

Preface by Howard Brod Brownstein, CTP, Editor

In 2011, contemporaneously with the formation of ABI's Commission to study the reform of chapter 11, I initiated the launch of a column in the *ABI Journal* entitled "Problems in the Code."

Our column is designed to be a parallel effort alongside the Commission's efforts to study the first major overhaul of our nation's business bankruptcy laws in over thirty years. The purpose of the column is to augment and support the Commission's work, by highlighting areas of the Bankruptcy Code and Rules that have proven to be problematical in theory and/or application, and offer legislative solutions to the problems, in both business and consumer cases.

Examples of situations that have given rise to "Problems in the Code" include:

- Circuit "Splits," whereby interpretation varies by jurisdiction, leading to inconsistent application of laws and forum shopping ;
- Areas where courts and/or attorneys have created "workarounds" to adapt the Code to the reality of business necessities and practice of law, such as the so-called "Jay Alix Protocol" in the Third Circuit; and
- Situations where one or more of the ultimate purposes of bankruptcy, e.g., creating fair opportunities for debtors to be rehabilitated, treating creditors of the same class equally, etc.—just aren't being served well by the Code and Rules as written.

In addition to the public hearings held by the Commission, the "Problems in the Code" column serves as another "voice of the people"—ABI members who are prominent or emerging bankruptcy law practitioners, and who have observed first-hand the imperfections of our system of bankruptcy laws.

Several months after launching the column, Frank Volk, Law Clerk in the U.S. District Court in Charleston, WV, joined me as a Coordinating Editor. Frank focuses on soliciting and editing articles about consumer bankruptcy, and I focus on business bankruptcy.

Our articles follow the general format of:

1. Here's the problem
2. Here's why it's a problem
3. Here's the suggested legislative solution

Over the past sixteen months, our column has published a prolific stream of articles in nearly every issue of ABI Journal (listed at: <http://journal.abi.org/category/column-name/problems-code-0>). We have been struck by the *breadth* of subjects in need of legislative attention. This published body of work is more evidence for the need for reform of Title 11.

Here is a list of article subjects published to date, in our current queue or in development:

- Treatment of Franchisee Leases under § 365(d)
- Priming Setoff Rights
- Impact of *Stern v. Marshall*
- Effect of *Northern Lights* on Chapter 15 Practice
- Calculation of Lease-Damage Claims after Early Termination
- Assumption of Intellectual Property Licenses
- Impracticality of Rule 2002(a)(2)
- Expediting Chapter 11 Liquidating Debtor's Distribution to Creditors
- Section 507(a)(4) and Executoriness
- *Qualitech* and § 365(h)
- Absence of Reference to LLC's in the Code
- Statutes of Limitations vs. Nondischargeability Actions
- Definition of "Income"
- *LGI* & Treatment of Third-Party Payors
- Treatment of Unrejected Leases
- Abuse of § 548 Fraudulent Transfers
- Tension Between Receiverships and Bankruptcy Proceedings
- The Decline of Avoidance Powers
- *Sunbeam* and *Lubrizol*: Rejection of Contracts
- Custodians' Obligation to Turnover and Grounds for Excuse from Compliance
- Priority of Environmental Claims
- Single-asset RE Cases and Expedited Treatment
- §327 Disinterestedness and Prepetition Turnaround Professionals

In addition to calling the attention of the Commission to the specific topics covered by the above articles, we hope that the Commission will also look for the "penumbra" of each topic—the implications of each topic on related subjects within the Code. The implications of the breadth of topics illustrated above are clear—nothing short of a systematic and exhaustive examination of Title 11 will suffice. In addition, the Commission's program of public hearings and soliciting input from all quarters are clearly appropriate and will be beneficial for the outcome.

It remains to be seen whether, after the Commission has completed its work and submitted it to our lawmakers, there will exist the political will to avoid just another "swinging of the pendulum" toward or away from perceived advantages to debtors or creditors, rather, we hope the changes made will optimize bankruptcy more efficiently and effectively for all concerned, and that this volume will contribute to this end.

