STATEMENT OF RICHARD E. MIKELS
TO THE AMERICAN BANKRUPTCY INSTITUTE'S
COMMISSION TO STUDY THE REFORM OF CHAPTER 11

SUBMITTED AT THE TURNAROUND MANAGEMENT ASSOCIATION
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I am very appreciative of the opportunity to present my thoughts to the Commission and I hope that they will be helpful to the Commission in its very important work. I have practiced insolvency law during most of the last forty years. I am the Chairman of the Bankruptcy, Reorganization and Commercial Law Department of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. I currently serve as a Vice President of the American College of Bankruptcy and as the Chairman of the College's Educational Programs Committee. I have been a member of the American Bankruptcy Institute ("ABI") since 1985 and was proud to have served as a member of its board of directors from 2000 - 2006. I am currently the co-chair of the Advisory Committee to the Commission: Plan Issues: Procedure and Structure and the Chairman of a subcommittee of the ABI Mediation Committee charged with developing model rules for bankruptcy mediation. I am an Adjunct Professor of Law at Boston University Law School where I have taught a seminar on Chapter 11 since 2008. Obviously, my views expressed in my testimony are not the views of any of the above referenced organizations or committees.

Over the years, I have spent a good deal of time writing and lecturing on the issues that are presently before the Commission. I have co-authored three (3) articles in the ABI Law Journal which deal with the effectiveness of Chapter 11 and its impact on the American economy. The most recent of the three (3) articles was co-authored by my associate, Ella Shenhav, and was published in December/January 2012 edition (the "2012 Article"). Instead of trying to restate what I have already written, I will include that article in this statement. Further, I have attached the other two (2) articles to this testimony for your reference. I apologize that there is some duplication in the three (3) articles, particularly with reference to the historical analysis. However, after consideration, I thought it would be unfair to the co-authors to simply paraphrase what has already been written. As you will see, the first article, entitled "*Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit*", was published in the ABI Journal in December/January 2003 (the "2003 Article") and was co-authored by the highly respected insolvency investment banker, Peter S. Kaufman of Gordian Group. The second article, entitled "The More Things Change… Reflections on 34 Years of

Practice", was published in the ABI Journal in October 2006 (the "2006 Article") and was co-authored by my associate, Charles W. Azano.

The text of the 2012 Article is as follows:

How Developments in Bankruptcy Practice Have Significant Impact on the Financial Markets and the Economy

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I. Introduction.

The idea for this topic began with conversations between one of the co-authors and a prominent bankruptcy attorney. That attorney believed that changes in the capital markets over the last few decades had significantly impacted bankruptcy practice, but that bankruptcy was of only minor significance to the capital markets. His view was that, in the broader economy, so few deals actually default that default remedies, including bankruptcy, are little more than an afterthought to market participants. The authors' perception is that this view is not uncommon among financial market participants. After all, particularly in boom times, the primary focus of the capital markets is making deals happen. In fact, changes in the financial markets, for example, the development of loan to own strategies and claims trading have certainly altered the outcome of reorganization cases and the rights and remedies available to debtors and creditors alike. However, the authors believe that while it is certainly true that changes in the financial markets have had a great impact on bankruptcy practice, it is also true that changes in bankruptcy practice have had enormous impact on the financial markets and on the economy.

II. Common Indicia of the Impact of Bankruptcy on the Financial Markets.

To truly appreciate the impact of bankruptcy on the financial markets, one need look no further than the everyday behavior of lenders and other financial markets participants as they go about their business. Lending documents, often hundreds of pages in length, include extensive and detailed sections dealing with the possibility of default. These provisions are so extensive that they reflect a great concern about how the loan will be collected in the event of default. Certainly, these provisions would be far narrower if concerns about default remedies were not paramount.

Additionally, billions of dollars are expended annually because of lenders' requirements that special purpose vehicles ("SPVs", also known as special purpose entities or bankruptcy-remote entities) be established as part of securitization transactions. These SPVs' primary purpose is to avoid the impact of bankruptcy laws upon default, and in particular, to avoid the automatic stay. Companies are encouraged to set up such vehicles by the prospect of a lower interest rate from potential lenders, who view the SPVs as a safety net that protects their loans from the impact of bankruptcy. These additional expenditures, enormous in the aggregate, would not be undertaken if people were not concerned about the impact of bankruptcy.

Other developments also reflect the keen awareness participants in the debt markets have of the effects of bankruptcy. Article 9 of the Uniform Commercial Code was recently revised to provide additional protections for secured creditors *vis a vis* bankruptcy trustees. Under Bankruptcy Code Section 544, the bankruptcy trustee has the rights and powers of a judgment lien creditor under certain circumstances. Prior to the passage of the revised Article 9, a judgment lien creditor had priority over a secured creditor who filed a financing statement but did not have possession of an instrument, and therefore the priority of secured creditors was limited. Under the revised Article 9, such a secured creditor would have priority over a judgment lien creditor, and thereby priority over a bankruptcy trustee. This revision, among others, has diminished the trustee's strong-arm powers and enhanced the priority enjoyed by secured creditors. The drafters of Article 9 would not have been inclined to make these changes were they not concerned about the rights of secured creditors *vis a vis* bankruptcy trustees.

Finally, there are those capital market participants that acknowledge the importance of bankruptcy administration to their business. At a 2007 ABI seminar, Ward Mooney, CEO of the commercial finance company Crystal Financial, indicated that certainty as to the ability and methodology of disposal of collateral in a Chapter 11 proceeding was a critical factor affecting the growth of second-tier lending. Mr. Mooney was his usual perceptive self. Understandably, if lenders are confident in their ability to realize upon their collateral at close to going concern values in a predictable timeframe, they will be more willing to make second-tier loans to companies. For an article discussing how changes in bankruptcy practice have created more certainty for creditors, please see Richard E. Mikels and Charles W. Azano, *"The More Things Change… Reflections on 34 Years of Practice,"* 25-Oct. Am. Bankr. Inst. J. 22 (2006) (hereinafter referred to as the "<u>34 Years Article</u>").

Changes in bankruptcy practice have created a sense of certainty as to the realization of collateral, and therefore encouraged lenders to more confidently rely on such collateral in extending second-tier loans. As certainty has increased, lenders have been encouraged to lend deeper and deeper into the balance sheet, resulting in more and more debt, higher advance rates, and the leveraging up of companies. Certainly, prior to the advent of the Great Recession (and even today to a great extent), the right side of balance sheets was likely to contain far greater debt in the capital structure at levels that would, in earlier times, have been supplied by equity investment.

III. Some of the Changes in Bankruptcy Practice that Have Altered the Financial Market Landscape.

It seems obvious that recent amendments to the Bankruptcy Code, such as BAPCPA, have made life more difficult for debtors, particularly retailers. It is the authors' view, however, that the changes that have had the greatest significance to the financial markets and the economy began long before these recent changes, and that the recent changes are a mere continuation of longstanding trends.

Prior to the passage of the Bankruptcy Reform Act of 1978 (the "Bankruptcy Code"), parties had the right to restructure under Chapter X or Chapter XI of the Bankruptcy Act. Chapter XI was very debtor-oriented, and Chapter X was very creditor-oriented. Chapter X required the appointment of a trustee at the commencement of a case, provided no exclusivity rights for debtors and any Chapter X plan was required to strictly follow the Absolute Priority Rule. Therefore, Chapter X was usually a financial death sentence for the very people that made the decision whether to file a proceeding (old equity and management). On the other hand, under Chapter XI, management was usually left in place, there was no Absolute Priority Rule (at least since the 1950s) and the debtor was the only party ever allowed to file a plan. It is not surprising that by 1978, few Chapter Xs were filed and even large public corporations were using Chapter XI, which was originally intended for small companies with unsecured trade debt, to restructure.

