THE NEW FACE OF CHAPTER 11

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Chapter 11 today lives in three different worlds. The first world is that of the large corporation. Each year, several dozen corporations with hundreds of millions in assets enter the bankruptcy system in Wilmington, New York, and a handful of other places. A single Enron or Worldcom generates more legal work than a thousand small cases combined. Many reorganization lawyers see only these cases.

The second world is that of the small business chapter 11. The vast majority of the 10,000 corporate reorganizations filed each year are of small businesses. The electrical subcontractor, the small family-run Italian restaurant, or the suburban jewelry store falls behind on payments to the IRS, landlords, workers, and suppliers and tries to sort out the mess in bankruptcy court. Most bankruptcy judges never see any other kind of corporate chapter 11.

Living largely apart from these two worlds is the one found in the *Federal Reporter* and *United States Reports*. The courts of appeal and the Supreme Court generate a regular flow of authoritative interpretations of the Bankruptcy Code, often focusing on its language, separate from its history or the practices that have taken deep root in large and small cases over the last 25 years.

In this paper, I explore these brave, new worlds and assess both the present and the future of chapter 11. The first two parts look at the world of large and small chapter 11s respectively. In the last part, I focus on what is likely to happen when formal bankruptcy law loses touch with bankruptcy practice.

I. THE LARGE CORPORATE CHAPTER 11 TODAY

In December 2002, the bankruptcy court in Delaware confirmed Global Crossing's plan of reorganization.[1] One of the largest corporations ever to go through chapter 11, Global Crossing is emblematic of chapter 11s past and its future. Global Crossing was formed in 1997 to close one of the last gaps in the Internet. The telecommunications cables connecting the continents were too small

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[1] *See* James S. Granelli, *Court Oks Global's Plan to Wipe Out Obligations*, L.A. TIMES, Dec. 18, 2002, pt. 3, at 1 (explaining court approved elimination of Global Crossing's debt at pennies on dollar); *Technology Briefing Communications: Global Crossing Reorganization Approved*, N.Y. TIMES, Dec. 18, 2002, at C4 (announcing federal bankruptcy judge approved Global Crossing's reorganization plans); *see also In re* Global Crossing, 295 B.R. 726, 730 (Bankr. S.D.N.Y. 2003) (stating court approved purchase agreement on Aug. 9, 2002, which was basis for reorganization plan eventually confirmed by debtors).

to accommodate the expected growth in Internet use outside of North America. In 1997, those outside North America accounted for only 20% Internet use. By 2000, they would account for almost half.[2]

To take advantage of this change, Global Crossing laid a trans-Atlantic cable within 10 months and embarked on ambitious plans to create a global fiber network. It reached $1 billion in revenues within its first 20 months. Global Crossing continued to invest billions in creating the first network of fiber optic cable across the world's oceans. Global Crossing was to be a major player in the Digital Age, and its market capitalization soon exceeded that of General Motors.[3]

Global Crossing's fall, however, was as swift as its rise. Competitors appeared. Internet traffic grew, but it doubled only every year, not every hundred days as some had predicted. Moreover, technological innovation allowed much more information to be carried over the same cable. As a result, there was massive overcapacity. Global Crossing's revenue barely paid its ongoing expenses. Its stock price collapsed as people quickly came to see that Global Crossing would never make back the billions it spent building its fiber optic network.[4]

Fiber optic cable was to the 1990s what iron rails and wooden ties were to the 1880s. A promising technology in a heavily regulated environment will bring people together as never before. An entrepreneur makes the enormous capital investment the technology requires, but demand falls far short of expectations. A visionary business that attracted capital from all over the world and that employs thousands cannot generate the funds needed to pay its creditors. Games are played with the business's finances to hide this reality for a time, but the truth is discovered soon enough.

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[2] *See generally* Donald J. Karl, *State Regulation of Anonymous Internet Use After* ACLU of Georgia v. Miller, 30 ARIZ. ST. L.J. 513, 513–14 (1998) (reporting in 1996 43 million Americans were online, in 1997 82 million persons worldwide were online, and growth was anticipated to reach up to 300 million persons worldwide by 2000); Peter Gallagher, *E-commerce Trends; Internet Use*, INT'L TRADE FORUM, Apr. 1, 1999, at 16, 17 (stating North American countries such as United States and Canada generally adopted Internet technologies more rapidly than rest of world); Press Release, Computer Industry Almanac Inc., North America is the Leading Region for Internet Users According to the Computer Industry Almanac (Aug. 18, 1999), *at* http://www.c-i-a.com/pr0899.htm (last updated Dec. 1999) (charting projected trends in internet usage worldwide).

[3] *See, e.g.*, Steven v. Brull, *Global Crossing's Harrowing Trek*, BUS. WK., Sept. 25, 2002, at 152 (noting Global Crossing's market capitalization and explaining impact of growth on people ranging from former President George Bush to Global Crossing receptionists); Peter J. Howe, *Trying Too Hard to Please: Wall Street Pressure to Keep Stock Prices High Led to Telecom's Fall*, BOSTON GLOBE, June 30, 2002, at G1 (stating Global Crossing's market capitalization eclipsed General Motors'); Daniel Yergin, *Herd on the Street: A Quarterly Stampede*, WASH. POST, June 30, 2002, at B01 (stating by February of 2000 market capitalization of Global Crossing was $50 billion, substantially more than General Motors).

[4] *See Big Losses; Review & Preview: December 5-11*, L.A. BUS. J., Dec. 15, 2003, at 3 (reporting losses of $25.7 billion in 2000 and 2001 and further bankruptcy filings cost investors $40 billion as demand for its fiber-optic network decreased); Julie Creswell, *The Emperor of Greed*, FORTUNE, June 24, 2002, at 106, 111 (explaining while Internet companies began to collapse in Spring 2000 Global Crossing's stock price dropped from $61 to $16); Christopher Stern, *Short Term Lenders Cut Off Qwest's Cash*, WASH. POST, Feb. 15, 2002, at E01 (stating Global Crossing's bankruptcy was caused when expectations of need for data capacity were never met).

At this point, we have to make the best of a bad situation. While we investigate the financial frauds and those who perpetrated them, we have to accept that the railroad has been built and the fiber optic cable has been laid. We need to sort through the financial mess and still ensure these assets are put to their best use. The equity receivership allowed 19th century investors to take control of the business, throw out bad managers, and agree upon a new capital structure consistent with the less-than-expected revenue of the railroad going forward.[5] Chapter 11 provides a similar forum today. From this perspective, Global Crossing is merely old wine in a new bottle. The technology is different, but the legal challenge is the same.

Closer examination, however, reveals fundamental differences between 19th century railroads on the one hand and Global Crossing and the many casualties of the dot.com era on the other. The railroads had to raise capital in bits and pieces. No one source of capital was large enough to build the entire project. Dozens of different types of bonds were secured by different parts of the road. Bondholders were scattered in New York, London, and Amsterdam. Creditors could not work together to hold a single foreclosure sale. Even if they could, no one buyer would be able to muster the resources to bid.