II. Introduction

Commission to Explore Overhauling Chapter 11¹

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It has been more than 30 years since the enactment of the Bankruptcy Code, and there is a growing view that the current law needs an overhaul. This need was identified at “Chapter 11 at the Crossroads: Does Reorganization Need Reform?,” a 2009 ABI-sponsored event billed as a “symposium on the past, present and future of U.S. corporate restructuring.” Out of the symposium came a consensus that there is a need to reform chapter 11, and that it needs to be reformed now.²

Agreeing on the specifics of reform is the next, more difficult step. ABI President **Geoff Berman** (Development Specialists Inc.; Los Angeles) has addressed the formation of a “commission” to study the current law and to recommend changes—a “Chapter 11 at the Crossroads: Part II,” if you will. In his inaugural address during the 2011 Annual Spring Meeting, he said:

Today’s typical case is expedited and does not resemble a classic reorganization: one in which a distressed company can find protection in the safe harbor of Chapter 11, dispose of unprofitable parts of the business, stabilize what remains, operate for a short time to see that the core business can be profitable, propose a plan based upon the smaller, profitable core business, restructure its balance sheet pursuant to a Chapter 11 plan, and emerge as a healthy, albeit smaller, business enterprise. Instead of that classic Chapter 11 model, today we see quick sales to new owners driven by creditor interests or an outright liquidation.

That current law needs updating was recognized in the opening

¹ Originally published in the *ABI Journal*, January 2011

² The work of the symposium is memorialized at “Chapter 11 at the Crossroads: Does Reorganization Need Reform?, Transcript of Proceedings,” available online at www.abiworld.org (“transcript”). See also Robert J. Keach, Robert M. Fishman, Melissa Kibler Knoll, Reginald W. Jackson and John D. Penn, “Legislative Symposium Roundtable: Chapter 11 at the Crossroads: Does Reorganization Need Reform?,” 18 *Am. Bankr. Inst. L. Rev.* 365 (Spring 2010) (“roundtable”).

panel of the 2009 symposium, which consisted of many of the “founding fathers” of the 1978 Code. The group revealed that the 1978 Code, at passage, was expected to have a “shelf life” of, at best, 40 or so years. As panelist **Rich Levin** (Cravath, Swaine & Moore LLP; New York) said:

The politics are very different, but there’s also something else that’s very different. And here again, I’ll ask Bob [Feidler] if he won’t agree with me that at the time in ’78, we said we need to revise the bankruptcy laws because the entire underlying credit economy in the business world had changed dramatically in the 40 years since the 1938 Chandler Act. At the same time, we said we knew that there would need to be a bankruptcy reform act of 2018, 40 years hence, because the entire credit economy and business world would change again. Now, it’s changed dramatically in 30 years, and I think we’re at that point, and leave aside the political compromise, which will have to be made to get anything through Congress; the point is that the system needs to be rethought. It’s done very well keeping up with the dramatic changes in the underlying business and credit economy, but it’s stretched dramatically, and lawyers and business people have learned how to use it. Both creditors and debtors have learned how to use it. Although they’ve been able to use it to accomplish things like GM, Chrysler and CIT, which might be traditional fast, prepackaged reorganizations without even bending the Code a little bit, it’s not designed for the current economy, and it needs to be rethought.³

Arguably, the best quality of the 1978 Bankruptcy Code was that the statute offered a balance between creditor and debtor interests, establishing what was often described as a “level playing field” for restructurings. When first enacted, the Bankruptcy Code arguably served the interests of all those impacted by a debtor in distress including employees, the surrounding community, the public interest and the creditor interests but it did so in a flexible way that balanced all interests while meeting the debtor’s goal of succeeding in saving its business. However, as the 2009 symposium panelists noted, the world changed, as did the 1978 Code.

While the Bankruptcy Code was developed in an era when the biggest employers were manufacturers, the biggest employers today are service companies such as retailers and technology-driven enterprises. Many of the remaining American manufacturers are less dependent on hard assets and more dependent on contracts.

Since the Code’s enactment, there has been an explosion in the use of secured credit, placing secured debt at all levels of the capital structure and trumping any long-term reorganization for the benefit of existing shareholders.

³ Transcript at p. 17.

The unparalleled expansion of distressed-debt markets and claims trading has made chapter 11 a financial and takeover play, minimizing the debtor's ability to control its own destiny. Debtors are more often multinational companies with international law implications. Indeed, these are just a few of the factors driving the need for change, as pointed out by Levin, who said:

You can't go back to the future. The world doesn't work as it did in '78. It's not a question of amendments; it's not a question of adjusting this or that; it's a question of, okay, we're in a very different world now — let's start from scratch and write something that makes sense for this world.⁴

Further, as Prof. *David Epstein* (University of Richmond Law School; Richmond, Va.) has noted, we have learned from the lessons of the past, and can apply them to the new environment:

