Statement Submitted to the American Bankruptcy Institute Commission to Study the Reform of Chapter 11

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My name is Buzz Rochelle. I am a partner in Rochelle McCullough, a 10-lawyer firm which represents chapter 11 debtors and committees, as well as post-confirmation trustees. I have practiced law in Dallas, Texas, since 1977. I have written and spoken all too often on the subject of bankruptcy reorganization, including publications in the *Collier on Bankruptcy* series.

The first five years of my practice were spent in cases filed before the Bankruptcy Code of 1978 became effective. That early experience still colors my view of the world; it reminds me not only that there were different ways of doing things before the Code was passed, but what high hopes were held for bankruptcy reform in the mid-1970s. While the Code was a splendid piece of work in its time, its prescriptions for dealing with a situation often fail to squarely address the problems at hand. It is as though we drive with maps 35 years old and then wonder why they don't get us where we want to go.

The recent survey of Texas chapter 11 lawyers, which Michelle Mendez prepared (the "Mendez Survey"), sought to assess attitudes on what was wrong and what was right with our current statutory framework. Based on the survey, I believe that I speak for most of my brother and sister lawyers in favoring a thorough overhaul: major maintenance is long overdue. Further delay will cause even more companies to take a route other than chapter 11 to get from Insolvency to Restructuring.

What are the Problems?

The Mendez Survey of Texas chapter 11 lawyers and my own experience suggest that chapter 11 cases are less successful than they were even a decade ago. Declining success has its roots in several basic changes which happened over decades:

1. Bankruptcy jurisdiction currently stands on shaky ground, and far too many assets, in an asset-scarce environment, must go to defending it. Creditors and debtors alike deserve the certainty of jurisdiction not open to dispute.

2. Although chapter 11 was designed to create a balance of power between the parties, today the secured lender holds all true power in the case. That dominance is harmful to everybody, even lenders.

3. Retaining state of incorporation as a ground for venue has sent many large chapter 11 cases to courts far from their principal places of business, their employees, and the communities which depend upon them. Even venue has been outsourced, with harmful consequences.

Problem One
Jurisdiction is in Tatters: an Article III Bankruptcy Court is Necessary

Throughout its history, the Bankruptcy Court has been plagued by its limited jurisdiction. The 1978 Code was supposed to remedy that, making the Bankruptcy Court a one-stop destination for all debtor matters. And for exactly three years it did that. But Supreme Court scrutiny of bankruptcy jurisdiction in *Northern Pipeline, Granfinanciera,* and now *Stern* has showed just how flawed a scheme Congress created. Each decade has brought a further limitation and further un-workability.

Item: I recently heard a creditor tell a bankruptcy judge that because of *Stern*, the court's confirmation order did not bind him, even though he was scheduled and had actual notice of the case. While the bankruptcy judge rebuffed that suggestion, the vignette suggests that further challenges to bankruptcy jurisdiction will come, and no Supreme Court to date has been inclined to uphold the bankruptcy court's powers. Court rulings must be certain, and if we are now at the point where creditors feel comfortable thumbing their noses at bankruptcy courts, those courts are beginning to lose their usefulness to society.

The Mendez Survey reflects a consistent opinion: it is time to end the jurisdictional fights by making the bankruptcy court an Article III Court. There may be less opposition to the idea than there was forty years ago: it is one of Fate's ironies that much of the really interesting and significant federal litigation these days happens in the bankruptcy court, while many district judges spend their days hearing mind-numbing plea bargains. Without question, the bankruptcy court today attracts a far higher caliber individual than it did when Warren Burger led the charge against making bankruptcy an Article III court. [1]

If the Congress balk at appointing bankruptcy judges under Article III, then Bankruptcy Judges need to become magistrates, and every matter which could be conceivably be challenged needs to be heard by a District Judge. Wouldn't the District Court like to be a place where sophisticated commercial issues are decided once more? Further, if District Judges held the reins in important cases, there would likely be less of a big-case flight to New York and Delaware. The first time that happened to an Article III district judge, the telephone lines to the Senators who appointed him would be burning; venue would no longer be just the protected baby of New York and Delaware.

[1] There was a time when federal district judges were prouder of themselves than they are today. To see just how rigid a caste they were forty years ago, see Countryman, "Scrambling to Define Bankruptcy Jurisdiction: the Chief Justice, the Judicial Conference, and the Legislative Process," 22 *Harvard Journal on Legislation* 1 (1985).

