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CHAPTER 11: A DEATH PENALTY FOR DEBTOR AND CREDITOR INTERESTS

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The last time I spoke before The Federalist Society, the subject was the death penalty. Today I am going to speak on the subject of another death penalty, Chapter 11. For as far as I am concerned, there is very little good to be accomplished, either from a social standpoint or in the particular case as it appears before our courts, under the rubric of Chapter 11 of the Bankrnptcy Code.

Neither I nor Professor Warren will be dealing with the question of individual bankruptcies because we did not think they fit with a discussion of the thrift and banking industries. That issue would better tie into today's subject of individual responsibilities and the socialization of risk. So we will address Chapter 11, the reorganization provision, which is more frequently utilized by corporations, partnerships, limited partnerships, and business entities than by individuals. Whereas the thrust of much of the Bankruptcy Code, and indeed its historical existence, was based on the idea of discharging the honest but unfortunate debtor, discharge and relieving the person of debts to make a fresh start in life simply does not come into play in most Chapter 11 cases for several reasons. The first and, for present purposes, conclusive one is that in Chapter 11, a debtor does not get a discharge until it confirms a plan of reorganization. What we *are* talking about is, as *The Wall Street Journal* defines a Chapter 11 proceeding, a breathing-space during which a company can avoid paying its creditors while it negotiates to restructure its debt.[1] The idea of Chapter 11 reorganization is that a company facing a large amount of debt, whether or not it is balance-sheet insolvent, can take advantage of the automatic stay. Creditors cannot collect on the debts, and the company can attempt to renegotiate its debt and continue business at the same time.

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1 Eugene Carlson, *Enterprise: Finding a Quick Route Through Bankruptcy*, WALL ST. J., Sept. 12, 1991, at B-1.

But what is really happening in Chapter 11? Is it fulfilling the goal of allowing businesses to reorganize? The reason I spoke of it as a death penalty is that, for all practical purposes, Chapter 11 is not facilitating reorganizations. The amended Bankruptcy Code, enacted in 1978, enabled companies to seek Chapter 11 relief much more easily. But only 10% of the bankruptcies that are filed in Chapter 11 end in confirmed plans of reorganization![2] That means that 90% of them are spending about two or three years each under the aegis of the bankruptcy court, shepherded along and, needless to say, paying the fees of lots of attorneys and professional people, for what end? Nothing. Because most of them end up liquidating. Even among those that file and confirm reorganization plans, many of them, in my experience, call for an orderly liquidation. So although you can speculate to your heart's content about the dynamics of reorganization, the fact is that it just does not occur in most businesses. Chapter 11 is more an intensive-care ward (or a mortuary) than a healing potion for sick businesses.

Let's try to demonstrate this conclusion on the basis of my experience, listing some of the express goals of the business reorganization law that Congress passed, undoubtedly with good intentions and high hopes, and then comparing those to actual cases. First, by enabling a business to continue its operations, Chapter 11 sought to preserve its going-concern value, assuming that if the business were broken up and liquidated in pieces, that value would be lost.[3] Second, Chapter 11 sought to protect the employment of workers.[4] Now, there are very well-known bankruptcy theorists who say this policy plays no part in reorganization law, and I think some of their arguments are well taken. But the fact is that concern for the welfare of workers provided a siguificant motivation for the passage of that law. Third, Chapter 11 posits a kind of debtor-creditor democracy in which the creditors will negotiate and reach a consensual arrangement with the debtor to reorganize the debts. All parties, it is assumed, will be participating equally.[5] Fourth, the reorganization law tried to give owners—current owners who are running companies, in some cases small mom and pop-type businesses—a chance to get a plan confirmed, and thus achieve through Chapter 11 what they would achieve by obtaining a discharge in personal bankruptcy.

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2 Davis, *Statistical Analysis of Chapter 11 Completed by A.O.'s Bankruptcy Division*, AM. BANKR. INST. NEWSL., Sept.-Oct. 1989, at 18 (summarizing a study by Ed Glynn, Bankruptcy Division of the Administrative Office of the U.S. Courts).

3 *See generally* 5 COLLIER ON BANKRUPTCY ¶ 1100.01 (2d ed. 1987).

4 *See, e.g.*, 11 U.S.C. § 1113 (1988).

5 *See, e.g., id.* §§ 1102, 1103 (1988).

Are any of these goals fulfilled? In my experience, that is very questionable. I would like to distinguish for analytical purposes between the vast majority of Chapter 11 proceedings, which you do not read about in *The Wall Street Journal*, and the big ones—Texaco, Continental and Eastern Airlines, Drexel-Burnham—which you do read about. They are two entirely different species of cases. Let's evaluate the type of case I worked on in terms of the Chapter 11 goals I just explained.