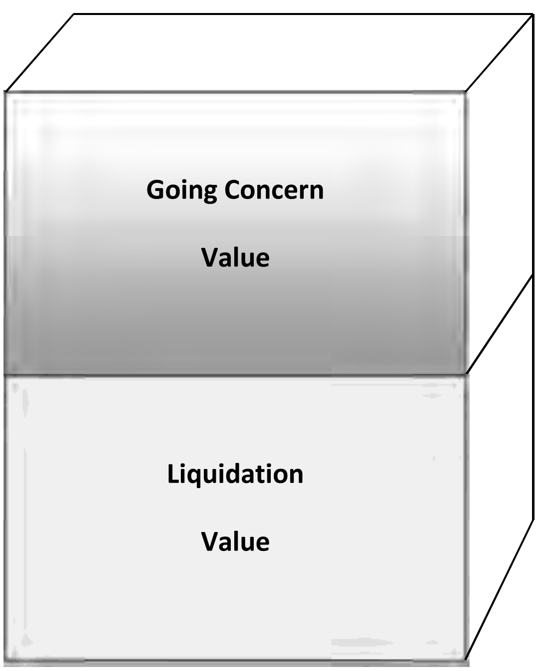
With the passage of the Bankruptcy Code, Congress decided to merge Chapter XI and X into a new Chapter 11 which contained many of the provisions of each older chapter. However, because Chapter 11 exclusivity is limited and the Absolute Priority Rule is paramount, Chapter 11 has followed Chapter X into less use, at least as a traditional reorganization vehicle. That is not to say that there are no Chapter 11 cases filed or that no restructurings are done under Chapter 11. However, we think it fair to say that modern Chapter 11 practice consists more of (a) pre-packaged plans because they avoid the vagaries of free-fall Chapter 11s, or (b) 363 sales for the benefit of lenders and other creditors. 363 sales have become, in essence, foreclosure vehicles that allow for realization of closer to going concern values than would state foreclosure remedies. Consequently, there are fewer free-fall Chapter 11s which are used to fight the secured creditor and save the business for old equity. In fact, it is safe to say that in the current environment, the company that files Chapter 11 is "in play". These dynamics and their impact on Chapter 11 practice are discussed in the article by Richard E. Mikels and Peter S. Kaufman, *"Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit," 22-Dec/Jan. Am. Bankr. Inst. J. 36 (2004).*

These changes have created levels of certainty for lenders that did not exist before 1978. In the mid-1970s, Chapter XI was viewed as a threat to lenders because of the uncertainty of the result. While Chapter XI technically did not deal with secured claims, bankruptcy judges were often not inclined to grant relief from stay until a deal was made between the debtor and the lender. Since only the debtor was authorized to file a plan, even the secured party needed the debtor's cooperation to realize greater than liquidation value. Further, unsecured creditors had to be dealt with since they needed to accept the plan by a class vote. All of this created uncertainty as to how long the lender would be delayed in the realization on its collateral and what form of restructuring might take place. Chapter 11, as currently practiced, is often not nearly as threatening to secured lenders as was Chapter XI.

IV. Why Have These Changes Impacted the Financial Markets?

The simple chart below expresses why such changes have significantly impacted the financial markets. Usually, as set forth in the chart, the going concern value is higher than liquidation value. In almost any bankruptcy regime, liquidation value is distributed in some fashion to creditors in their order of priority. The real issue in determining the impact of bankruptcy on the financial markets is to understand how the difference between liquidation value and the going concern value is distributed among constituencies. Under Chapter XI, only the debtor could file a plan and therefore creditors' choices were often either to accept liquidation value or to accept the debtor's plan. The debtor was unlikely to propose a plan that did not provide for the retention of some value by old equity holders. Today, under Chapter 11, increasingly, creditors, in their order of priority, can legitimately hold higher expectations that they will realize the going concern value of an enterprise. On the other hand, it has become harder for old equity to retain any interest. This all contributes to a higher level of certainty for lenders and other creditors.

Therefore it can be seen why lenders would be willing to lend deeper and deeper into the balance sheet today than they would have been prior to 1978. If the grey area in the chart was likely to be distributed in part to old equity, that uncertainty would significantly reduce any lender's appetite to lend against going concern valuations. If some or all of the grey area were to be distributed to old equity, the value in the grey area would be significantly less likely to serve as the basis for lending deeper and deeper into the asset base. Recovery would be far from certain.



Many people feel that the changes in bankruptcy practice have occurred primarily because of changes in the financial markets, such as the rise of "loan to own" strategies and increased claims trading, both of which have significant impact on Chapter 11 cases. However, if all or a portion of the grey area were likely to be retained by old equity and/or lower-tier creditors in order for more than liquidation value to be realized, then loan to own would be a far less effective strategy. Loan to own strategy works because, under the present Chapter 11, the fulcrum security holders have a reasonable expectation that they will end up with the equity of the company. If Chapter XI were still the controlling restructuring regime, a loan to own strategy would be far less effective. Likewise, the claims trading industry needs to be able to assess the likely result of Chapter 11 cases. If the only way to realize greater than liquidation value were to provide old equity with some value, there would be a serious diminishment in the certainty that allows the claims trading market to flourish. Therefore bankruptcy impacts these markets as much as these markets impact bankruptcy.

V. Conclusion: Are These Changes a Good Thing or a Bad Thing?

The authors feel that the impact of the changes in bankruptcy practice on financial markets has been significant and has both good and bad elements. In the 34 Years Article, this was discussed as follows:

> In reality, all of these changes have been good for someone and bad for someone else. For example, as chapter 11 administration becomes less flexible and therefore more predictable, that tends to be a good thing for lenders and a bad thing for debtors. Lenders are able to make better underwriting decisions if there is more certainty as to the disposition of the loan in the event the debtor faces financial difficulty. As has happened in the real world, in such circumstances, lenders … comforted by additional certainty, are more willing to make loans… into increasingly risky opportunities. Further, advance rates will tend to increase so that more debt can be placed on the same assets. This is, of course, good in the sense that the aggressive lending stimulates the economy. However, when the inevitable recession occurs, the more aggressive lending may well transform itself into layers of risk that the economy can no longer absorb, leading to a deeper recession.
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> *Id.*, at p. 72.

The authors' prediction in 2006 about the likely severity of the recession that would not begin for over a year was based in good part on a belief that in fact bankruptcy policies and practice have a great impact on the financial markets and the economy.

The changes discussed have been beneficial in that prior to 2008 they contributed to unprecedented vibrancy in the financial markets. Loans became more plentiful and the economy benefited greatly. However, as in all other aspects of life, too much of a good thing is not necessarily advantageous, and an overheated economy lends itself to "bubbles" that are painful to resolve.

Monetary and fiscal policies clearly have great impact on the financial markets and the economy. The same is true of developments in bankruptcy practice and policy. Certainly the impact of bankruptcy is longer term, and therefore it is harder to perceive its influence. However, what we do in the bankruptcy field and how we do it plays a very significant role in our financial markets and our economy.

End of Article

A FEW CONCEPTS WORTH HIGHLIGHTING IN TERMS OF REORGANIZATION POLICY:

1. The reorganization policy of a society has a tremendous impact on the long run economy of that society. If the bankruptcy system is generally favorable towards creditors and creates a more certain environment as to the methodology and likely recoveries of defaulted loans, lenders will, over time, become more willing to lend greater amounts against asset values. This is what occurred in the United States prior to the 2007 crash. Concepts such as loan-to-own and claims trading were allowed to flourish and the rise of debt in our society provided significant stimulus to the economy. As predicted in the 2006 article, the unprecedented layers of debt deepened the inevitable recession. We can never hope to "outlaw" the business cycle but there are certain factors which will moderate the swings and certain factors which will lead to greater peaks and valleys over the course of time. An abundance of debt will lead to increased prosperity but will also lead to deeper recessions. Obviously, the bankruptcy system is only one factor in determining the rise and fall of the economy. However, its role is significant.

