1).


\(^{150}\) Id.

\(^{151}\) See, e.g., In re Adventist Living Ctrs., Inc., 52 F.3d 159, 162 (7th Cir. 1995); Flav-O-Rich, Inc., v. Rawson Food Serv., Inc. (In re Rawson Food Service, Inc.), 846 F.2d 1343, 1347 (11th Cir. 1988).


has received the goods within forty-five days before the commencement of the bankruptcy case and the seller demands reclamation in writing within forty-five days after the date of receipt of the goods or, if the forty-five day period expires after the commencement of the case, within twenty days after the case is commenced. Because debtors are usually insolvent during the forty-five day period, the amendment effectively gives sellers the right to reclaim goods sold on credit and received by the debtor within forty-five days before bankruptcy.

Second, the amendments to section 546(c) delete the reference to statutory or common-law right of reclamation which, presumably, was intended to replace nonbankruptcy law regarding reclamation rights with the rights granted under section 546(c). Third, the section 546(c) amendments clarify that a seller’s right of reclamation is subject to prior rights of secured creditors that have security interests in the goods or the proceeds thereof. This change is not significant because, under the version of section 546(c) in effect before the 2005 amendments, the seller’s rights were subordinated to the rights of a good-faith purchaser and courts have held that a secured creditor is such a purchaser. Fourth, the 2005 amendments delete the judicial option of giving the seller, in lieu of reclamation, either administrative claim priority or a lien to secure its claim. Finally, section 546(c), as amended, provides that if a seller fails to make a timely written demand for reclamation, “the seller still may assert the rights contained in section 503(b)(9).”

To the extent that the debtor still has possession of goods delivered within forty-five days before bankruptcy, and a timely demand for reclamation is made, the seller would have the right to the return of the goods. Upon return, of course, the debtor could repurchase the same or similar goods from the seller, paying for the goods in the ordinary course of business under section 363(c)(1). Postpetition

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154 BAPCPA § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).
155 See id.
156 See id.
157 Id.
158 See, e.g., In re Reliable Drug Stores, Inc., 70 F.3d 948, 949 (7th Cir. 1995); Pester Ref. Co. v. Ethyl Corp. (In re Pester Ref. Co.), 964 F.2d 842, 844–45 (8th Cir. 1992); see also 11 U.S.C. § 546(c).
159 See BAPCPA § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)).
160 Id.
161 See id.
purchases are administrative expenses under section 503(b). It is likely, therefore, that there will be a reduction in the need for courts to order critical-vendor payments where the vendor has reclamation rights. Alternatively, courts are likely to be more willing to grant the debtor authority to pay in full the prepetition claims of critical vendors who have the right to compel the return of goods, whether relying on section 105(a), section 363(b), or the doctrine of necessity as authority. It is unlikely that courts will require the debtor to return reclaimed goods only to repurchase them. The practical solution in such cases is to allow the debtor to pay the prepetition claim for the purchase price immediately.

C. A Broader Implication of the 2005 Amendments on Payment of Critical-Vendor Claims

The enactment of section 503(b)(9) may also affect the doctrine of necessity and critical-vendor payments in another way. As discussed above, supporters of the doctrine of necessity and judicial authority to pay critical vendors have argued that the Bankruptcy Code’s silence regarding a doctrine that existed under pre-Code law does not stand in the way of its recognition after the Code’s enactment in 1978. The absence of any mention of the doctrine in the Code could be consistent with its continuing viability. Nevertheless, now that Congress has spoken on the treatment of prepetition unsecured vendor claims in section 503(b)(9), a broader question that may arise when debtors request court authorization to pay prepetition critical-vendor claims is whether the 2005 legislation includes a negative inference. Indeed, the Bankruptcy Code now expressly grants administrative expense priority to vendors under section 503(b)(9). The 2005 amendments also give vendors broader reclamation rights that exceed those afforded to vendors under state law. Clearly, the Code is no longer silent on the authority to pay prepetition unsecured claims be-

164 See Vilaplana, supra note 26, at 528.
165 See BAPCPA § 1227(b), 119 Stat. at 199–200 (to be codified at 11 U.S.C. § 503(b)(9)).
166 Id.
167 Compare id. § 1227(a), 119 Stat. at 199–200 (to be codified at, and amending, 11 U.S.C. § 546(c)) (allowing a seller to demand in writing reclamation of goods received by an insolvent debtor within 45 days of the date of receipt of such goods by the debtor, provided certain conditions are met), with U.C.C. § 2–702(2) (2003) (allowing a seller to reclaim goods received by an insolvent buyer within ten days of receipt).
fore confirmation of a plan. The more protection that Congress expressly provides for prepetition vendors, the less likely it will be that courts will use equitable powers to authorize extraordinary treatment to vendors who do not qualify for the codified protection. For example, a seller delivers goods twenty-five days before the commencement of the case and, therefore, is not eligible for administrative priority. If the goods have been resold to consumers before a reclamation demand is made so that reclamation is not possible, will appellate courts tolerate a bankruptcy court’s exercise of discretion to allow payment to the seller in full at the commencement of the case? Will courts be willing to give a provider of services (who is not within the scope of section 503(b)(9)) essentially the same section 503(b)(9) rights as the provider of goods by using section 105(a), section 363(b), or the doctrine of necessity? Or will appellate courts view such orders as an inappropriate rewriting of the Code?