Problem Two
The Growing Power of the Secured Lender has Created Unintended and Unhealthy Consequences for Chapter 11

The Code's drafters intended to create a balance of power and a fruitful tension between debtor, secured creditors, and unsecured creditors, so that no single group could dominate a chapter 11 case. That is how it worked for a roughly a decade. Today that is no longer true, as many responses to the Mendez Survey note. How did that happen? My answers would only be speculation, but we have a different typical beginning to a chapter 11 case today than we had in 1980.[2]

Today one does not hear of over-secured lenders' collateral cushions providing them adequate protection; thirty years ago, it was a debtor lawyer's first line of defense, and it often succeeded. The debtor continued to use cash collateral at the start of the case, and could focus on fixing its problems rather than handing over *de facto* control of the case to the lender.[3] Today the newly-filed debtor is already under water; the secured lender is under-secured; and use of cash collateral generally comes with concessions that tighten security documentation and tie the debtor to a short-term budget which allows for little but locating an asset purchaser.

Secured creditor control of all the assets has a domino effect, starting with low expectations from trade creditors. They have learned that the bankruptcy process is not their friend. Tied to already-small unsecured recoveries is the relatively new phenomenon of overly-aggressive liquidation trustees. Many creditors feel that they are on the receiving end of preference suits when they shouldn't be, facing the unpalatable choice of spending fees to defend the suit or paying what feels like extortion to the trustee. Not every liquidation trustee acts this way, but the current tiny-recovery environment encourages the practice, which further harms public perception of the bankruptcy process.

In this asset-poor environment, there also appears to be an increase in suits by litigation trusts against former officers and directors. It is true that in any distress situation, a debtor's management may do questionable or stupid things, and many times those individuals deserve to be honorees at a lawsuit. Even so, the frequency with which former management becomes a

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[2] My own theories suggest that these things changed in the lending world, and these changes rippled through chapter 11, increasing secured lenders' control:

- UCC amendments made it far easier to encumber all of a debtor's personalty;
- Computing advances allowed better monitoring of collateral;
- Largely because banks, private equity and hedge funds challenged each other for market share in an increasingly competitive environment Lenders became more risk-friendly, and advanced more against the same collateral than they would previously.

Because today's advance rates are higher than a generation ago, there is less room for error when things go awry. Today's debtor has far less maneuvering room than his father did, and the lender's liens are far more likely to cover virtually everything of value.

[3] This level of control does not seem to me to be in serious debate, although secured lender representatives would rather not discuss it publicly. Perhaps the clearest explication appears in Westbrook and Warren, "Secured Party in Possession," *ABI Journal*, September, 2003.

litigation target in fraud and breach of fiduciary duty actions has increased markedly in the last twenty years. A debtor's lawyer is now hard-pressed to assure management that they can come out the other side unscathed, if they just stay the course. The net effect of this change further drives companies away from trying to reorganize in chapter 11.

Rather than effecting a turnaround in chapter 11 today, the standard place for that to occur is under a forbearance agreement. Compared with chapter 11, forbearance is cheaper and faster, and the lender has better control of the situation.[4] If it works, then everyone goes home happy. If it doesn't work, the bank's relative position is improved, the debtor has given up most of its leverage, and the unsecured creditors are out in the cold when chapter 11 is filed.

The rise of secured creditor dominance is nothing that appeared overnight: it has been building for thirty-five years. In time, while all creditors are equal, lenders have become more equal than others. The completeness of lender control, and the disparity of benefit today in chapter 11, raises a basic question: why should the federal government sponsor liquidations benefiting only lenders? There needs to be a re-striking of the balance. Unless other parties have a stake and a share in the outcome, the chapter 11 process itself will be held in disrepute. Chapter 11 should be amended to be more conducive to reorganizing companies and preserving jobs.[5]

I suggest that changes need to occur in chapter 11 which cause greater distribution to unsecureds. That is a hard problem, given the seeming inviolability of the secured lender's Constitutional property rights.[6] Serene in the knowledge that everyone will find something to hate in this list, I diffidently offer a few possibilities, hoping that they will spur further productive thought by others:

- Amend and merge Sections 503 (b) (1) and (9). Provide that costs of administration shall include not only post-filing costs and immediately pre-filing claims, but also a fixed and substantial percentage (say, 25%?) of pre-petition unsecured debt. Require that this amount must be escrowed upon the case's filing, or within some short time afterward. Make it clear in the statute that the secured lender may elect to "gift" this amount to the estate. If debtor and lender cannot do this, require that the case either be converted to

[4] Forbearance agreements also are the bank's first shot at leverage on getting the holes in their security documents filled; if the debtor wants his breathing space, he will be required to reaffirm the validity of all grants of security and affirmatively state that the bank has been an absolute sweetheart throughout the lending relation, leaving the debtor amazed that anyone could imagine that there might be causes of action against them. That waiver can later cause problems for an unsecured committee if a chapter 11 follows.