The equity receivership allowed diverse investors to coordinate their efforts and confront the special challenges of restructuring in a world with poorly developed capital markets.[6] It developed an elaborate mechanism that mimicked a market sale. Old investors exchanged their old bonds for bonds in the reorganized railroad that were, in principle, worth their share of what they would have received if the railroad could have been sold for cash.[7]

Today, creditors of insolvent businesses—even those as large as Global Crossing—no longer need a substitute for a market sale. Instead of providing a substitute for a market sale, chapter 11 now serves as the forum where such sales are conducted. In the equity receivership, judges protected minority investors when

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[5] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 58–59 (2001) (stating one goal of equity receivership was "to rework the railroad's capital structure, reducing its obligations so that it could get back on track financially"); *see also* Am. Brake Shoe & Foundry Co. v. Interborough Rapid Transit Co., 1 F. Supp. 820, 826 (S.D.N.Y. 1932) (noting purpose of equity receivership is to preserve assets and continue business); David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1355–57 (1998) [hereinafter *Evolutionary Theory*] (discussing strong ideological and interest group support for preserving railroads under equity receivership scheme).

[6] *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 928–34 (2001) [hereinafter *Control Rights*] (presenting equity receivership in 19th century as flexible procedure for investors and bankers to give railroads new capital structure); *see also* John C. Anderson & Peter G. Wright, *Liquidating Plans of Reorganization*, 56 AM. BANKR. L.J. 29, 33 (1982) (discussing how old creditors and stakeholders would purchase assets from equity receiver and adjust their respective rights through new company formed to acquire assets). *See generally* JAMES W. ELY, JR., RAILROADS AND AMERICAN LAW 175–80 (Princeton University Press 2001) (chronicling changes in equity receivership schema during 19th century).

[7] An excellent account of the equity receivership can be found in SKEEL, *supra* note 5, at 48–69. Robert Rasmussen and I have also offered an account. *See* Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 397–408 and *Control Rights*, *supra* note 6, at 925–36.

valuations could not be set in the market.[8] To carry out this task, they developed the absolute priority rule.[9] In modern chapter 11, the judge ensures that sale is conducted in a way that brings the highest price. The emerging case law focuses on lock-up agreements and bust-up fees.[10]

In what has become a common pattern in large chapter 11 reorganizations, Global Crossing filed its petition with new buyers already tentatively lined up. In return for $750 million, Singapore Technologies and Hutchison Whampoa would acquire 78% of the equity of the new company.[11] Old creditors would receive the cash and new (and dramatically reduced) debt as well as a minority equity stake. The old equityholders would be wiped out. The job of the bankruptcy judge was to ensure that this deal was in the creditors' interest. Some creditors objected to this deal and alleged that there were undisclosed connections between the buyer and members of Global Crossing's board. Other bidders also appeared.[12]

At this point, the creditors hoped to be the beneficiaries of a bidding war. Global Crossing's financial condition, however, turned out to be worse than expected. Other bidders retreated, and Singapore and Whampoa took their first offer off the table. Negotiations continued, and after 11 months, Global Crossing reached a new deal with them. Before this deal could be consummated, however, regulators balked at allowing a Chinese company to own an important piece of the United States' technological infrastructure. At the same time, Carl Icahn launched a competing bid for the assets. Filing a chapter 11 petition puts the business in play, and Global Crossing was no exception.

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[8] *See* Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11*, 72 AM. BANKR. L.J. 227, 228–32 (1998) (discussing role of courts in terms of treating minority investors fairly in equity receivership).

[9] *See* 11 U.S.C. § 1129(b)(2)(B)(ii) (2002); *see also* Computer Task Group v. Brotby (*In re* Brotby), 303 B.R. 177, 181 (B.A.P. 9th Cir. 2003) (discussing exception to absolute priority rule); *In re* Exide Tech., 303 B.R. 48, 61 (Bankr. D. Del. 2003) ("Section 1129(b)(2) sets forth the 'absolute priority rule,' applicable to unsecured creditors, which provides that a plan may be confirmed despite rejection by a class of unsecured creditors if the plan does not offer a junior claimant any property before each unsecured claims receives full satisfaction of its allowed claim.").

[10] *See generally In re* Lawson, Inc., 300 B.R. 227, 231 (Bankr. D. Del. 2003) (requiring creditor consent of lock-up agreement); *In re* TS Indus., Inc., 227 B.R. 682 (Bankr. D. Utah 1990) (stating despite fact pre-petition workout agreement was not financial accommodation entered into in anticipation of bankruptcy, it is still within scope of Code); *In re* Apex Oil Co., 92 B.R. 847, 854 (Bankr. E.D. Mo. 1988) (addressing 5% bust-up fee limiting Apex's ability to sell purchased assets to third parties); *In re* Texaco, 81 B.R. 813, 815 (Bankr. S.D.N.Y. 1988) (upholding stipulation agreement between debtor and creditor not to violate section 1125 meaning of "solicitation").

[11] *See* Simon Romero, *Global Crossing Alternatives Are Considered*, N.Y. TIMES, May 20, 2002, at C5 (noting Hutchinson Whampoa and Singapore Technologies initial offer of $750 million for Global Crossing's assets); *see also* Rahul Jacob et al., *A New Chapter for the Global Crossing Story*, FIN. TIMES (London), Jan. 29, 2002, at 25 ("Hutchinson Whampoa and Singapore Technologies, which have agreed to invest the Dollars 750m of new equity, already have separate joint ventures with Asia Global Crossing, a subsidiary which is outside yesterday's chapter 11 filing."). *But see Global Crossing Buyer Exits*, WASH. POST, May 1, 2003, at E02 (indicating Hutchinson Whampoa's exit from plans to buy assets).

[12] *See generally* Jeff St. Onge, *Court Approves Global Crossing Plan*, TORONTO STAR, Dec. 18, 2002, at C04 (describing who would get what under Global Crossing's reorganization plan).

In the equity receivership, no actual sale could take place, but as Global Crossing suggests, sales are now part of the warp and woof of chapter 11 practice. Of the 10 largest chapter 11s of 2002, eight used the bankruptcy court as a way of selling their assets to the highest bidder, whether piecemeal or as a going concern.[13] As with Global Crossing, most of the sales were in the works before the chapter 11 petition was filed. Budget's negotiations with Avis were public a month before it filed its petition, and Avis entered into a formal agreement to buy it several weeks later.[14] McLeodUSA's prenegotiated plan included selling 58% of the equity and control of the business to Forstmann Little.[15] Exodus Communications entered chapter 11 after its efforts to find a buyer outside had failed. Within weeks, it reached a deal with Cable & Wireless, a buyer whom it had courted unsuccessfully several months before it filed.[16]

Chapter 11 allows for piecemeal sales when they bring the highest returns. Early on, Global Crossing's huge operating losses gave rise to speculation that the creditors might shut it down and sell it in pieces.[17] In some cases, liquidation is contemplated from the start. Comdisco reached an agreement to sell one of its principal businesses to Hewlett-Packard for $610 million before filing for bankruptcy.[18] As has become commonplace, the bankruptcy judge insisted that others have the chance to bid.[19] An auction ensued and this division was ultimately

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[13] The eight companies who used the bankruptcy court as a way of selling their assets to the highest bidder were: Global Crossing; Comdisco; XO Communications; McLeodUSA; Budget; Unicapital; Exodus; and Iridium. The data here is taken from Lynn LoPucki's Bankruptcy Research Database. *See* http://lopucki.law.ucla.edu. [hereinafter BANKRUPTCY RESEARCH DATABASE].