VI. PROCEDURAL SAFEGUARDS UNDER PROPOSED AMENDMENTS TO THE FEDERAL RULES OF BANKRUPTCY PROCEDURE

Critics of critical-vendor orders at the early stages of a case have complained that there are few, if any, procedural safeguards on such orders.168 First-day motions for authority to pay certain prebankruptcy claims have been routine in many bankruptcy courts. These motions have been granted without sufficient notice and opportunity to be heard. In some cases, such motions are granted before the formation of a committee of unsecured creditors and with little input from creditor interests. In reaction to such criticism regarding motions for relief filed and heard on the first day of a case, the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States proposed a draft of a new Rule 6003 of the Federal Rules of Bankruptcy Procedure.169 The preliminary draft of the proposed

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amendments was published for public comment in August 2005.\textsuperscript{170} The rule, as amended, would read as follows:

\textbf{Rule 6003. Interim and Final Relief Immediately Following the Commencement of the Case—Applications for Employment; Motions for Use, Sale, or Lease of Property; and Motions for Assumptions, Assignments, and Rejections of Executory Contracts}

Except to the extent that relief is necessary to avoid immediate and irreparable harm, the court shall not, within 20 days after the filing of the petition, grant relief regarding the following:

\ldots

(b) a motion to use, sell, lease, or otherwise incur an obligation regarding property of the estate, including a motion to pay all or part of a claim that arose before the filing of the petition, but not a motion under Rule 4001.\ldots\textsuperscript{171}

The Committee Note explaining the purpose of the proposed rule states:

[t]here can be a flurry of activity during the first days of a bankruptcy case. This activity frequently takes place prior to the formation of a creditors’ committee, and it also can include substantial amounts of materials for the court and parties in interest to review and evaluate. This rule is intended to alleviate some of the time pressures present at the start of a case so that full and close consideration can be given to matters that may have a fundamental impact on the case.\textsuperscript{172}

The eventual promulgation of the new Rule 6003 by the Supreme Court is highly likely, though it probably will not become effective until at least December 1, 2007, because of the lengthy rulemaking process under the Rules Enabling Act.\textsuperscript{173} The result will be greater creditor and committee response to any request by a debtor to pay prepetition unsecured claims.

\textsuperscript{170} \textit{Id.}
\textsuperscript{171} \textit{Id.}
\textsuperscript{172} \textit{Id.}
CONCLUSION

The 2005 amendments to the Bankruptcy Code, which grant vendors administrative priority for goods delivered within twenty days before bankruptcy and greater reclamation rights, should reduce the demand for payments to critical vendors during the early days of a Chapter 11 case. In those situations where a debtor seeks permission to pay a vendor’s prebankruptcy administrative claim, the court would have the discretion to grant the request under section 503(b). Nevertheless the 2005 amendments leave uncertain the bankruptcy court’s discretion to provide similar protection for, or to authorize early payment to, creditors with unsecured claims that fall outside the scope of these new statutory protections.

The recent judicial trend has been to narrow the bankruptcy court’s equitable power to authorize payment of prebankruptcy unsecured claims before confirmation of a Chapter 11 plan. Several appellate court decisions have rejected entirely the doctrine of necessity and the use of section 105(a) to authorize payment of prebankruptcy non-priority claims, while the Seventh Circuit in In re Kmart Corp. has kept the door open to the possible use of section 363(b) with strict evidentiary burdens to safeguard against unwarranted payments.174 Several bankruptcy courts have provided stringent tests for making critical-vendor payments, such as the three-part test used in In re CoServ, L.L.C. and In re Mirant Corp.175 Clearly, orders granting debtors wide discretion to pay prebankruptcy claims of creditors that they perceive as critical to the reorganization effort will no longer be routine in future cases.

Yet bankruptcy courts should, and likely will, continue the practice of authorizing the payment of prebankruptcy debt in certain situations, such as when the claim has priority under section 507(a) and a delay in payment would cause disruption to the debtor’s business. Courts probably will rely on the doctrine of necessity, section 105(a), or section 363(b) when granting such orders. For example, the timely payment of priority wage claims, which now can be as high as $10,000 per employee, has been, and will continue to be, unchallenged and routine in the majority of Chapter 11 cases. If and when the proposed new Bankruptcy Rule 6003 becomes effective, it should be relatively easy for a reorganizing debtor to prove that payment of

174 359 F.3d 866, 872–73 (7th Cir. 2004).
priority wage claims during the first days of the case is “necessary to avoid immediate and irreparable harm” so that the court would not have to wait until twenty days after the commencement of the case to grant the requested relief.176