2. Reorganization policy is also significant in terms of encouraging capital formation. If reorganization policy provides certainty to lenders, it will encourage more and more debt over a long period of time. This is clearly a long term phenomenon since reorganization policy is only one factor affecting the day-to-day willingness of lenders to lend. For example, today lenders are reticent to lend to risky debtors due to the tenuous economy. Further, with interest rates artificially low, there are sometimes better alternative investments available and current low interest rates do not always adequately compensate for the risks inherent in lending. There are many countervailing factors at any time and reorganization policy has far greater impact on long term lending trends rather than day-to-day credit decisions. However, it is possible that a reorganization policy that creates the most certainty for lenders might reduce the willingness of entrepreneurs and families to create businesses. If a lender can anticipate the timing of its return after default and has assurance that it will be able to realize closer to going concern values, it will be more likely to make riskier loans. By the same token, parties contemplating the start-up of a business are more likely to take the significant "plunge" if the reorganization system will provide them with the possibility of a second chance if things go wrong. If the reorganization system does not do so, then the risk of starting or expanding a business becomes greater. If there is a high risk that, after investing a substantial portion of one's net worth and adding years of sweat equity, a down turn in the economy or an operational

aberration will cause you to lose your business, you might be less likely to start the business in the first place. There is no right answer, merely a balancing of the needs of different constituencies to accomplish the best economic result for society. This is a hard balance to achieve for political as well as economic reasons. One of the most important tasks of the Commission, and ultimately Congress, is to find the right balance. In the 2006 Article, which I have attached, I discussed many of the trends which have led to a more creditor oriented reorganization system. Footnote 6 of that article mentions a number of other articles on this subject, including some co-authored by Commissioners Harvey Miller and James Sprayregen. The need for the proper balance is critical. If the balance too heavily favors debtors (creating significant uncertainty for lenders) this will almost certainly make debt financing less available. By the same token, if the balance too heavily favors creditors, entrepreneurs may well be less willing to take an equity risk. Is it merely coincidence that since 1977 this country has experienced a gradual drop in business formation?[1]

3. If the sole purpose of a bankruptcy policy is to maximize creditor return, then a policy which completely favors creditors is optimal. Without consideration of a second chance for debtors and their equity holders, a reorganization will become a search for the highest recovery at the lowest cost. Obviously, there will be disputes among creditor constituencies about how this is best accomplished in a particular case. However, the realization value from a going concern is usually a better option over the acceptance of liquidation value, after adjusting for the cost of maintaining the going concern. Once it is determined that there is no value for old equity (and maybe lower levels of debt), there is great incentive to use the reorganization process for the accomplishment of Section 363 sales (unless of course there is a pre-negotiated plan which alters the securities of the debtor to similar effect). The sale route is infinitely less expensive and quicker than requiring a traditional plan process for cases when the result of the case is merely to exchange equity holders. It is not surprising that the majority of Chapter 11 cases in recent years are simply sales of going businesses.

4. In the 2003 Article, concern was raised that Chapter 11 was not beneficial to the very people that make the decision about whether to file. In my experience, it is quite common for people to approach bankruptcy professionals asking for ways to save their

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[1] Barry C. Lynn and Lina Khan, The Slow-Motion Collapse of American Entrepreneurship, Washington Monthly, July/August 2012. (Citing Census Bureau "employer business" data adjusted for the growth in population: between 1977-1989 Americans created more than 27 new businesses for every 10,000 working-age citizens, in the 1990s this number dropped to fewer than 25, and in the 2000s it fell to 22. Data from the Small Business Administration shows the share of the working-age population that is self-employed has been declining since 1994 (between 1994 and 2009 this share declined nearly 25%). According to the Bureau of Labor Statistics, the total share of the self-employed dropped steadily over the last two decades, in 1994 there were 663 self-employed for every 10,000 working-age Americans; by 2009 this number was down to 606. The analysis of the above data led this article's authors to conclude that there is a substantial decline in entrepreneurship in America over the last thirty years.)

companies. Any honest professional would have to disclose that the company may be saved in terms of continuation of the business and continuation of many jobs, but that the old equity, and most likely management, will be left with little or no recovery or continued employment. The authors raised the issue of whether value was being lost for creditors because of the very same bankruptcy policies that favor creditors. How many companies are filing later than they should because the filing is to the personal financial detriment of the very parties making the decision whether to file? This might be similar to the situation with respect to the 2005 Amendments to the Bankruptcy Code which were requested by landlords, but which have made retail reorganizations far more difficult to accomplish, to the detriment of the landlords. Is it possible that the favoring of creditors in bankruptcy policies have benefited creditors on a case by case basis, but has cost creditors overall? This is certainly a possibility, particularly when recoveries to lower tier creditors are considered.

5. Is it possible that merging Chapters X, XI and XII was not as good an idea as it seemed? Are reorganization policies really the same for large public corporations as they are for middle market companies or single asset real estate entities? With respect to large public debtors, the creditors and equity holders are primarily investors who bought securities with particular attributes related to risk, benefits and priority. It would appear that the policies for altering those expectations are very different than for smaller market entrepreneurs or family businesses. Inclusion of limited exclusivity and the implementation of the absolute priority rule in the bankruptcy regime make the most sense with respect to large public entities whose creditors and equity holders made informed investment decisions and understood their risk and relative priorities. I am not sure that the considerations are the same with respect to smaller businesses. Should entrepreneurs and families who are involved in the day to day operations of their businesses be provided some level of protection not available to holders of securities in public companies? Further, single asset real estate cases have totally different policy underpinnings than large public or middle market cases. Single asset real estate cases are disfavored by some because they are often essentially two party disputes; there is no business operation, at the end of the day the building is still in existence, the same employees are necessary and the tenants are largely unaffected. I am not saying that there should not be single asset real estate reorganizations or that the disfavor in which they are held is justified. I am simply saying that the underlying reorganization policies differ significantly depending on the nature of the debtor. Shoe-horning single asset real estate cases into Chapter 11 may well be bad policy. For example, there are certain creditor protections that were incorporated into Chapter 11 with single asset real estate cases in mind because lenders and Congress felt scandalized by the result in *In re Pine Gate Assocs.*, 1976 W.L. 359641 (N.D. Ga. 1976) and the vagaries of judicial valuations generally. For example, the Section 1111(2)(b) Election is designed to mitigate the impact of judicial valuations which prove to undervalue collateral, primarily in single

asset real estate cases. This is not to say that the 1111(2)(b) Election should not exist in business cases, but rather that its existence should depend on an analysis of the policies surrounding business cases, not single asset real estate cases. The same could be said of Section 1129(a)(10). Section 1129(a)(10)'s requirement that at least one impaired class vote in favor of the plan (if there are any impaired classes) makes far more sense in a single asset real estate case (the concern is that such cases are essentially two party disputes) than it does in business cases. The policy considerations behind the reorganization rules for different types of entities may well be better reflected in separate Chapters rather than attempting to deal with all the differing policy considerations in one Chapter.

6. One of the risks of merging large public company cases and middle market cases is that the case law that makes sense in large public company cases often begins to control the middle market cases. What works as a matter of reorganization policy for large public companies is not necessarily the best policy in middle market cases. With only one chapter, the precedent in large cases often controls. As just one example, the concept of critical vendors may make perfect sense in a large public case. For example, a large retailer probably has substantial leverage over its trade. The granting of critical vendor status to a few vendors may make excellent business sense and is less likely to provide leverage for vendors for whom the debtor is a critical component of its business plan. In the middle market, however, the leverage is often with the vendors because the debtor is not as likely to be as major a purchaser. However, the vendors, seeing critical vendor status be granted in larger cases, are more likely to use their leverage to compel the debtor to recognize them as critical vendors in the middle market case. This can create cash flow problems for the debtor and political problems with the trade. In fact, controlling creditor's expectations is far more important in middle market cases. If creditors do not believe that the debtor can pay them for prepetition amounts, they are unlikely to ask for such payments. If their expectation is to be paid prepetition amounts, they are more likely to become irate and obstinate if that option is not made available. Middle market debtors simply need more protection from the bankruptcy system than do large public debtors.

I hope that my statement will help you consider issues that are important to reorganization policy and to the future economy. Your role will in fact help shape the economic future of our country. The issues raised are not easy issues to resolve and I hope my discussion of these issues and the underlying policies will help you make the right choices. Thank you for providing me with the opportunity to influence the direction of the system to which I have devoted my legal career.

Straight & Narrow ETHICS

Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit

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Since its enactment in 1978 chapter 11 appears to have gradually evolved into a more creditor-oriented procedure. The creditor orientation has certain appeal since it respects existing priorities between the various stakeholders. However, this trend may have exacerbated what some might view as a flaw in the system. The problem is that companies may not be opting to utilize chapter 11 as early as they should in order to help fix operational and/or leverage problems.[3] This disconnect is particularly pronounced with respect to closely held businesses. The incorporation into chapter 11 proceedings of the absolute priority rule and the limited period of debtor exclusivity to file a reorganization plan are designed to be beneficial to creditor constituencies, but are detrimental to the interests of management and stockholders. Since management and stockholders are likely to be the very people who make the decision of whether or not to file a chapter 11 proceeding, these provisions, among others, make chapter 11 less attractive to the decision-makers. Ironically, in the long run this reticence about filing could impact creditor recoveries negatively.