[14] *See* Mariko Sanchanta, *Cendant Focuses on Budget Target*, FIN. TIMES (London), June 30, 2002, at 30 (stating that Cendant, Avis's parent, would acquire Budget in a pre-packaged chapter 11); *Cendant, Owner of Avis, to Acquire Budget*, N.Y. TIMES, Aug. 23, 2002, at C3 (announcing sale agreement several weeks after chapter 11 filing).

[15] *See* Ricardo Roberts, *Of McLeodUSA: Teddy Fortsman Buys More*, SEC. DATA PUBLISHING, Nov. 17, 2003, at 1 (detailing purchase of McleodUSA by Fortsman and noting Fortsman Little as largest shareholder with 58% of McLeod); *see also* Leon Lazaroff, *McLeodUSA Sells More Assets*, DAILY DEAL (New York), May 16, 2002, M and A (noting same benefit to Fortsman Little as result of McLeod's restructuring).

[16] *See, e.g.*, *At Deadline*, COMPUTERWORLD, Dec. 3, 2001, at 6 (stating Exodus sold to Cable & Wireless for $575 million cash and assumption of $180 million in liabilities); Gren Manuel, *Cable & Wireless Establishes Foothold, Faces Obstacles in Global Web-Hosting War*, WALL ST. J., Dec. 3, 2001, at B8 (mentioning sale agreement).

[17] *See* Geraldine Fabrikant & Simon Romero, *A Rival Offer is Expected for Global*, N.Y. TIMES, Mar. 4, 2002, at C1 (discussing how investors believed Global Crossing would liquidate with different assets being sold at auction); Henry Sender, *Deals & Deal Makers: Global Crossing's Many Creditors Quarrel Over Best Method to Recoup Their Money*, WALL ST. J., Mar. 6, 2002, at C1 (stating even with bankruptcy protection creditors wanted to liquidate because of accumulating operating costs).

[18] *See Comdisco Fee Protested*, CHI. TRIB., Nov. 21, 2001, pt. 3, at 2 (stating Comdisco "had accepted a $610 million 'stalking horse' bid from Hewlett-Packard"); *Comdisco Seeks Bankruptcy Protection*, L.A. TIMES, July 17, 2001, pt. 3, at 5 (indicating Comdisco was selling technology services business to Hewlett-Packard Co. for $610 million).

[19] *See generally* Peter Loftus, *SunGard Data CEO is Resolved to Seal Deal with Comdisco*, WALL. ST. J., Nov. 14, 2001, at B14B (stating federal bankruptcy court "ruled that a competing $750 million bid from Hewlett-Packard . . . wasn't valid because it didn't meet the court's auction guidelines."); Jon Van, *SunGard's Bid for Comdisco Unit Beats HP; $825 Million Deal Depends on Ruling in Antitrust Case*, CHI. TRIB., Nov. 10, 2001, at 1 (noting Judge Barliant ruled against Hewlett-Packard as they tried to buy up Comdisco for

sold for $825 million to another buyer within several months of the petition. Comdisco then proceeded to find buyers for the rest of its assets.[20]

Formed in 1997, UniCapital acquired equipment leases and repackaged them for sale to banks. It raised $532 million in an initial public offering.[21] But it too was done-in by the collapse of the telecommunications sector. Most of its assets were sold, and what was not sold was put into a limited liability company that became a wholly owned subsidiary of its principal secured lender. UniCapital had roughly 500 employees at the time it filed, but only eight by the time it was over.[22]

Iridium was a system of low-earth satellites. Built at a cost of billions, millions were needed each month to maintain them in low earth orbit. Its operating losses were so large that the creditors faced the choice of selling the satellites for less than 1% of what it cost to put them in orbit or firing their retrorockets and burning them up in the atmosphere.[23]

Of the large publicly traded firms that exited chapter 11 in 2002, the assets of more than half were sold in chapter 11 or were transferred to a new owner under the plan of reorganization.[24] In some cases, such as in the case of Birmingham Steel, the sales are more or less completed before the fact and the chapter 11 merely insures that no one else will bid more.[25] In other cases, the bankruptcy judge conducts an auction in open court. Warren Buffet acquired Fruit of the Loom in this fashion.[26] The sale may involve more elaborate negotiations. Sterling Chemical sells half its assets in chapter 11 and a third party investor acquires control of what is left under a

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new bid of $750 million, stating bid violated auction rules established by court and further insisting on integrity of bankruptcy process).

[20] *See Comdisco Fee Protested*, *supra* note 18, at 2 ("After an auction and a court fight, [Comdisco] was sold . . . to SunGard Data Systems Inc. for $825 million."); Rob Kaiser, *Judge's Competition Ruling Opens Way for Comdisco Unit Buyout*, CHI. TRIB., Nov. 15, 2001, at 1 (discussing SunGard's winning bid of $825 million and how Comdisco planned to auction another part of company worth significantly more than disaster recovery unit).

[21] Terry Brennan, *UniCapital to Emerge from Chapter 11*, DAILY DEAL (New York) Jan. 9, 2002, at Bankruptcies (noting UniCapital's IPO).

[22] *Id*. ("UniCapital, which raised $532 million in an initial public offering . . . has continued to operate with just eight employees after it had roughly 500 employees at filing before selling most of its assets").

[23] Simon Rockman, *Online: A Mobile Failure Waiting to Happen: Simon Rockman Warns the Third Generation Mobile Vision Could Crash to Earth Just Like the Dollars 7bn Iridium Satellite Project*, THE GUARDIAN (London), Feb. 8, 2001, at 8 (noting alternative of burning satellites by crashing them into atmosphere may have been cheaper in long run).

[24] *See* BANKRUPTCY RESEARCH DATABASE, *supra* note 13. Following LoPucki's convention, a large chapter 11 is a publicly traded corporation that reports more than $100 million in assets in 1980 dollars. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675–83 (2004) [hereinafter *Chapter 11 at Twilight*] (providing more detailed account of various sale agreements made by large public companies as part of their chapter 11 proceedings).

[25] *MCI Stock to Disappear*, WASH. POST, May 22, 2002, at E02 (relating Birmingham Steel's sale agreement with Nucor which required Birmingham to file for chapter 11 bankruptcy protection in Delaware).

[26] *Chapter 11 at Twilight*, *supra* note 24, at 676 (discussing auction conducted for Fruit of the Loom); *Fruit of the Loom Auction*, CHI. TRIB., Dec. 6, 2001, at 2 (announcing judge's approval of auction for Fruit of the Loom).

plan of reorganization.[27] In other instances, a going-concern sale is not possible. After its business plan fails, WebVan enters chapter 11 in order to allow an orderly sale of its assets.[28]

If we take a snapshot of the business before and after the chapter 11, we would not be able to tell whether there has been a chapter 11 or a traditional corporate control transaction. The business may now be folded into another. Even if it is not, the old shareholders are gone as are the old managers and the old board. New managers run a business whose operations have been streamlined and whose workforce has been reduced. The process itself resembles the takeover battles we see elsewhere. Corporate raiders square off against each other in a bidding war, while the board's independent directors pay careful heed to their *Revlon* duties.[29] The lawyers shuttle between their offices in New York and a courtroom in Wilmington. Chapter 11 has morphed into a branch of the law governing mergers and acquisitions.