Courts also should have discretion to authorize payment of non-priority claims, but only in extraordinary circumstances and with procedural safeguards that afford parties in interest an opportunity to be heard before relief is granted. Anyone who doubts that such authority should exist should read Official Committee of Equity Security Holders v. Mabey, where the Fourth Circuit, only because of its view that section 105(a) was insufficient authority on which to rely, shut the door on the creation of a $15 million emergency treatment fund to be used to pay the $10,000–$15,000 cost of timely surgery or fertilization for each victim of a defective contraceptive device.177 The medical treatment was likely to cure infertility, the expenditure would have benefited the estate by mitigating tort claims, and the amount spent on each woman would have been deducted from future plan distributions almost certain to exceed the cost of the medical treatment, so creation of the treatment fund would not adversely affect distributions to creditors.178

Now that Congress has added section 503(b)(9) to the Code to grant administrative priority to claims of certain vendors, and has amended section 546(c) to expand reclamation rights, it should complete its statutory treatment with respect to the payment of prebankruptcy claims before a Chapter 11 plan is confirmed. The Code should be amended to clarify the extent to which the doctrine of necessity applies in Chapter 11 cases. The legislation would avoid further uncertainty, as well as expensive and time-consuming litigation, over the propriety of allowing payment of prebankruptcy debts. It also would result in more national uniformity (and less forum shopping) regarding payment of prebankruptcy claims outside of a plan. The legislation should recognize different standards to be applied depending on the type of debt sought to be paid.

176 See Draft of Proposed Amendments, supra note 169.
177 See 832 F.2d 299, 301–02 (4th Cir. 1987).
178 See id. at 301.
The National Bankruptcy Conference\textsuperscript{179} has proposed the addition of a new section 1117 to the Code dealing with payment of pre-bankruptcy claims before confirmation of a plan.\textsuperscript{180} That proposal would establish a “best interest of the estate” test for the payment of priority wage claims and contributions to an employee benefit plan owed to employees, and for payment of customer claims, such as war-

\textsuperscript{179} The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of approximately sixty-five lawyers, law professors, and bankruptcy judges. Its primary purpose is to study the operation of bankruptcy and related laws and to make proposals for their reform. The Author is a member of the Conference.

\textsuperscript{180} The following is the proposal:

**Section 1117. Payment of Prepetition Claims**

(a) After the order for relief, except as provided in section 365, 503, 546, 1110, 1113, 1114, or 1168, subsection (b) or (c) of this section, a plan confirmed in the case, or the order confirming the plan, the trustee may not pay an unsecured claim that arose before the commencement of the case under this title.

(b) The court, on request of the trustee and after notice and a hearing, may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if such payment is in the best interest of the estate and—

(1) the claim is owed to an employee of the debtor and is of the kind and for the amount and time periods specified in section 507(a)(4) or 507(a)(5); or

(2) the claim arose from the purchase, before the commencement of the case, of goods or services, or the right to use technology or information, from the debtor in the ordinary course of business of the debtor, including a claim based on a warranty, right to a price discount, or right to receive delivery of goods or services.

(c) The court, on request of the trustee and after notice and a hearing, may authorize the trustee to pay, or otherwise perform an obligation in connection with, an unsecured claim that arose before the commencement of the case, other than a claim of the kind specified in subsection (b), whether or not proof of the claim has been filed or deemed filed or the claim has been allowed, if—

(1) there is a compelling public interest in the continuation of the debtor’s business and a material risk that the debtor’s business will not continue without such payment or performance;

(2) such payment or performance is necessary to permit the reorganization of the debtor and the benefit to the estate of such payment or performance substantially outweighs the cost to the estate; or

(3) there is a compelling public interest in such payment or performance and the benefit to the estate of such payment or performance outweighs the cost to the estate.

ranty claims and claims based on price discount or frequent flier-type programs. Apparently, the standard for these claims would be the same as the standard used whenever the court, under section 363(b), approves an expenditure outside the ordinary course of business. For other types of unsecured claims, however, the court would not have discretion to authorize payment unless there is an evidentiary showing that at least one of the following three more stringent standards is satisfied: (1) there is a compelling public interest in the continuation of the debtor’s business and a material risk that the debtor’s business will not continue without such payment; (2) the payment is necessary to permit the reorganization of the debtor and the benefit to the estate of the payment substantially outweighs the cost to the estate; or (3) there is a compelling public interest in the payment and the benefit to the estate of such payment or performance outweighs the cost to the estate.\footnote{181}

Congress should consider enactment of the National Bankruptcy Conference proposal or a similar provision on payment of prebankruptcy claims in a Chapter 11 case before confirmation of a plan. If such a proposal is enacted, and proposed new Rule 6003 of the Federal Rules of Bankruptcy Procedure is promulgated, courts will have the flexibility they need to authorize payment of a prebankruptcy claim only when the particular circumstances justify such payment, and parties in interest will have procedural safeguards to assure a meaningful opportunity to be heard at the evidentiary hearings.

\footnote{181 The National Bankruptcy Conference also supports the adoption of procedural requirements to assure an opportunity for the creditors’ committee, United States trustee, and other parties in interest to be heard before the court grants an order authorizing payment of prebankruptcy debt, unless delay in payment would cause immediate and irreparable harm to the estate. It has, however, temporarily deferred proposing a statutory provision on procedural matters in view of the proposed new Rule 6003 of the Federal Rules of Bankruptcy Procedure.}