[5] Just after the passage of the 78 Code, Professor Countryman sent a Christmas card to friends which showed him dressed in a gray sweatshirt and looking very severe indeed. The sweatshirt had this message in red iron-on letters on its front: *Want Real Reform?* Opening the card, there was another picture of Countryman, his back to the camera, right arm raised, with index finger pointing to the sky. On the back of his sweatshirt was the iron-on answer to his question: *Abolish All Liens!* No one took Vern's Jacobin Christmas card seriously. Thirty-five years later, it's food for thought.

[6] Rough treatment of secured creditors by some bankruptcy referees in the Sixties and Seventies is what led to the codification of Adequate Protection in 1978. Because the pendulum has swung so far, turnabout is now fair play: there needs to be devised some form of Adequate Protection for unsecured creditors as well.

chapter 7 or dismissed. Since no one is being forced to do anything, there would not be a Constitutional taking problem. Such a provision might kill chapter 11 outright, or it might cause all parties to take sufficient thought long before disaster struck to act more responsibly.

- Put substantial curbs on, and take much of the economic reward out of, claims trading. As it has developed over the years, there is simply no social purpose served by the federal government's enabling speculation in this area. Doing so would cause lenders to be more circumspect at the start of a lending relation, since one of their back-door exists would be significantly constrained. For instance:
    - Make a purchased claim allowable only in the amount paid by the claims buyer.
    - Leave the claims buyer with an allowable claim in the face amount of the debt it purchased, but allow the claim for voting purposes only in the amount which it paid. Secured lenders which actually stayed the course would have greater control of the plan, and the less a claims trader paid, the less sway he would have in the case's outcome.

- Stop taking away a debtor's tax attributes because of debt forgiveness under a plan. Provide, instead, that they survive reorganization, and that any purchaser under a plan must allocate a substantial percentage of the attribute's value in its purchase price.[7] Provide, further, that this percentage shall be distributed to unsecured creditors under a plan.

- Provide that a sale free and clear under Section 363 shall only occur if a defined percentage of the sale proceeds is allocated to payment to unsecured creditors. If the lienholder is unwilling to do so, the property shall be abandoned and the lender can enjoy his state foreclosure rights.

- Consider altering the current statutory version of the Absolute Priority Rule in Section 1129 (b) and replacing it with some version of Relative Priority. A century's experience with Absolute Priority teaches us that the secured lender has uniformly used the rule to its advantage, and at the expense of everybody else in the case.[8] The bankruptcy court has equitable roots: why not codify equitable principles here and ensure fairer treatment?

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[7] Before the Internal Revenue Service pushed the changes which now govern treatment of tax attributes thirty years ago, loss carrybacks and carryforwards were far more valuable to prospective purchasers. In return for a few more tax dollars from a company needing help, the Service significantly hampered reorganization.

[8] The central irony of the ruling in *Northern Pacific R. R. v. Boyd*, 228 U.S. 482 (1913) is all but lost on us a century later. At the time of Holmes' ruling, the standard corporate structure had the mortgage debt held by the public and the stock held by insiders. Accordingly, when a railroad became financially distressed, the financiers did what they knew best: they fleeced the public by leaving the stock ownership unaffected while giving a large haircut to the public mortgage and debtholders. Holmes' opinion was meant to strike at this practice and prevent the scamming of the public. Instead, what happened over time was that the financier class simply began to issue itself the instruments that strict priority placed at the top of the list, while putting the public holders in securities junior to them. One can only conclude that a strict priority system will always be thus manipulated, and that ensuring fairness to Everybody Else is more likely to occur in a flexible system of Relative Priority.

Problem Three
Should Venue be Proper in the State of Incorporation?

The headlines are consistent:

- American Airlines, largest Dallas-Fort Worth employer, files in New York
- Enron Corporation, major Houston employer, files in New York.
- Energy Future Holdings, utility serving half of Texas, will file somewhere else

This story is not confined to Texas and has been repeated dozens of times in the last twenty years: a huge company, often a city's largest employer, files its chapter 11 petition somewhere else, typically New York or Delaware.[9] There seem to be three reasons underlying this practice: forecastability, experience, and choice.