As a result, the use of chapter 11 as a business tool for fixing sick companies has diminished over time. In many cases, because debtors have elected to delay filing, chapter 11 has become a substitute for foreclosure proceedings for the benefit of creditors. Certainly, selling assets in a chapter 11 proceeding allows for sales as going concerns and, therefore, should provide more benefit to creditors than liquidation by foreclosure. Because many companies that could be otherwise restructured significantly delay filing chapter 11, this leads us to conclude that a substantial loss in value to creditors and equity alike is prevalent. Put another way, the opportunity for creditors and equity-holders to realize the going-concern value from a successful reorganization may all too often be squandered in favor of "better-than-liquidation" value realized in §363 sales.


Richard E. Mikels

A professional approached to advise a debtor (including a closely held business) in financial difficulty is often faced with moral and ethical dilemmas because of the current trends in chapter 11 cases favoring creditors. The professional must harmonize his or her duty toward the fictional corporate entity, which may be at odds with the interests of management and equity that are often focused on their own financial plight (notwithstanding their own duties to all constituents). Creditor interests often differ from those of management and stockholders. The developing corporate-law theory of applying an additional fiduciary duty to creditors when the zone of insolvency is reached further complicates the decision-makers' conundrum.

Business Arrangements and Reorganizations Under the Bankruptcy Act

Prior to the passage of the Bankruptcy Code in 1978, there were essentially two choices available for business debtors under the Bankruptcy Act—chapters X and XI.[4] These were designed to reflect a distinction between closely held businesses and large, public companies.[5] That is, closely held businesses were expected to restructure under chapter XI, while large, public companies were expected to look to chapter X. This distinction reflected Congress's awareness that different debtor types required different frameworks for reorganization.

Under chapter XI, certain leverage was afforded to the debtor. For example, while under chapter XI, the debtor, which typically remained in possession of its assets, was the plan only entity permitted to file a reorganization plan and was not limited by an exclusive period for filing a plan. In addition, the absolute priority rule did not apply. Creditor protections included an absence of a cramdown and, at least on the surface, the plan of arrangement could not alter the debtors' secured debt. In practice, however, the imposition of the automatic stay usually generated positive negotiations with secured creditors.

Chapter XI reflected a public policy favoring the ability of closely held businesses to reorganize. Because chapter XI allowed value to flow to stockholders of closely held businesses, it naturally was less threatening to the principals of the closely held business. Further, the closely held business debtor, as the exclusive plan proponent, could propose to maintain its current management. This leverage, coupled with the absence of an absolute priority rule, aided the closely held business in its reorganization efforts and provided an incentive for proposing a plan that shared the going-concern value between the creditors and the stockholders.

While a successful reorganization was not certain, it was clear that the possibility of the business being retained by equity interests was likely. With no limitation on the exclusivity period, the closely held business debtor was given time to solve the operational and/or leverage problems that forced the debtor to reorganize in the first place. In an arrangement under chapter XI, unsecured creditors would realize significantly greater value than they would through a liquidation, and equity-holders were permitted to retain value.

As a matter of policy, many have argued that it is unfair for stockholders to retain any interest until creditors are paid in full. On the other hand, a major purpose of a reorganization-based system (vs. a liquidation-based system) is to produce more overall value for constituents. If a case is filed with sufficient time to incorporate a business solution, then there should be more value to share between

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1 Richard E. Mikels is a shareholder in Mintz Levin's Boston office and chairman and manager of the Bankruptcy, Restructuring and Commercial Law Section. The authors are grateful and appreciative to Adrienne K. Walker, an associate with the Boston office of Mintz Levin, for her assistance in the preparation of this article.

2 Peter S. Kaufman is the head of Restructuring and Distressed M&A for the New York-based investment bank Gordian Group LLC.

3 This concern was addressed more than 30 years ago in the 1973 report of the Commission on Bankruptcy Laws, when it recognized that "[i]nitiating relief should not be a death knell. The process should encourage resort to it, by debtors and creditors, that cuts short the dissipation of assets and the accumulation of debts. Belated commencement of a case may kill an opportunity for reorganization or arrangement." *See Report on the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong. 1st Sess. (1973).

4 The Bankruptcy Act, as amended from time to time, also had separate chapters for Agricultural Compositions (chapter VIII), Railroads (chapter VIII), Municipal Debt Readjustment (chapter IX), Real Property Arrangements by Persons Other Than Corporations (chapter XII), Wage Earner Plans (chapter XIII) and Maritime Commission Liens (chapter XIV).

5 *See* H.R. Rep. No. 95-595, at 242-46 (1977); *see, also,* Posner, Eric A., "The Political Economy of the Bankruptcy Reform Act of 1978," 96 Mich. L. Rev. 47 (1997) (noting that although the drafters intended chapter XI for closely held corporations and chapter X for public corporations, the wording of the statute did not actually reflect this requirement). Because of this lack of clarity as discussed herein, most companies, large and small, preferred to file under chapter XI rather than chapter X.

(enabling legislation for adoption passed and enacted; adoption expected), Australia (adoption recommended) and New Zealand (adoption recommended).

The introduction of the model law in Mexico, South Africa, Japan, Poland and Romania, and its prospective adoption in the United States, Britain and Argentina, will provide an impetus to other countries who are currently studying its adoption. If the model law is widely adopted in domestic insolvency legislation around the world, it will move international insolvency cooperation to an entirely new and higher plane.

Conclusion

The globalization of commerce has dramatically increased the interdependence in cross-border reorganizations of systems and procedures that facilitate the preservation of enterprise values through international cooperation and coordination.

The steadily increasing cooperation between courts in cross-border insolvencies and reorganizations, the expanding adoption of the UNCITRAL Model Law on Cross-border Insolvencies and the experience gained under the EU Regulation on Insolvency Proceedings all prove that international insolvency systems and procedures have advanced more in the last 10 years than in the previous 100 years. Moreover, the pace of change is accelerating and will continue to bring benefits to international trade and commerce and all of those who participate in it. ■

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the various stakeholders than is likely to be available to creditors alone when the reorganization is commenced too late to provide a higher level of benefit to all of the debtor's constituents.

In chapter X cases, creditors' interests were paramount. Under chapter X, a trustee was automatically appointed to exercise control over the administration of the estate and businesses operations; the absolute priority rule was imposed and could not be waived. In addition, the likelihood that management would be replaced and stockholders' interests would be eliminated was all but a foregone conclusion.

It does not take an economic genius to recognize that if chapter X was a likely disaster for the very people deciding whether to file, few chapter X petitions would be filed. Of course, that is precisely what happened. In addition, the creditors found chapter X cumbersome and too costly. Because the Bankruptcy Act did not specifically define the type of debtor required to file under chapter X or XI, the choice of chapter XI over chapter X predominated, even by large, public corporations. Today, the more chapter 11 appears to the corporate decision-makers to resemble old chapter X, the less likely it is that corporations will file in a timely manner.

Obstacles to Reorganization Under the Bankruptcy Code

Under the Bankruptcy Code, no differentiation is made between closely held businesses and large, public companies. Underlying policy considerations, however, may warrant different rules for different types of business debtors. In drafting the current Bankruptcy Code, many provisions of chapters X and XI of the Bankruptcy Act were merged into chapter 11. During Congress's debate over the adoption of the Bankruptcy Code, no significant challenge was raised as to the application of the proposed "one-size-fits-all" chapter 11 system for closely held and publicly held businesses. While the Bankruptcy Code distinguishes debtors in certain circumstances,[6] most business bankruptcies are required to file under chapter 11, which contains uniform provisions that do not allow for differentiation based on debtor type.[7]

The problems with the Bankruptcy Code's lack of differentiation between closely held businesses and public companies stems from the classic corporate structure of these two entities. The construct of a corporation as a separate entity was created as a legal fiction to enable entrepreneurs to invest in a business with little risk to their personal wealth, other than to the extent of their own personal investments in the corporation. Closely held businesses frequently have few stockholders, most of whom are involved in the day-to-day management of the business and many of whom are likely to be guarantors of the company's bank debt. The shares of a closely held business are not exchanged in a public market and are often subject to transfer restrictions.