There continue to be some chapter 11 cases in which the sale of the business is never in prospect. In these cases, the embers of the equity receivership still burn. Here again, however, the differences between the equity receivership and modern chapter 11 are enormous. The railroads possessed primitive capital structures. When the Atchison, Topeka, and Santa Fe railroads entered receivership, there were 43 different types of bonds. By contrast, corporations today have far simpler capital structures. Their form is the product of deliberate design. Global Crossing's capital structure was structured so that it had to return repeatedly to capital markets. A bank group held much of the senior debt and was well-positioned to monitor the business and negotiate with it as its condition deteriorated.[30]

The elaborate committee structure of the equity receivership provided investors with a way to communicate with each other that did not exist elsewhere. The ability of creditors to control their debtor and negotiate with each other outside of chapter 11 is now vastly greater than it was during the equity receivership—or even in chapter 11 just 20 years ago. Often chapter 11 is needed only to put in place a plan that the key players negotiated before the petition was filed.

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[27] *Chapter 11 at Twilight*, *supra* note 24 (noting Sterling Chemical sold half its proceeds for benefit of secured creditors); Kerri Walsh, *Sterling Moves Ahead With Planned Chlorate Sale*, CHEMICAL WK., Sept. 25, 2002, at 13 (announcing Sterling Chemical's plan to sell assets to secured creditors).

[28] *Chapter 11 for Webvan: 'Orderly Sale' Planned*, CHI. TRIB., July 15, 2001, at 5 (stating Webvan filed chapter 11 and plans orderly sale of remaining assets); *see also* Kathleen Pender, *On Paper, Webvan Doesn't Look Bankrupt: Assets of Dot-Com Grocery Service Could Exceed Debts*, S.F. CHRON., July 17, 2001, at B1 (analyzing worth of Webvan's assets).

[29] Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173, 185 (Del. 1986) (holding directors have duty to maximize shareholder profits); *see* Dennis Dunne, *The Revlon Duties and the Sale of Companies in Chapter 11*, THE BUS. LAW., Aug. 1997, at 1333 (discussing "duty to maximize short-term stockholder value if and when the sale of control or break-up of the company becomes inevitable"); Anthony Wall, *Playing it Safe in Divesting Unwanted Business*, MERGERS AND ACQUISITIONS, Nov.-Dec. 1993, at 17 (noting Delaware courts require directors to maximize shareholder value by conducting fair auction or otherwise ensuring best price after deciding to sell company).

[30] *See, e.g.*, *Global Crossing Obtains Waiver Resolving Year-End Bank Covenant Concerns*, BUS. WIRE, Dec. 28, 2001 (noting J.P. Morgan and Citibank waive financial covenants on behalf of bank consortium).

After Global Crossing, NTL was the largest chapter 11 that wrapped up in 2002.[31] Most of its creditors agreed on a plan of reorganization before the petition was filed. The judge confirmed this plan, with only minor modifications, a few months later. Ninety percent of Williams Communications's bondholders signed on to a prenegotiated plan before its petition was filed.[32]

Of the large businesses whose assets are not sold in chapter 11, more than half enter chapter 11 with a prenegotiated plan.[33] The judge usually confirms it within several months after only minor modifications.[34] These modifications typically are made to appease those junior creditors able to make nonfrivolous (if only barely nonfrivolous) claims that the senior lenders are not properly secured or that the business's assets are worth more than anyone is willing to pay for them.

When the financial affairs of the business are murky, confirming the prenegotiated plan may take time. Sunbeam had to contend with a financial mess left in the wake of Al Dunlop's catastrophic management of the business.[35] From the start, the senior bank group was in control and sought to implement a plan of reorganization in which it received all the equity of the business while the subordinated noteholders and the general creditors were wiped out. Sorting out the finances, regulatory issues with the SEC, and lawsuits with accountants, insurers, and Dunlop, however, took time.[36]

The messy financials gave the subordinated debenture holders some small leverage, which they ultimately converted (through bargaining) into 1.5% of the equity of the business.[37] The dynamic of out-of-the-money junior investors gaining concessions because of their power to raise objections in the bankruptcy court is one that we have seen in corporate reorganizations since the time of the equity receivership. But this power is dramatically smaller. The senior lenders are in

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[31] *See generally* Andrew Backover, *SEC Subpoenas Qwest For Papers Linked To Global Crossing Deals*, USA TODAY, Feb. 12, 2002, at 2B (stating Global Crossing's filing for chapter 11 was largest in telecom sector); Mitchell Pacelle, *Bondholders Near Deal For Control*, WALL ST. J., Apr. 8, 2002, at A4 (discussing impending chapter 11 filing of NTL, one of largest ever corporate workouts).

[32] *See generally* Jonathan Berke, *Distressed-Debt Buyers Back NTL*, DAILY DEAL (New York), May 15, 2002, at Bankrupt (noting pre-arranged nature of chapter 11 filing of NTL).

[33] BANKRUPTCY RESEARCH DATABASE, *supra* note 13.

[34] Of the 25 large businesses that entered with a prepackaged or prenegotiated plan, the median time was 140 days, and only three took more than 300 days. Of the twenty-two that emerged and entered without a plan, only 4 took less than 300 days and the average was over 400. BANKRUPTCY RESEARCH DATABASE, *supra* note 13.

[35] *See* Jonathan C. Dickey & Steven Bucholz, SEC Disclosure, Accounting & Enforcement Conference-Fourth Annual, *After Enron: SEC Compliance, Disclosure and Enforcement Challenges in the New Era*, GLASSER LEGAL WORKS, *3, *23–*24 (Apr. 2002), *at* http://web2.westlaw.com (last visited Apr. 28, 2004) (discussing financial mess Sunbeam faced after Dunlop's shady management); *see also* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 382 (2002) (explaining ruinous management of Sunbeam).

[36] *See* Michael Lauzon, *Sunbeam Plant to Close; Work Will Go Outside*, PLASTICS NEWS, Aug. 4, 2003, at 1 (generalizing financial and logistical difficulties Sunbeam has faced over several year period).

[37] *See Chapter 11 at Twilight*, *supra* note 24, at 679 n.20 (noting how out-of-the-money subordinated debenture holders at Sunbeam were able to extract 1.5% of the equity).

control of the process. Junior creditors now receive less than what equityholders used to receive.

In any event, the time Sunbeam spent having its prenegotiated plan confirmed (almost two years) was more than twice as long as any other large case from 2002. Typical is the six months Guilford Mills spent confirming its prenegotiated plan.[38] In many cases, it does not even take that long to confirm the plan. Chiquita Brands was in and out of chapter 11 in 100 days;[39] McLeod, a telecommunications giant with thousands of employees and almost $2 billion a year in sales, in only 64 days.[40]

In looking at the large chapter 11s of 2002, there is one other striking contrast between these businesses and the railroads reorganized in the 19th century. The railroads generated substantial operating profits. Value would be lost if the railroad did not stay intact. The value of keeping the business intact is far less obvious with businesses in chapter 11 today. To be sure, WebVan's customized warehouses, Iridium's satellite system, and Global Crossing's fiber optic cables have relatively little value if broken up piecemeal. But they may not have much value kept together either.