I suggested that the small Chapter 11 case concerns the paradigmatic debtor, whose owner is the sort of person you want to have running the company until his business improves or the economy turns. Is that sort of case common? I would say no. Of the cases in which I participated, a large number involved one-asset real estate joint venture speculations. In such cases, investors had formed a limited partnership to build a hotel or to develop raw land or to buy an oil drilling rig, and had persuaded a financial institution to lend them a lot of money. Other debtors are simply crooks. A lot of crooks take advantage of Chapter 11. Some will file one case listing two or three pieces of property; after allowing the creditor to foreclose, the court will discover that the property seems to belong to another entity 1000 miles away, that filed Chapter 11 just as the first foreclosure was about to take place. These constitute not an insignificant number of the total cases filed. Are these debtors people that society would demand we protect? It seems unlikely. Most of these people made bargains fully aware of the consequences: if you are going into a real estate speculation, for instance, you know that you may lose your money, and that you may have to pay up on your guarantee. Similarly, society should give these crooks no advantages. There are bankruptcy criminal laws, but they are hardly enforced nowadays, because it is far more attractive to a U.S. Attorney to prosecute the thrifts and the drug dealers. In the end, the small businessmen—the "worthy" debtors—account for a very small portion of actual filings. And in light of the (possibly overstated) Chapter 11 success rate of 10%, there is obviously a question as to the costs and benefits of reorganization law.

Let's talk about the workers. I think the rationale for protecting them arose many decades ago, when the labor market was not as flexible as it is today. It is indeed sad to see people lose their jobs. A lot of my friends lost their jobs in the banking and oil industry down-turn in the 1980s. They did not have a Chapter 11 proceeding to protect them. They lost their jobs because, for whatever reason, their company or their industry could not go into Chapter 11. But to say that Chapter 11 provides worker relief is largely a mirage.

Most reorganized businesses ultimately fail. Protecting workers is an admirable goal, but it is certainly not a controlling one.

Consider next the goal of achieving debtor-creditor democracy. Chapter 11 aspires to create benefits for creditors and debtors alike by allowing them to sit around the table, negotiate with each other, and formulate a plan of reorganization based on their relative priorities in the company. But it is crucial to remember that there are different kinds of creditors. Sure, credit card creditors and bank creditors make loans knowing that a certain number are not going to pay off. There are, however, an awful lot of creditors that are themselves no bigger than the hypothetical mom and pop debtor. Every real estate speculator bought his land from somebody in West Houston, quite often a farmer. Every hotel is supplied by the food services and the laundry services, and these usually are not big organizations. They are not able to spread their risks or bear the expenses of the delay that occurs in Chapter 11.

Would the small creditors be better off liquidating the company and sharing quickly what small pittance remains rather than waiting three or four years? Unequivocally yes. Why? Because the overhead costs of Chapter 11 are extremely high. In Houston, a company seeking Chapter 11 bankruptcy relief will have to put up about $40,000 as a retainer to its lawyers. The creditor's lawyer will have to appear in court about once or twice a month, waiting with his clock running until the judge reaches the particular matter on the docket. The expenses of collecting a debt in Chapter 11 can easily run into the tens of thousands of dollars. Small creditors cannot afford it. So what do they do? They do not participate. The idea of creditor participation becomes a fantasy. Chapter 11 provides for creditor committees, but in most Chapter 11s there are no functioning creditor committees. The debtor is allowed to run the business, and he usually runs it for his own benefit because he does not think he has too much time left. Either small creditors are effectively disenfranchised from the Chapter 11 process, or they find that their costs radically exceed any potential recovery.

As I suggested earlier, we can distinguish small cases from the big cases, where there is arguably some benefit to the creditors in continuing operations. Perhaps Eastern Airlines, if it had been able to work out its labor problems, would have yielded a larger return to creditors by staying alive. Perhaps the same is true for Continental Airlines. It remains rather questionable, however, because so many of even the big cases file a second time in Chapter 11.[6]

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6 *'Chapter 22' Cases Point to Flaws in Bankruptcy System*, HOUSTON POST, July 2, 1991, at C-10.

The point of this discussion is that the law allows a company to stay in business without paying its debts, and simply does not fulfill the express goals of its enactment. The only way we can solve this problem is to change the bankruptcy law. And I would point out that in the past 200 years, there have been about five or six different bankruptcy laws. They tend to ebb and flow between showing excessive care for creditors and excessive care for debtors. It is not unusual to propose changes to the Code.

What would I propose to change? I think one possibility is to require some kind of petition seeking permission to reorganize one's debts. I would exclude most one-asset real estate ventures from the Chapter 11 process. Those ventures fail because the market has not met their expectations. Their investors incurred a mortgage debt and are trying to get out from under it. It seems to me that the real estate companies and the lending institutions would be better off if we just let creditors foreclose and let the market evaluate those assets anew.

As for the big companies, I think it might be helpful—realizing that there were a lot of difficulties with a former law that called for this measure[7]—simply to oust management and install an operating trustee as soon as the companies file under Chapter 11. Most of these companies do not end up with the management with whom they started, and they certainly do not end up with the original shareholders. Perhaps the imposition of an objective trustee in cases where the company's assets exceed a certain level would allow the preservation of those assets, eliminating the emotion and the incentive to delay that typify the present system.

I leave you with the thought that Chapter 11 is a kind of death penalty for debtors and for creditor interests. I told The Federalist Society the last time I spoke here that the criminal death penalty procedures were not working well, and I am telling you now that the death penalty procedures for bankruptcy are not working well either. Sometime I will come and have something optimistic to say.

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7 *See generally supra* note 2 (describing Chapter X of the Chandler Act, Act of June 22, 1938, L. 575, 52 Stat. 840).