When such a closely held business is contemplating chapter 11, usually the stockholders/managers initiate a professional consultation (*e.g.*, lawyer and/or investment banker). In this scenario, the stockholders likely are concerned with their personal business problems as well as the problems of the business. The professional here has a fiduciary duty to his or her client (*i.e.*, the closely held business), but unless the business is reorganized and the stockholders' interests survive, the professional has not truly achieved the objectives presented by the individuals who consulted with him or her at the outset of the case.

The management and stockholders contacting the professionals will view the corporate fiction as a mere instrumentality for their entrepreneurial endeavors. That is, of course, why we have corporations in the first place. Corporations allow the entrepreneur to further his or her business interests while providing a fictional vehicle used to protect the entrepreneur's assets. The growth of the American economy was due in no small part to this development. It would be consistent with this protective philosophy to allow entrepreneurs an opportunity to restructure their instrumentalities during difficult times. Such a policy choice was inherent under chapter XI of the Bankruptcy Act, but not under chapter X.

The policies surrounding reorganization of public companies are somewhat different from those presented by the closely held business. In public companies, stockholders are often separate from management. This results in professional managers running the company and a diverse body of stockholders serving as absentee owners. Generally, these stockholders are independent investors who, in purchasing the stock, assumed the risk of the success or failure of a company. However, we would also observe that in order to preserve the flow of equity capital to larger, public entities, stockholders must not have their investments eradicated because of a snapshot at a particular point in time when a business has stumbled and enterprise valuation of a company may ebb at or below the face amount of the debt for what may be a temporary period.

A creditor-oriented case can be made that it is appropriate to distribute value according to the priorities the parties contracted for and what the non-bankruptcy law already dictates. While the result may or may not be fair and appropriate on a case-by-case basis, the question is whether the reorganization system is working. Again, because preservation of value for stockholders in chapter 11 may be viewed as problematic by the decision-makers, many companies do not file until it is too late to preserve the optimum value of the business.

There are pre-packaged cases that work, where much of the reorganization is done prior to filing so as to lessen the uncertainty inherent with chapter 11, but those cases typically provide balance-sheet fixes only. If a company requires the protection of the automatic stay to undergo an operational fix, chapter 11 is less likely to provide the time necessary to accomplish that goal and consequently will be less favorably viewed by the constituency making the decision of whether to file.

Therefore, this problem is prevalent with respect to both public and closely held companies, but it may be more pronounced with respect to closely held businesses. While it is beneficial that value is being realized for creditors, the blood, sweat and tears of the owners are not being accorded the same consideration as under chapter XI of the Bankruptcy Act. These facts seem to diminish the use of chapter 11 for traditional reorganizations, particularly where operational remedies are required.

The difficulties faced by a closely held business in reorganization under chapter 11 often stem from the debtor's limited exclusive period provided under §1121(b) to file a reorganization plan, and the application of the absolute priority rule pursuant to §1129(b)(2)(B)(i) and (ii).

Exclusivity

As discussed above, chapter XI of the Bankruptcy Act did not have a defined exclusive period within which the debtor must file a plan. Under chapter XI, the debtor retained exclusivity throughout the case. This gave the debtor an opportunity to fix the business, not just to mend the balance sheet. Under chapter 11 of the Bankruptcy Code, however, the debtor retains an exclusive period for only 120 days to propose a reorganization plan.[8] For many companies, this 120-day exclusive period is hardly sufficient to correct their balance sheets and is not a sufficient amount of time in which to stabilize the business and fix the problems that forced the company to file for relief in the first place. Often, a business needs an opportunity within chapter 11 to solve business problems that cannot be adequately addressed without the benefit of the automatic stay. The mere hope of a court-allowed extension of exclusivity (which is certainly to be expected in larger, public-company filings)[9] can be perceived as too risky to make chapter 11 an attractive option to management and stockholders—particularly in closely held businesses.

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[6] See subchapter III of chapter 7 (stockbroker liquidations), subchapter IV of chapter 7 (commodity broker liquidations), chapter 9 (municipalities), subchapter IV of chapter 11 (railroad reorganizations) and chapter 13 (individuals with regular income).

[7] The legislative history, however, reveals that the proposal by the Commission on the Bankruptcy Laws of the United States for a single consolidated business reorganization chapter differed significantly from what Congress ultimately enacted as chapter 11. *See* Peebles, Ralph E., "Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule," 63 Am. Bankr. L.J. 65 (1989) (summarizing the above differences, including a relaxed application of the absolute priority rule in the context of reorganizing close corporations).

[8] 11 U.S.C. §1121(b).

"The More Things Change..."

Reflections on 34 Years of Practice

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I recently participated in a program about trends in the bankruptcy field.[1] While thinking about trends in preparation for the program, what struck me most was that bankruptcy attorneys today struggle with the same issues they did 34 years ago, when I started practicing. For example, whether a debtor can use collateral over the objection of a secured creditor or whether the stay should be lifted were, and likely always will be, hotly-contested issues in reorganizations. Even though the issues remain the same, the criteria we apply and resolutions we reach change over time. Sometimes these changes appear to be permanent trends. In other cases, these changes are more like the movements of a pendulum that swings back and forth over long periods of time. As these changes occur, at least in the short-term, it is extremely difficult to distinguish between the two.

Richard E. Mikels

It is my belief that most of the issues discussed in this article are not one-way trends, but rather are like pendulums that will swing back and forth depending on the political, economic and legal factors of the time. In particular, I have observed three philosophical pendulums that have contributed to the changing state of bankruptcy jurisprudence over the past 34 years: (1) the debtor-orientation or creditor-orientation of judges, Congress and society; (2) the inherent tension between sanctity of contract as an important basis of capitalist society versus the overriding social value derived from successful reorganizations; and (3) the debate between judges advancing a strict constructionist judicial philosophy versus judges that apply a more flexible approach in their reading of the Bankruptcy Code.

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On the Edge

I could pick any point in time as a base from which to look forward and discuss these pendulum swings. A good place to start is with an illustration from the mid-70s that sticks out in my mind as an obvious example of how things have changed. At that time, I was a young associate, and my boss called me into his office and told me that I should leave immediately to go to court to cover a hearing. I had little background on the case and no time for preparation, but I dutifully hustled over to the court (some things never change for young associates). When I arrived, I discovered that my hearing was low on the calendar. I took a seat in the back of the courtroom so I could watch what was going on and learn from more-experienced attorneys. The judge that day was Judge Paul Glennon, who was one of the nicest men that I have had the pleasure to know. Judge Glennon would almost never convert a case. He believed that chapter XI offered people an opportunity to save the businesses that they had built through their "blood, sweat and tears." He thought that honest people deserved that opportunity, and he did not want to be the one to take it away. His views were probably at the pro-debtor extreme, even for that day, but that only makes this example more compelling because this was a pro-debtor period of time.

As I sat in the back of the courtroom, I watched a hearing about the chapter XI equivalent of a chapter 11 motion to convert. The debtor was a record distributor. It soon became clear that the judge was not going to convert the case, even though all the parties in the case (except maybe the debtor) wanted the case converted because, quite frankly, it needed to be. Finally, a creditor jumped up from the back of the courtroom and asked if he could be heard. Judge Glennon said, "of course, you come right up here." The creditor said, "but judge, I'm not an attorney." The judge responded, "that's okay, you come right up here and you tell me what it is on your mind." The creditor replied, "your honor, this is a record distributor. If you don't convert this case and liquidate today, the inventory will be worthless in three months."

Judge Glennon paused and looked at the young creditor and said, "well, I'm always walking up to Filene's or to Jordan's, and I buy Lawrence Welk records and I buy Guy Lombardo records, and they never go out of style." The poor creditor was becoming apoplectic because he could see his money flying out the window. He sputtered, "Your Honor, Your Honor, Your Honor...I personally have a million-dollar record inventory and I don't have even one of the artists you just named." Judge Glennon looked down from the bench and calmly stated, "young man, you are obviously out of step."[2]

Now, what does this illustrate in terms of trends and pendulums?