WebVan's business had no value as a going concern. Its business model could not generate any revenue given the tiny margins in the industry and the competition from conventional grocery stores, WalMart, and other on-line grocery businesses.[41] Iridium's market niche was very small in a world in which it could not compete in price or reliability with ordinary cell phone subscribers in most markets. Its potential market was largely limited to workers on ocean oil drilling rigs, employees of the Central Intelligence Agency, and others with similarly specialized needs.[42] Even in Global Crossing, the value of keeping the assets together has not

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[38] *See* Richard Craver, *Greensboro, N.C., Textile Manufacturer Exits Bankruptcy*, HIGH POINT ENTERPRISE, Oct. 5, 2002, at 1 (reporting Guilfford Mill's emergence from bankruptcy after only six months). *See generally* Alec P. Ostrow, *The Involuntary Chapter 11 Case: Why Don't We Do It In the Gap? (No One Will Be Watching Us)*, 5 J. BANKR. L. & PRAC. 63, 64 (1995) (asserting strategies for spending less time in bankruptcy court); Steven E. Sherman, PRACTISING LAW INSTITUTE: REAL ESTATE LAW AND PRACTICE COURSE HANDBOOK SERIES, *The Problems of Indenture Trustees and Bondholders 1994: Defaulted Bonds, High Yield Issues, and Bankruptcy*, "Overview of Bankruptcy from the Indenture Trustee's Perspective" 337, 367–68 (discussing how prenegotiated plans provide speed and comfort in bankruptcy courts).

[39] *See Chiquita, Fresh Out of Bankruptcy, Issues New Stock*, N.Y. TIMES, Mar. 20, 2002, at C4 (reporting Chiquita's emergence from chapter 11 when judge approved reorganization plan on March 8, 2002, after only filing in late November of 2001).

[40] *See McLeodUSA Inc.*, WALL ST. J., Mar. 29, 2002, at B7 (noting McLeod filed for chapter 11 on January 31, 2002); Henny Sender, *McLeod Offers Test of Chapter 11 in Telecom Sector*, WALL ST. J., June 19, 2002, at C1 (remarking McLeod was in and out of bankruptcy court from late January to mid-April 2002 and stating McLeod's revenue in 2001 to be $1.8 billion); Press Release, McLeodUSA, McLeodUSA Reports Third Quarter 2003 Results (Oct. 22, 2003), http://www.mcleodusa.com/investorRelations/PressArchiveDetails.do?year=2003 (stating company had 3,480 employees in 2003).

[41] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 767 (2002) [hereinafter *The End of Bankruptcy*] (describing failure of WebVan's business plan); Michael Totty & Ann Grimes, *If at First You Don't Succeed…*, WALL ST. J., Feb. 11, 2002, at R6 (citing lack of demand and competition as reasons for WebVan's demise).

[42] *See The End of Bankruptcy*, *supra* note 41, at 767–68 (discussing Iridium's failure in more detail and characterizing it as "[o]ne of the largest business failures in history" in part due to fact Iridium "was a firm

always been self-evident. Global Crossing has to compete in a market in which one can create networks through contract. As long as these contracting costs are low, Global's ability to offer direct connections between Tokyo and London may not be worth much. A pulse of light can be transferred between multiple carriers much more easily than rail freight. The value of what is being preserved by keeping the business intact is much smaller than in the case of railroads.

The difference between the receivership and the large businesses in reorganization today is even more manifest in other large businesses in chapter 11. Outside the telecommunications sector they often lack large infrastructure investments. Some, such as Chiquita Brands and NTL, are holding companies. Their operating subsidiaries were not in chapter 11. Chapter 11 provides a relatively cheap way to put a new capital structure in place, but the value being preserved is only that of the holding company. The worst thing that would happen in the absence of a reorganization would be for the equity of the operating companies to be spread among diverse creditors.

In many other large chapter 11s, particularly those in which there was neither a prenegotiated plan nor an asset sale, the corporation is a collection of discrete businesses, such as movie theaters (Carmike Cinema),[43] nursing homes (Sun HeathCare, Carematrix, and Mariner Post-Acute Network),[44] or hotels (Lodgian).[45] What is at risk is the synergy gained from putting these different discrete businesses under one umbrella. This synergy itself, however, is often of recent vintage. The business itself was formed through the same highly leveraged acquisitions that precipitated the financial distress and the need to reorganize. Unlike a railroad, the synergy that these businesses possess is intangible and often quite small.

Lodgian exploits the synergies that exist when one company runs a Holiday Inn in Myrtle Beach, a Hilton in Fort Wayne, and a Radisson in Phoenix.[46] Independent

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built entirely of assets that had no use in any other configuration"); *see also* David Barboza, *Iridium, Bankrupt, Is Planning a Fiery Ending for Its 88 Satellites*, N.Y. TIMES, Apr. 11, 2000, at C1 (analyzing Iridium's fall).

[43] *See Carmike Cinemas Files Plan for Reworking Debt*, N.Y. TIMES, Oct. 2, 2001, at C4 (stating Carmike Cinemas has 328 theaters in thirty-five states); *Carmike Movie Chain Files for Bankruptcy Protection*, N.Y. TIMES, Aug. 9, 2000, at C3 (reporting Carmike Cinemas filed for bankruptcy protection after it missed $9 million payment to bondholders); *Judge Approves Chapter 11 Plan for Carmike Cinemas*, N.Y. TIMES, Jan. 4, 2002, at C3 (noting Carmike Cinemas won judge's approval of chapter 11 recovery plan).

[44] *See CareMatrix Files for Bankruptcy Protection*, N.Y. TIMES, Nov. 11, 2000, at C3 (reporting CareMatrix and nine of its affiliates filed for bankruptcy); *Nursing Chain Seeks Chapter 11*, N.Y. TIMES, Jan. 19, 2000, at C6 (explaining Mariner Post-Acute Network operates more than 400 nursing homes throughout United States); *Sun Healthcare Group Files for Bankruptcy Protection*, N.Y. TIMES, Oct. 15, 1999, at C4 (stating Sun HealthCare operates "one of the largest nursing home chains in the nation" and provides care at 320 nursing homes).

[45] *See* LODGIAN, INC., 2002 ANNUAL REPORT 1 (2003) [hereinafter LODGIAN 2002 REPORT] (describing how Lodgian's operation includes ninety-seven hotels located in thirty states); LODGIAN, INC., 2001 ANNUAL REPORT 1 (2002) [hereinafter LODGIAN 2001 REPORT] (announcing Lodgian and eighty-one of its subsidiaries filed for bankruptcy); *see also Servico to Acquire Impac Hotel Group in Stock Deal*, N.Y. TIMES, Mar. 24, 1998, at D4 (explaining Lodgian will operate hotels in thirty-five states).