But in a sense that's back to the future because in a sense that is conceptually what had to be done in 1978 and in the Chandler Act before that. We've all acknowledged this lesson of history. The world does change, and absent a meaningful Bankruptcy Code, what's going to happen is that all of the leverage is with the holders of the debtor, with the secured creditors. If you're going to have any kind of a "balance," to use one of the [words] that we started with, Congress has to recreate that balance every 30 or 40 years.⁵

The 2009 symposium panelists generally agreed that some parts of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), such as the shortened time to assume or reject leases and the creation of new administrative claims, went too far and hindered restructurings; derivative safe harbors were far too broad and needed to be at least curtailed;⁶ and changes needed to be made to make it easier to access credit, given the overleveraged balance sheets so common among today's debtor entities. While support for retaining the basic debtor-in-possession model was strong, some tweaking was suggested, including the possible limited use of monitors or similar persons, and examining the role of the creditors' committee, given the prevalence of claims trading. An examination of possible additional safeguards when all of the assets are sold in a § 363 sale was also suggested.

The ubiquitous and expansive use of secured credit is a primary challenge to the traditional reorganization regime. How can reorganization be financed when there is little or no apparent equity in the assets? In the case of overleveraged balance sheets, how are employee, tort claimant and trade creditor interests to be protected, or at least recognized, much less equity interests?

⁴ *Id.* at. p. 39.

⁵ *Id.*

⁶ As Fishman noted, discussing the panel on safe harbors, "everybody on this panel conceded that these Bankruptcy Code sections are definitions and applications run amok." Roundtable at p. 375.

An examination of priorities, adequate protection, surcharge and other factors may be in order.

The 2009 symposium was simply the latest group to explore possible change. Before it, the National Bankruptcy Review Commission suggested changes, most of which never found their way into legislation.⁷ The Select Advisory Committee on Business Reorganization (SABRE), a special committee of the ABA's Section on Business Law, issued reports in 2001 and 2004, respectively, proposing changes to the bankruptcy laws designed to reduce the time and cost of chapter 11.⁸ Many of those proposals warrant reconsideration. There is also a considerable body of scholarship in law reviews, journals and papers on the subject of—and need for—reform that needs to be evaluated.⁹ Changes in practice suggest areas of exploration. For example, should the Code recognize now-routine practices, such as “first-day” motions, and set guidelines for them? Court decisions have raised additional issues for examination. For example, recent opinions in the Second and Third Circuits have sparked intense debate on the continued efficacy of the absolute-priority rule. Other decisions suggest possible needed fixes in the cramdown provisions and other key Code sections.

ABI is the logical organization to do this work for two fundamental reasons. First, it is not a political organization, but rather is unbiased, and thus has no interest other than intellectual honesty and an open process. Second, its more than 13,000 members represent all segments of bankruptcy practice, including practitioners who advise small, mid-size and large enterprises. Given ABI's 30-year nonpartisan tradition, the commission will be a forum for all voices and points of view.

Geoff Berman has tasked the authors of this article to assist him in selecting a working group of the “best and the brightest” from among chapter 11 practitioners, academics, bankers and perhaps Congress to study possible business bankruptcy law reforms, especially where there is clear consensus, and to identify possible choices and options, even where finding consensus proves elusive. The commission will hold hearings nationwide to hear and collect data and opinions on various issues. It will also solicit and accept written submissions on selected issues. ABI's “commissioners” will also discuss, debate and search for consensus for change. The final result will be a comprehensive report, part blueprint for reform and part catalog of open issues and current options, to be considered in updating the bankruptcy laws. If the commission succeeds, its work will lead to reform legislation, but legislation fully informed by the careful and thorough process of the commission, and the input of the entire insolvency community.

7 See Report of the National Bankruptcy Review Commission, Oct. 20, 1997, Volume I.

8 Karen M. Gebbia-Pinetti (reporter), “First Report of the Select Advisory Committee on Business Reorganization,” 57 *Bus. Law.* 163 (November 2001); Gebbia-Pinetti, “Second Report of the Select Advisory Committee of Business Reorganization,” 60 *Bus. Law.* 277 (November 2004).

9 As Fishman noted, discussing the panel on safe harbors, “everybody on this panel conceded that these Bankruptcy Code sections are definitions and applications run amok.” Roundtable at p. 375.

The new ABI commission will endeavor to do the work that Congress will require to change the law. It is expected that this will be a multi-year effort that will involve ABI's best and brightest. The 2009 symposium helped bring the issues of today's environment to the forefront of the insolvency community's attention once again, and one thing is clear: The time to start addressing those issues is now.