The above story occurred during a pro-debtor period, and Judge Glennon was a debtor-oriented judge who read the Bankruptcy Act in a flexible way to give every debtor a chance to reorganize. If Judge Glennon had not been a debtor-oriented judge, or if he did not believe that

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1 On April 26, 2006, Massachusetts Continuing Legal Education held a conference titled "Business Bankruptcies for Nonspecialists." The particular panel referred to in this article was titled "Corporate Bankruptcies after BAPCPA: What To Do about New Provisions You Don't Like."

2 All of the quotes included in the foregoing story are to the best of the author's recollection.

the bankruptcy laws should be interpreted flexibly, or if he believed that the value of a reorganization should not override contractual expectations, this hearing would have come out quite differently. Obviously, not every judge in a particular time will be debtor-oriented, or creditor-oriented, or a strict constructionist, or take a flexible approach. These are movements of a pendulum, not absolutes. As a result, there will always be some debtor-oriented opinions even during markedly creditor-oriented periods, just as you will find some creative and flexible jurisprudence even in times when a strict constructionist philosophy is favored.[3]

Debtor- or Creditor-Oriented Pendulum

In order to understand whether debtors or creditors tend to be favored at any particular point in time, it is necessary to consider trends in the economy, law and politics, including trends in the outlook of judges and Congress. Some judges are debtor-oriented, while other judges tend to favor creditors. This may be more difficult to interpret than it first appears. This is because there are some judges who are very concerned that a reorganization be successful, but have no particular bias in terms of the outcome on the debtor or the creditors.[4] Most creditor-oriented judges are in fact secured creditor-oriented judges, although a few that I have seen actually interpret the Code in a manner favorable to unsecured creditors. There will always be judges who will view reorganizations as being for the primary purpose of allowing debtors to restructure their businesses, while other judges feel that reorganizations should maximize value for the benefit of creditors. Therefore, the outcome of a particular case is greatly affected by the philosophy of the judge on this key issue. Not only will the results differ on confirmation issues, but, among other things, determinations regarding the debtor's use of collateral and the time afforded the debtor to reorganize can differ depending on the perspective of a particular judge.

In addition to the orientation of judges, there is the question of the outlook of Congress. During the Great Depression, Congress passed provisions of the Bankruptcy Act to provide for reorganization. Among those provisions were chapters X and XI. Chapter X was originally designed for large public companies and usually provided for the immediate appointment of a trustee, the absolute priority rule was a requirement for plan confirmation, and the debtor did not enjoy any right of plan filing exclusivity. By contrast, chapter XI provided for a presumption of management continuation, there was no absolute-priority rule requirement for plan confirmation (at least after the early 1950s), and the debtor was the only party that could ever file a plan. Obviously, chapter X was disadvantageous to debtors and to the people making decisions for debtors on whether to file and under which chapter. As a result, by the end of the reign of the Bankruptcy Act, even most large public companies filed under chapter XI rather than chapter X. Because only the debtor could file a chapter XI plan, and because there was no absolute priority rule, creditors were usually faced with the option of taking liquidation value or dividing the difference between liquidation value and going-concern value with equity. While chapter XI technically only dealt with restructuring unsecured claims, bankruptcy judges were not quick to terminate the automatic stay, making it in the best interest of secured creditors to agree to a restructuring. In sum, chapter XI was wonderful for debtors and their shareholders, who were often able to retain the residual value of the company.

Contrast this with the current approach to exclusivity and the absolute-priority rule. Exclusivity (particularly after BAPCPA) is limited in time, and the absolute-priority rule is a cramdown requirement designed to protect nonconsenting classes of unsecured creditors. The absolute-priority rule can be waived, but if it is not, lower classes of debt and equity must be eliminated unless the senior unsecured classes are paid in full. Accordingly, it has become more likely that business entities (particularly middle-market companies whose directors are more likely to have a financial stake significant to their net worth and less likely to be concerned about securities law issues) will attempt to solve their financial problems outside the context of formal proceedings. The logical result, therefore, is that many companies will delay filing until it is too late to actually reorganize. It is not surprising, given these developments, that a large percentage of chapter 11 cases today are actually asset-disposition vehicles for the benefit of creditors. Clearly, for better or worse, the development of the bankruptcy statutes themselves has significantly contributed to creditor-oriented trends.

Last October, as we approached the effective date for BAPCPA, it was not an uncommon opinion for bankruptcy professionals to predict a deluge of chapter 11 filings so that companies could reorganize free from the new and more restrictive amendments to the Code. That deluge, however, proved to be at most a trickle as only three major companies—Delta, Northwest and Delphi—opted to file prior to Oct. 17, 2005. Why, unlike the consumer side, where a record number of people filed chapter 7 to avoid the new amendments, weren't there more filings of corporate entities at that time?

It is my view that the pre-amendment chapter 11 statute was already sufficiently negative for debtors[5] that companies did not file just to avoid the amendments.[6]

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[3] By way of example, the Supreme Court's decision in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), might be viewed as a debtor-oriented decision in a period that has generally been dominated by creditor orientation.

[4] Reorganization-oriented judges are often thought to be debtor-oriented judges. Debtor's counsel must be aware of the difference, however, to avoid overplaying a perceived advantage. For example, in the case of *Capitol Enterprises Inc.*, Chapter 11 Case No. 90-42166-JFQ (Bankr. D. Mass.), a judge universally viewed as debtor-oriented surprised all sides by terminating exclusivity at the request of the creditors' committee. The order, however, restricted the creditors' committee from filing a plan calling for the liquidation of the debtor. In fact, the judge was not debtor-oriented but reorganization-oriented. For purposes of this article, reorganization-orientation is similar to debtor-orientation in the sense that creditors will remain restricted from realizing on their collateral. However, in terms of assessing relative leverage, a reorganization-oriented judge is less favorable to the debtor than a debtor-oriented judge would be. A debtor-oriented judge will try to give the debtor an opportunity to restructure. A reorganization-oriented judge, by contrast, would argue that the purpose of chapter 11 is to realize the benefits of a restructuring, but would be less interested in how particular stakeholders fare in the process.

[5] Among the people making decisions on behalf of debtors are shareholders and managers. While the trends in chapter 11 have not been favorable for shareholders, chapter 11 entails its own set of risks for management including potential loss of jobs and loss of equity value from stock option plans and the like. However, lenders seeking to induce management to support a sale of the company's assets in chapter 11 often agree to key employee retention programs (KERPs), which allow significant value to flow to management. Under BAPCPA, the use of KERPs was significantly restricted, but early cases decided under BAPCPA have allowed incentive bonus systems to provide similar incentives. *See, e.g., In re Nobex Corp.*, Chapter 11 Case No. 05-20050 (Bankr. D. Del.)

[6] For articles discussing the effectiveness of chapter 11 as it currently exists, see the following: Miller, Harvey R., and Waisman, Shai Y., "Is Chapter 11 Bankrupt?," 47 B. C. L. Rev. 129 (2005); Sprayregen, James H.M., Friedland, Jonathan, and Higgins, Roger J., "Chapter 11: Not Perfect, But Better than the Alternative," J. Bankr. L. & Prac., Vol. 14, No. 6 (2005); Miller, Harvey R., and Waisman, Shai Y., "Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses in the Twenty-First Century?," 78 Am. Bankr. L. J. 153 (2004); Baird, Douglas G., "The New Face of Chapter 11," 12 Am. Bankr. Inst. L. Rev. 69 (2004); Mikels, Richard E., and Kaufman, Peter S., "Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 for Mutual Benefit," 22-Dec/Jan. Am. Bankr. Inst. J. 26 (2004); and Baird, Douglas G., and Rasmussen, Robert K., "Chapter 11 at Twilight," 56 Stan. L. Rev. 673 (2003).