[46] *See* LODGIAN 2002 REPORT, *supra* note 45, at 6–7 (providing list of hotels Lodgian operates); LODGIAN 2001 REPORT, *supra* note 45, at 6–7 (detailing Lodgian's hotel portfolio).

of Lodgian, each enjoys the services various franchisors provide, including national reservation systems and marketing and advertising programs. Lodgian does have something to offer the hotels in addition to what their various franchisors provide. Lodgian can enter into single contracts with food, telephone and software vendors. It can provide centralized accounting, tax, and payroll services. It can help train employees. But the individual hotels are separate corporations that stand on their own. A creditor of Lodgian can foreclose on the equity Lodgian holds in the corporation that runs the Holiday Inn in Richfield, Ohio, and the Holiday Inn still remains a Holiday Inn employing the same people and serving the same community.[47]

When we ask what value Lodgian has that chapter 11 might preserve, we have to identify the value of the business over and above the value of the underlying assets. The hotels employ 5,000 people and generate $400 million of revenue a year, but they are not the locus of Lodgian's value as a going concern. Lodgian proper is a business employing the 118 people in Atlanta who oversee a portfolio of 97 hotels.[48]

Sun HealthCare tells a similar story.[49] It acquired a number of nursing homes and put them under its management. Each nursing facility can stand on its own or, if cut loose from Sun HealthCare, join another. Sun HealthCare takes advantage of the economies of scale that exist from owning multiple homes. Like Lodgian, its problems arose from its aggressive acquisitions in the late 1990s.[50] Its debts were restructured as it encountered financial distress. A group of senior lenders now had a security interest in all its assets. They agreed on a plan of reorganization before the petition was filed, but the plan fell apart when the valuations on which the restructuring was premised proved inaccurate. Creditors argued that the guarantees

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[47] As part of its reorganization plan, Lodgian cast off several hotel properties, including its Holiday Inn in Richfield in Ohio. The new owners of the hotel have maintained its Holiday Inn franchise. *See Chapter 11 at Twilight*, *supra* note 24, at 681 (discussing Lodgian under chapter 11 and stating "creditor[s] of Lodgian can foreclose on the equity Lodgian holds in the corporation that runs [the hotel] and [the hotel] would still remain open for business, employing the same people."). *See generally* Press Release, Lodgian, Inc., Lodgian to Sell Non-Strategic Hotels from Portfolio, Proceeds to Be Used to Pay Down Debt and For Property Renovations (Oct. 17, 2003), *at* http://www.lodgian.com/news/pr10172003a.pdf (last visited Feb. 24, 2004) (describing make-up of Lodgian and noting how they sought to sell off 20% of their hotel portfolio in order to pay off debt and re-invest in remaining properties).

[48] *See Chapter 11 at Twilight*, *supra* note 24, at 682 (providing factual background about Lodgian hotel portfolio). *See generally* Press Release, Lodgian, Inc., Lodgian Completes Financial Restructuring, Names W. Thomas Parrington Interim CEO (May 23, 2003), *at* http://www.lodgian.com/news/pr05232003final.pdf (last visited Feb. 24, 2004) (conveying these facts and more).

[49] *See generally Sun Healthcare Credit*, N.Y. TIMES , Mar. 1, 2002, at Bus./Fin. Desk (describing emergence from chapter 11); Press Release, Sun HealthCare Group Inc., Sun HealthCare Group Emerges from Bankruptcy (Feb. 28, 2002), *at* http://www.sunh.com/Production/AboutSHG/sun_reorgupd.asp (last visited Feb. 20, 2004) (same).

[50] *See* Willaim H. Sudell, Jr. & Eric D. Schwartz, *What's Going on in Delaware?*, 8 AM. BANKR. INST. L. REV. 107, 110–11 (2000) (discussing reasons for coming into financial distress). *See generally* Press Release, Sun HealthCare Group, Inc., Sun Files Joint Plan of Reorganization (Nov. 8, 2001), *at* http://www.sunh.com/Production/AboutSHG/MR-Sun_Reorg_Plan_11-01.pdf (blaming financial difficulties on drastic cuts in Medicare reimbursements and underpayment by state-funded programs) (last visited Apr. 28, 2004).

subsidiaries had given the senior lenders were not supported by reasonably equivalent value and were therefore suspect.[51] In the end, the senior lenders settled on a plan that gave them 90% of the common stock of the business as well as 8 of 9 seats on the board.[52] The ninth seat was the CEO who was hired by representatives of the secured creditors during the chapter 11.

Of all the large cases that concluded in 2002, the one most resembling the traditional chapter 11 was that of Pillowtex, the manufacturer of Cannon and Royal Velvet towels and Fieldcrest sheets and pillows.[53] It cost millions to build the factories, hire thousands of employees, and create all the relationships that made Pillowtex's business work, but these have no value as a going concern in a world in which the towels, pillows, and sheets can be made under the same labels for less off shore. The chapter 11 from which Pillowtex emerged in 2002 only postponed the inevitable. It filed for chapter 11 again in July 2003, and its factories were closed and it remaining assets sold off piecemeal.[54]

Some features of the traditional corporate reorganization are still in evidence. The substantive changes in the rights of real property lessees from the non-bankruptcy baseline are a major component of a number of large chapter 11s, such as Kmart and United Airlines. Even here, however, a new dynamic is at work.[55] The senior lenders are the ones usually in control. Fundamental changes are afoot.

Chapter 11 is performing a new role. During the 1980s, nine of ten large businesses entering chapter 11, crafted a plan of reorganization there, and then

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[51] *See In re* Sun Healthcare Group, Inc., 245 B.R. 779, 783–85 (Bankr. D. Del. 2000) (describing Sun Healthcare's plan of reorganization); *see also Sun Healthcare Says it Reached Agreement to Reorganize Itself*, N.Y. TIMES, Oct. 28, 1999, at B20 (noting Sun Healthcare had reached tentative plan of reorganization as of October 28, 1999).

[52] *See In re Sun Healthcare*, 245 B.R. at 783 (finding Sun Healthcare's reorganization plan included debtors using their cash collateral to pay any party having pre-petition lien in cash collateral with replacement liens of same type and priority); *see also Sun Healthcare Wants to Issue Stock as it Reorganizes*, N.Y. TIMES, Nov. 9, 2001, at C4 (stating Sun Healthcare planned to issue 25 million shares to senior lenders and approximately one million shares to unsecured lenders).

[53] *See Pillowtex Files for Reorganization*, L.A. TIMES, Jan. 3, 2002, at B2 (reporting Pillowtex's plan of reorganization consists of canceling previous shares and distributing to secured creditors new shares of equal value while unsecured creditors would receive combination of new shares and stock options).

[54] *See generally Company Briefs*, N.Y. TIMES, July 21, 2003, at C4 (reporting Pillowtex filed for chapter 11 after failing to find buyer for itself). We see a similar pattern in Glenoit. After leaving bankruptcy, Glenoit moved most of its production to China and used remaining sites in the United States primarily as warehouses and distribution centers. *See generally* Claudia H. Deutsch, *Burlington Made to Order for Investor Seeking a Test*, N.Y. TIMES, Aug. 14, 2003, at C1 (stating Glenoit's ultimate goal was to go public again after recovery).