Seeking a Familiar, Forecastable Court: Around 1990, some counsel and debtors began to think that New York and Delaware courts were more debtor-friendly, and perhaps more fee-friendly, than the Flyover Jurisdictions. Banks liked it, too – they could easily become familiar with the handful of New York and Delaware judges, and the courts were close enough that the banks' go-to law firms were a cab ride or train trip away. Commerce thrives on certainty. Having all large cases handled by a small number of well-known counsel and judges should provide an advantage to the process.

Seeking an Experienced Court: The expertise gained by a small number of judges hearing most of the large cases should be an advantage to the overall process. Certainly that ought to be so, from a mega-case procedural standpoint, and even from a learning-curve standpoint: why should estates suffer while judges learn on the job? Nobody wants her big case to be the court's first rodeo.

Providing a Choice: A practicing lawyer likes to give her client choices, and the current venue statute does so: place of incorporation or principal place of business? How could that possibly be bad? It may be that the debtor would rather not endure home-town scrutiny and obloquy. And the debtor does not always make the choice in a vacuum. The lender often makes its opinion known, however subtly, that it prefers venue near its home base.

Were these points all there were to say, the matter might end. But other considerations and surprises emerge. Two stand out for me.

Unsettling Empiricism: The disturbing studies done by LoPucki and others[10] indicated that the bad outcome and recidivism rates for NY/Del chapter 11s were far higher than for large

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[9] I would not be understood to suggest that every large chapter 11 case leaves Texas, or another part of the hinterlands, for New York or Delaware, but my perception is that the majority do so.

[10] See, *e.g.,* LoPucki and Kalin, "The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a 'Race to the Bottom'", 54 *Vanderbilt L. Rev*. 231(2001); LoPucki and Doherty, "Why Are Delaware and New York Bankruptcy Reorganizations Failing?", Vanderbilt Law Review 1935-85 (2002); LoPucki,

cases in the country generally. Ironically, the New York and Delaware courts' experience seemed not to protect the debtors from a second filing and the further losses thereby entailed. Instead, it appeared that experience resulted in a lowering of standards and a readiness to confirm flawed plans clearly bound to fail.[11] The studies appeared to explode the notion that mega-case jurisdictions were engaged in Olympian allocation of capital, dispassionately wise and far above the pressures of competing interests. It may be that the mega-case jurisdictions have taken the findings to heart and done more to ensure that "Confirmation 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."[12] But closing the barn door after the cow escapes is a prospective remedy at best.

Adverse Societal Effects: The argument for forecastability, while perhaps true for debtors and lenders, may be outweighed by other considerations. The most important, to my mind, is that chapter 11 is not only financial and commercial, but also social legislation. It aims not only to seek rational handling of distressed assets, but it also to soften the blows of economic dislocation. Having a choice of venues is all very well for the debtor making plans, or the bank or hedge fund considering how to deal with a loss. For a run-of-the-mill creditor, company employee, or the city of which the debtor is an important part, a case filed far away becomes a remote, slow-motion dismemberment. The small creditor often stands to lose a significant part of its revenue through the changes worked by the case. The employee has even more invested: she doesn't have another job to feed her family. The city stands to lose a significant part of its economic engine. From their standpoints, each of these groups has more to lose than the lender who has the case filed in its backyard.

The unspoken but implicit message in a filing across the country from home base is that nobody counts but the lenders and debtor's management. I have never known a bankruptcy judge who did not see his duties as a sacred trust; but judges are human, and a judge thousands of miles away cannot perceive the employees and the regional economy as important as the people who stand before him every day in the courtroom. Out of sight means out of mind.

It may be that the quantitative results reached in a mega-case in New York or Delaware would differ not at all from one filed in a principal place of business. Even were that so, there is a qualitative difference between public perception of a local judge's ruling when compared to one rendered a thousand miles away. Justice must not merely be done: it must be *seen* to be done. Without that final component, respect for the court dwindles and erodes the bedrock upon which our system must be built.

Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts. Univ. of Michigan Press (2006).

[11] In these matters I am a mere country mouse, but knowledgeable city mice have told me that many of these failed plans were creations of claims buyers interested not in fixing a company, but in quickly liquidating their positions post-confirmation at a profit. After that, they had no concern. It might be shabby of me to think in such ways, but I am not the first advocate to ask *cui bono?*: "The famous Lucius Cassius, whom the Roman people used to regard as a very honest and wise judge, was in the habit of asking, time and again, 'To whose benefit?'" Cicero, *In Defense of Roscius Amerinus*.

[12] 11 U.S.C. section 1129 (a) (11).