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During periods when chapter 11 is not favorable to debtors, it should be expected that debtors will attempt out-of-court solutions rather than chapter 11 filings. Under such circumstances, the filings that do occur will tend to be after such out-of-court attempts have failed, and regrettably after it is too late for an economic restructuring to be successful.[7]

Indeed, over the past few years, the bankruptcy bar has observed the debtor/creditor pendulum shift to create a system more favorable to creditors. By way of example, some of these creditor-oriented trends[8] include:[9]

• *New lenders, new types of lending.* Over the last few periods, new types of lenders and new tranches of lending have increased the likelihood that debtors facing financial difficulty will be more susceptible to being over-leveraged. An over-leveraged company is less likely to be able to yield significant continuing value to equity in a reorganization. The new breed of lenders and lending comes in many varieties, including mezzanine financing, second-lien financing, hedge fund investments, securitization and junk bonds. The proliferation of this new lending and similar aggressive investing has tended to make it significantly more difficult to restructure successfully under chapter 11 while preserving value for equity. In the event of a sale, the proceeds will be distributed in order of priority unless a "tip" can otherwise be negotiated for out-of-the-money creditors or equity. Even if there is not a sale, the reorganization of an over-levered company is more likely than in the past to provide for the exchange of the lower tranches of debt for equity, leaving little or no value for pre-existing equity.[10] Of course, there are examples of cases that are successful from the perspective of equity; however, as a trend, changes in the capital markets have made it increasingly difficult for equity to retain value in a reorganized debtor.

• *Expanding notions of fiduciary duty.* In the past, board members and officers of companies owed a fiduciary duty solely to stockholders. Today, when a company approaches insolvency, that duty begins to run to creditors, or to creditors and stockholders together. This shift changes the dynamics of out-of-court workouts and reorganizations. In fact, this trend may be one of the few pro-creditor trends that makes a chapter 11 filing more likely because directors and officers are less likely to be second-guessed for decisions made in the context of a chapter 11, particularly if such decisions are approved by a bankruptcy court.

• *The lessening impact of lender liability.* It was not so long ago that the very mention of the word "control" would cause bank officers to break out in a rash. Today, that fear has been minimized in comparison to the past.[11] Not only are lenders less afraid of being accused of being in control; in fact, effective control is often their goal. For example, lenders have become much more aggressive in their negotiation of debtor-in-possession (DIP) financing orders, sometimes seeking to include a requirement of a sale of the company at particular points, a grant of relief from the automatic stay upon default, and the inclusion of tight budgets and negative covenants, which together can impact operations. Sometimes even the content of any plan the debtor may file is impacted by the DIP financing order. Further, lenders are requiring that debtors hire professionals who can help the lender assess the overall situation and, in some cases, liquidate the debtor in the manner most beneficial for the lender.

• *The rise of new professionals.* Thirty-four years ago, bankruptcy attorneys handled most issues that are today carried out by workout consultants or investment bankers. With most information flowing from opposing counsel, or from the debtor's management, a lender had to be concerned about the quality of the information it was receiving and what it might find if it took possession and commenced foreclosure. Workout consultants (now "financial advisors") became major players in the field in the 1980s. These professionals benefited the debtor by helping solve operational and balance-sheet problems. Ultimately, lenders required that debtors hire such professionals, generally from a short list of "suggestions" provided by the lender. With a workout consultant in place, the lender had increased confidence that the debtor's management was receiving sound outside business advice. Significantly, the lender was better able to rely on the information it was receiving and gained assurance that it would have a better idea on how to proceed if a liquidation was necessary. The flow of more reliable information provided the lender with increased leverage because it was able to make more informed decisions and to execute on those decisions without as much uncertainty.

Over the past few years, the role of the workout consultant has expanded in one sense and contracted in another. It has expanded into the role of chief restructuring officer (CRO). Now instead of being merely an outside professional, the CRO is part of the debtor's inside operation and is a manager of certain aspects of the company's operations. The employment of CROs is often required by lenders, and the lenders are usually allowed (by specific agreement with the debtor) to confer directly with the CRO. From the lender's perspective, a CRO will be in a position to provide reliable information from the debtor itself. Further, the lender will have the ability to participate in strategy discussions with a manager of the company who will be making decisions about whether to reorganize or liquidate. Obviously, it is more beneficial for creditors than for the debtor to have in place managers with less allegiance to shareholders and other management.

Simultaneously, the role of the workout consultant has been diminished by the increased role of investment bankers in insolvency cases. The expansion of the role of the investment

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7 For further discussion of this, *see* Mikels and Kaufman, *supra* note 6.

8 These trends tend to impact the relative positions of debtors and creditors, both during out-of-court workouts and chapter 11 proceedings. As changes occur in debtor/creditor trends, there is a resulting change in the bargaining leverage between debtors and creditors. These changes impact the benefits and uses of out-of-court restructurings and chapter 11 proceedings.

9 A more detailed discussion of creditor-oriented trends appears in an article by Harvey Miller and Shai Waisman. *See* Miller & Waisman, 47 B. C. L. Rev. 129, *supra* note 6. This is an excellent article and should be required reading for anyone practicing bankruptcy law.

10 The position in the economy that banks occupied 30 years ago is now populated with nonbank, nonregulated entities. At that time, banks generally did not want to take possession of operating assets and run companies. This provided the debtor with enormous leverage in the form of the threat of "handing over the keys" and thereby limiting the bank's recovery to liquidation value. Lenders in the market today tend to be more willing to preserve the going-concern value of companies by assuming ownership and/or operations of the debtor. Indeed, some of these lenders are known for their "loan-to-own" philosophy. As a result, "handing over the keys" is far less likely to be as threatening to the lender today, particularly if a chief restructuring officer is in place.

11 It is possible that this particular pendulum may have already begun to inch back. The case *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs. Inc.)*, 299 B.R. 732 (Bankr. D. Del. 2003), dealt with assertions by a creditors' committee that lenders can be held liable on account of a debtor's "deepening insolvency." The facts of this case, however, bear a striking resemblance to old-fashioned lender liability cases where lender control was alleged.

banker was predictable considering that more and more chapter 11 cases result in sales. However, investment bankers are now also heavily involved in other functions traditionally performed by lawyers or business consultants, including obtaining alternative sources of financing and even restructuring the balance sheet. Sometimes investment bankers are hired by the debtor on its own, but quite often, investment bankers are required by lenders. The investment banker can provide the debtor and the lender with a professional analysis of the benefits of a likely sale, which can be compared with any proposal for reorganization.

• *Claims trading.* Claims trading has had a significant impact on chapter 11 cases. At one time, the likely members of a creditors' committee were suppliers or other entities that had an inherent interest in the debtor's survival. Today, these claims are frequently sold to claims traders whose primary interest is either to earn a rapid return on their investment or even to take over the ownership and control of the debtor and its operations. Both goals are a disadvantage to the debtor and an incentive for the debtor to try to reorganize without a chapter 11 filing.

The notion that the debtor/creditor orientation of judges and Congress, and that the legal, economic and political trends that might favor debtors or creditors, play an important role in determining the outcome of reorganizations is not surprising. It is only common sense that the history of bankruptcy laws would reflect our country's economic prosperity, or lack thereof. In times of economic downturn, Congress is more likely to respond to the plight of so many of its constituents and become more forgiving of debtors. In contrast, during lengthy periods of relative prosperity, trends would naturally tend to stress the sanctity of contract, providing more certainty in commercial dealings but also making it more difficult for companies to reorganize.

Sanctity of Contract or Value of Reorganization Pendulum

For a capitalist system to work efficiently, it is critically important for people to be able to engage in contractual relations with others. Contracting parties must be able to assume that their agreements will be carried out and that courts will generally enforce these contracts. The concept of reorganization, however, constitutes a major exception to such expectations. By its nature, reorganizations will restructure or even obliterate contractual expectations. The tension between sanctity of contract and the value of reorganization can be illustrated by the following hypothetical: a lender is owed $50 million, and the debtor is in default. The liquidation value of the debtor is slightly more than $50 million, but the debtor's going-concern value is $100 million. Under this set of facts, it may well be in the lender's interest to foreclose as soon as possible in order to get paid in full before risking any deterioration of its collateral. Absent reorganization statutes that would restrict the lender's ability to enforce its loan documents according to their terms, the lender would likely foreclose on its collateral and liquidate the debtor. Of course, this would eliminate the other $50 million in going-concern value that could potentially go to subordinate creditors and perhaps equity, and would probably eliminate jobs and other social benefits that flow from a reorganized company.