[55] United's success in making enormous changes in its collective bargaining agreements was due in large measure to the way in which the post-petition lenders were able to impose financial covenants that tied the managers' hands. For an examination of the control creditors now exercise inside and out of bankruptcy see Douglas G. Baird & Robert K. Rasmussen, Corporate Governance, State-Contingent Control Rights and Financial Distress (2004) (unpublished manuscript, on file with author); *see also Chapter 11 at Twilight*, *supra* note 24, at 697–98 (placing board selection in creditor hands if turned over during reorganization). *See generally Evolutionary Theory*, *supra* note 5, at 1391–92 (requiring publicly held firms to obtain direct or indirect consent from each of its creditors when opting out of chapter 11).

emerged intact.[56] In 2002, this was true in fewer than one in four.[57] Today the vast majority of the cases—three-quarters or more—fit the two patterns I have identified. Most often, chapter 11 is merely one way in which a business is sold. It is liquidated or merged with or acquired by another. Alternatively, the bankruptcy judge merely puts in place a restructuring of debt that the major investors have settled upon outside of bankruptcy and the chapter 11 is over within a few months.

Nearly every chapter 11 raises its own set of distinctive issues, but a number of patterns frequently recur. Features commonly found in large financially distressed businesses en route to chapter 11s include the following:

1. As the firm encounters financial distress, creditors realign themselves and shore up their positions. If the business's fortunes continue to decline, a major lender emerges with a security interest in all the business's assets. The board of the corporation may have been largely asleep as conditions declined, but when the picture becomes sufficiently grim, the independent directors wake up. When they do, they are attuned to the fiduciary duties they owe to the creditors. Whatever loyalty they once might have shown to the CEO who picked them quickly evaporates.

   The senior lenders assess the condition of the business. In many instances, new managers are needed to put the business's affairs in order. The first step is often hiring a Chief Restructuring Officer. Several businesses (including Alvarez & Marsal or AlixPartners) specialize in providing such personnel. Once hired, the CRO often goes on to replace the CEO.
2. When the business enters chapter 11, a senior lender becomes the post-petition lender. Covenants in the loan further tighten control over the debtor and the course of the chapter 11. Events of defaults include failure to meet specified financial targets, failure to sell the assets by a specified date, and sometimes even the filing of any motion in the bankruptcy court without its blessing.
3. The sale of the business is the benchmark by which all other options are assessed.
4. Once the restructuring is complete, the senior lenders or the new buyers replace the old board.

The disappearance of the traditional reorganization stems not from changes in the law, but from changes in the economy that have been underway for a long

[56] *See* BANKRUPTCY RESEARCH DATABASE, *supra* note 13.

[57] *See Chapter 11 at Twilight*, *supra* note 24, at 674 n.2 (noting continued decrease in chapter 11 filings). According to the American Bankruptcy Institute, for the twelve-month period ending June 30, 2003, chapter 11 filings, by corporations, decreased 5.2%. *Id.*; *see also The End of Bankruptcy*, *supra* note 41, at 751 (commenting on disappearance of corporate reorganization and how many corporations now use chapter 11 to sell off assets and divide up proceeds).

period of time.[58] The equity receivership of the 19th century railroad was desirable because of a conjunction of a number of different conditions. There was a huge capital investment in a particular business and the assets were worth far more if kept together than if sold off piecemeal. The creditors were scattered across the globe and could not effectively control the railroad or shape its future outside the kind of collective forum that the receivership provided. Finally, the capital markets were not liquid enough to have a sale of the railroad as a going concern.

Any one of these conditions can still exist today, but each is less likely. Moreover, the conjunction of all of them at the same time is increasingly improbable. Most important, the going-concern surplus is less evident now than in the time of the great railroads. Few businesses today center around specialized long-lived assets. In a service-oriented economy, the assets walk out the door at 5:00pm. Today the costs of starting a business are those involved in creating and implementing a business plan. Millions are spent training staff, building a client base, and cementing relationships with suppliers. But these investments are fundamentally different from those involved with building a railroad. The most salient characteristic of a railroad is low operating costs relative to the initial capital investment. Railroads of the 19th century generated at least enough revenue to cover their operating expenses. By contrast, a new business venture may be unable to cover its expenses if it is only just a little worse than a rival business. The hundreds of millions spent trying to establish WebVan were worthless once its business model failed.[59]

Dynamic capital structures take account of the possibility of financial distress. A bank lending group is in control of Sunbeam, Lodgian, and Sun Healthcare before the chapter 11 begins. As creditors gain more control over businesses outside of bankruptcy, they also control its entry into bankruptcy. One can argue that, to the extent that chapter 11 provides benefits to senior lenders, it is appropriate to impose a tax or a toll of some form, especially when those less able to exercise control are likely to receive little or nothing under current law.

But the benefits that chapter 11 brings to senior lenders may not, in the grand scheme of things, be that large. The ability of bankruptcy judges to conduct sales and their willingness to confirm prenegotiated plans means that for several dozen large corporations a year, chapter 11 provides senior creditors a better (if only slightly better) path to a desired end. Moreover, the amount of the going-concern surplus any business possesses puts a natural cap on the tax that senior creditors will

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[58] These ideas are set out in greater detail in *The End of Bankruptcy*, *supra* note 41. *See also* Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. ILL. L. REV. 1, 9–10 (1994) (theorizing changes in economy and bankruptcy law are inherently interrelated).

[59] *See* Linda Himelstein, *Webvan Left the Basics on the Shelf*, BUS. WK., July 23, 2001, at 43 (attributing Webvan's failure to unfamiliarity with grocery business and competitors' greater commercial efficiency and discussing the millions of dollars shelled out up-front). *See generally* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1073 (2003) (positing current business models require high initial investments that only cover primary stage of corporate development).

pay to use chapter 11 and, as noted, in the case of modern businesses, this amount is much smaller than it once was. Finally, we need to recognize that chapter 11 already imposes a "tax" of sorts in large cases. Through such devices as "carve-outs" in dip lending agreements, the senior lenders already pay to use chapter 11.[60] The light the equity receivership casts over chapter 11 has all but disappeared.

II. SMALL CHAPTER 11S

The world of large chapter 11s is utterly different from the world that most bankruptcy judges see, a world in which the typical business has less (often far less) than $100,000 in assets and only one or two employees (if any). While the number of large businesses filing for chapter 11 has increased, the total number of chapter 11s is only half of what it was 20 years ago.[61] Understanding the dynamics of small chapter 11 cases (and these are the overwhelming majority of all chapter 11s) requires, in the first instance, asking how the businesses in financial distress that file for chapter 11 are different from those that do not.