Congress' position in this debate has changed over time. As discussed above, in enacting the Code in the late 1970s, Congress moved away from the flexibility afforded debtors under chapter XI of the Bankruptcy Act by requiring compliance with the absolute-priority rule unless creditors voluntarily waive their rights. Other additions to the 1978 Code favored sanctity of contract as well, including the introduction of the §1111(b)(2) election[17] and more concrete rules governing a debtor's use of collateral. Moreover, Congress' latest statement has clearly been in favor of recognizing the sanctity of contracts as BAPCPA, among other things, reduced time for debtor protections (*e.g.*, time for plan exclusivity, time for determining whether to assume or reject leases), increased available causes for dismissing or converting cases, expanded the rules making reorganization more difficult for single-asset real estate debtors, and provided new advantages for certain creditors, including utilities, wage claims of retired employees, unions, equipment lessors and lessors of real estate. With the granting of each new priority or other benefit to a particular constituency, Congress makes a determination that the value of protecting the rights of such a constituency in accordance with, or closer to, its contractual expectations is more important than the value of reorganization.

[17] The §1111(b)(2) election was designed to protect secured creditors from having their secured claim diminished by a bankruptcy judge's opinion of value rather than an actual testing of the market.

Courts have generally (not without exception) also embraced this trend in favor of sanctity of contract as well. *See, e.g., Bank of America NT & SA v. 203 North LaSalle P'ship*, 526 U.S. 434 (1999) (requiring a market test of value before new value exception can be utilized by equity); *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) (allowing a secured claim for cramdown purposes to be valued depending on its use by the debtor, rather than limiting the secured claim to a lower liquidation value).

Strict-Constructionist or Flexible-Approach Pendulum

For years, bankruptcy courts recognized the benefit of flexibility in the administration of reorganizations. Many times, the requirements for a successful reorganization will not fit neatly into the black-and-white rules set forth in a statute. The willingness of courts to fashion remedies appropriate to the goals favoring successful reorganizations has led to numerous bankruptcy innovations that were not specifically drafted into the statute. While some of these innovations have been criticized on the merits, all were developed by judges with a view toward the goals and purposes of bankruptcy and reorganization administration. Examples of these judge-made innovations include the new-value exception to the absolute-priority rule, the creation of the "channeling injunction" that became the model for §524(g), payments to pre-petition critical vendors that were deemed by the court to be necessary for the debtor's reorganization, third-party releases, the substantive consolidation of debtors' estates, equitable subordination of claims, and the extension of the benefits of the stay to nondebtors in cases where the debtor's reorganization efforts would otherwise be impaired.

Currently, the Supreme Court's strict constructionist approach has become central to bankruptcy jurisprudence. Consider, for example, *Hartford Underwriters Insurance Co. v. Union Planters Bank N.A.*, in which Justice Scalia admonishes courts to start any statutory interpretation with the idea that Congress "says in a statute what it means and means what it says...." *See* 530 U.S. 1 (2000), *quoting Connecticut Nat. Bank v. Germain*, 503 U.S. 249 (1992). Contrast the approach advocated by Justice Scalia to that of Justice Douglas, who wrote the following:

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"[W]e do not read these statutory words with the ease of a computer... There is an overriding consideration that equitable principles govern the exercise of bankruptcy jurisdiction." *Bank of Marin v. England*, 385 U.S. 99 (1966) (internal citations omitted). Today, the strict constructionist approach is dominant, but it was not so long ago that the flexible approach was the accepted view.

The trend toward the strict-constructionist approach can be illustrated by the case *In re Catapult Entertainment Inc.*, 165 F.3d 747 (9th Cir. 1999), decided by the Ninth Circuit and followed by other circuits including the Third, Fourth, Fifth and Eleventh Circuits. Based on nonbankruptcy federal law dealing with patent licenses, the licensee of a nonexclusive patent license cannot transfer its rights to the license without the consent of the licensor. The reasoning of *Catapult* recognizes a debtor's inability to transfer such licenses, but further reads §365(c)(1) of the Code to restrict the ability of debtors to even assume patent licenses without the consent of the licensor. These decisions, taking a strict constructionist approach, could lead to debtors being unable to even retain patent licenses that may be very valuable and critical to the debtor's reorganization. Since this is a trend and not an absolute, there are courts that adopt an approach more consistent with the goals of reorganization. For example the First Circuit in *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), agreed that a nonexclusive patent license could not be assigned under federal nonbankruptcy law, but interpreted §365(c) to allow the debtor to assume and retain the patent license. While this is the minority approach, it is likely that 20 years ago it would have been the majority approach, reflecting a more flexible reading of the Code in order to realize the goals and values of reorganization.

The flexibility judges once enjoyed under §105 of the Code is being limited as well. *See, e.g., Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988) ("whatever equitable powers remain in bankruptcy courts must and can only be exercised within the confines of Bankruptcy Code"). For years, bankruptcy judges seemed to use this section as a way of reaching what they perceived to be the right and equitable solution. *See, e.g., In re Just For Feet Inc.*, 242 B.R. 821 (D. Del. 1999) (relying on §105(a) to permit certain pre-petition vendors to be paid under "necessity of payment" doctrine). Yet courts are now less likely to find creative solutions by the application of §105 because of the trend toward strict judicial interpretation.[13] For example, the First Circuit in *In re Jamo*, 283 F.3d 392 (1st Cir. 2002), declared that §105 may be invoked only if the equitable remedy dispensed by the court is necessary to preserve an identifiable right inferred elsewhere in the Code. As courts take a less-flexible approach to a court's equitable powers and to §105, there will logically be a corresponding negative impact on many debtors' ability to reorganize successfully.

Conclusion

The purpose of this article is to point out observed trends over the past few decades. No value judgment has been made in this article regarding whether such changes are beneficial or detrimental. In reality, all of these changes have been good for someone and bad for someone else. For example, as chapter 11 administration becomes less flexible and therefore more predictable, that tends to be a good thing for lenders and a bad thing for debtors. Lenders are able to make better underwriting decisions if there is more certainty as to the disposition of the loan in the event the debtor faces financial difficulty. As has happened in the real world, in such circumstances, lenders (as well as equity investors), comforted by additional certainty, are more willing to make loans (or investments) into increasingly risky opportunities. Further, advance rates will tend to increase so that more debt can be placed on the same assets. This is, of course, good in the sense that the aggressive lending stimulates the economy. However, when the inevitable recession occurs, the more aggressive lending may well transform itself into layers of risk that the economy can no longer absorb, leading to a deeper recession. This is, of course, what happened in the real estate boom of the mid-1980s, leading to a real estate recession of almost catastrophic proportions in the late 1980s and early 1990s.

As discussed, there have been significant changes in the capital markets. If the administration of reorganization does not keep up with the changes in the capital markets, then chapter 11 administration will become irrelevant or even detrimental to the economy. Therefore, it could be credibly argued that the significant changes to the capital markets have been a major impetus to the changes that have occurred in the administration of reorganization. However, there is cause and effect running in both directions. It is certainly true that changes in the capital markets have had a significant impact on chapter 11 case administration. But it is also true that if only the debtor could file a plan, there were no absolute-priority rule, and creditors could not control the chapter 11 process as much as they currently do, there likely would be much less claims trading, and second-lien lending would be much more risky and probably less prevalent.

In the early 1980s, a young but prominent debtor's attorney[14] explained to me that debtors enjoyed two forms of leverage: the exclusive right to file plans and the ability to threaten the shutdown of a business, which would substantially diminish asset values for creditors. It is certainly true that the effectiveness of each of these sources of debtor leverage has eroded over time. This is, of course, good news for creditor constituencies that seek certainty in their dealings with troubled companies. However, it makes it substantially harder for debtors to reorganize in a manner that creates value and opportunity for management, equity and even lower levels of debt. To some, this may simply reflect a just outcome for reorganizations. Why, after all, they would ask, should out-of-the-money classes receive anything until senior classes are paid in full? However, there will always be those that believe that the reorganization process is designed to allow people a last chance at saving their business. It is this controversy between the two sides, neither of which is inherently right or wrong, that will keep the pendulums swinging back and forth with the political, economic and legal changes of the future. ■

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[13] As pointed out elsewhere in this article, we are dealing with trends, not absolutes. Even though a trend is currently favoring one point of view, there will be decisions that fall on the other side. For example, while there is a clear trend restricting the bankruptcy court's powers under §105, the Sixth Circuit recently relied on §105 to conclude that a bankruptcy court may enjoin a nonconsenting creditor's claims against a nondebtor. *See In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002). It is interesting to compare the Sixth Circuit's reasoning to the Third Circuit's analysis of §105 powers in *In re Combustion Engineering Inc.*, 391 F.3d 190 (3rd Cir. 2005).

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