More than 500,000 businesses shut their doors each year. Many more encounter financial distress. Of these, only 10,000 file for chapter 11. A close look at the filings in one bankruptcy court allows us to gain some perspective on the dynamics of these small cases.[62] In the Northern District of Illinois' Eastern

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[60] Bankruptcy Judge Peter Walsh describes such carve-outs as "the price of admission to the bankruptcy court." *See* Letter from Peter J. Walsh, Judge, United States Bankruptcy Court, District of Delaware, to Delaware Bankruptcy Counsel, *Re: First Day DIP Financing Orders*, ¶12 (Apr. 2, 1998) (on file with author & American Bankruptcy Institute Law Review). The professional fees of creditors that are out of the money are sometimes included in the carve-out as well. *See* Irve J. Goldman & Ira B. Charmoy, *Survey of Bankruptcy Cases of Note Decided by the Second Circuit: July 31, 1998–December 1999*, 20 QUINNIPIAC L. REV. 89, 90 (2000) (concluding secured creditors can either agree to carve-out or engage in wasteful litigation as to whether secured creditor would be adequately protected); Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445, 458 (2002) (arguing although carve-outs do not benefit secured creditors, court might require it as condition to creditor receiving chapter 11 benefits); William L. Medford, *Obtaining Attorney Fee Carve-Outs in Cash-collateral Orders: Has Hen House Left Committee Counsel in the Dark?*, AM. BANKR. INST. J., Oct. 2000, at 28 (explaining carve-outs segregate from liens amount sufficient to pay debtor's counsel fees and expenses).

[61] *See Chapter 11 at Twilight*, *supra* note 24, at 699 n.2 (stating number of aggregate chapter 11 filings has fallen in half over last two decades); United States Courts Bankruptcy Statistics, *Table F-3A U.S. Bankruptcy Courts Business and Nonbusiness Bankruptcy Cases Commenced* (listing 21,206 chapter 11 cases filed for 12-month period ended June 1983), *at* http://www.uscourts.gov/bnkrpctystats/MarchBK1986-2003.pdf (last visited Feb. 24, 2004); United States Courts Bankruptcy Statistics, *Table F-2 U.S. Bankruptcy Courts Business and Nonbusiness Bankruptcy Cases Commenced* (listing 10,722 chapter 11 cases filed for 12 month period ended March 2003), *at* http://www.uscourts.gov/Press_Releases/303f2.xls (last visited Feb. 24, 2004); *see also Control Rights*, *supra* note 6, at 942 (noting increasingly large number of large firms filing under chapter 11); Bruce A. Henoch, *Postpetition Financing: Is There Life After Debt?*, 8 BANKR. DEV. J. 575 (1991) ("Although the number of petitions filed under chapter 11 . . . has decreased since the mid-1980's, the size of the companies filing has increased dramatically.") (internal citations omitted).

[62] Edward Morrison compiled a database and analyzed the filings in the Bankruptcy Court for the Northern District of Illinois, Eastern Division. The database is on file with the author [hereinafter MORRISON DATABASE]. This database was first used by Edward Morrison to examine how bankruptcy judges made shutdown decisions. See Edward R. Morrison, Bankruptcy Decision-Making: An Empirical Study of Small Business Bankruptcies (dissertation, University of Chicago, August 2003) (on file with author) [hereinafter

Division, 99 businesses filed for chapter 11 in 1999. Some (but no more than one in three) are qualitatively similar to the large chapter 11 cases discussed in Part I. A restaurant/microbrewery is sold as a going concern, as is a chain of Mrs. Field's cookie franchises and a hotel. Senior lenders use chapter 11 to sort out the problems of two sub-prime consumer finance companies. A carpet retailer with several stores shuts down. A manufacturer of furnace linings sorts out its asbestos liabilities in chapter 11.[63]

There are some differences between these cases and the mega-chapter 11s. Fewer emerge as stand-alone entities. The most valuable part of the business may be an asset—such as a magazine or a software program—that stands alone. A direct mail advertiser with 190 employees is sold to another business and is merged into it. In mega-cases, the appointment of a trustee is virtually unheard of. Senior creditors use their power to force the appointment of a CRO. In small chapter 11s, creditors still do push for the appointment of a trustee when bad behavior comes to light.[64]

These businesses, however, have a crucial feature in common with mega-cases. The business and the corporate entity largely overlap. A nexus of contracts and relationships center on the corporate entity. At first approximation, someone who buys a controlling interest in the stock owns the business. A cattle feed manufacturer does business in corporate form. If I buy a controlling interest in the equity of the corporation, I become the owner of this business. I acquire not merely the hard assets, but the economic benefits that flow from the many contracts of the business and the many relationships it has developed over the years. These range from the loyal customers to the dependable suppliers, as well as all of the intellectual property, from the patents to the business methods that are embedded in the day-to-day habits of supervisors that are passed down informally from one generation to the next.

But these cases are only a minority of the operating businesses that file for chapter 11. As businesses become smaller, less of it centers on the corporate entity. Instead the affairs of the business revolve around its owner-manager. In the largest of these, the business and the owner-manager can still be distinguished from each other. We find an entrepreneur who built a business, such as a chain of jewelry stores or a contractor who specializes in ornamental plaster work, with a solid track record. The business has an identity distinct from the owner-manager. The owner-

Morrison Dissertation]. A draft of this paper can be downloaded and is available at http://ssrn.com/abstract=461031 (last visited Apr. 6, 2004).

[63] *See* MORRISON DATABASE, *supra* note 62.

[64] Modern trustees, however, conduct going-concern sales when it will fetch the highest price. *See generally* United States v. Schilling (*In re* Big Rivers Elec. Corp.), 355 F.3d 415, 422 (6th Cir. 2004) ("In a Chapter 11 case, a trustee replaces the debtor in possession and takes immediate control of the business and the reorganization effort."); *In re* Intercat, Inc., 247 B.R. 911, 920–21 (Bankr. S.D. Ga. 2000) ("[I]n the appropriate case, the appointment of a trustee is a power which is critical for the court to exercise in order to preserve the integrity of the bankruptcy process and to insure that the interest of creditors are served."); Barry L. Zaretsky, *Trustees and Examiners in Chapter 11*, 44 S.C. L. REV. 907, 910 (1993) (stating role of trustee is to represent estate and often to investigate and act more credibly than debtor or committees).

manager could turn over the reins to someone else and the business, while not the same, might still continue.

The business lands in chapter 11 even though there is a core that may be sound. The jeweler overestimates his ability to expand. He opens new stores that fail, and the remaining ones are not profitable enough to cover the losses. The contractor's estimate for renovating the concert hall of the Chicago Symphony Orchestra is off by $600,000. Notwithstanding these reverses, there is still synergy among the assets. The businesses have well-established reputations, trained staffs, and successful business plans. Unlike the large businesses, however, a going-concern sale is less attractive.[65] They need to scale back, and, as they scale back, the business increasingly turns on the owner-manager.

These businesses that lie just at the fringe of where a going-concern sale is possible can be most comfortably reconciled with traditional accounts of corporate reorganizations. Notwithstanding the reverses it has suffered, there is a core business that may survive if its current owner-manager remains in place. These businesses, however, are a distinct minority of those in chapter 11. They constitute perhaps only one in ten. Even this overstates matters. In some cases, the chapter 11 is precipitated not by a need to sort out a financial mess with multiple creditors, but rather to alter the dynamics of negotiations with a single creditor. In one case, for example, the chapter 11 filing came minutes before a former waitress at a successful steakhouse was about to begin her sexual harassment suit in District Court. The chapter 11 was entirely consumed with negotiating an end to this suit, as well as a racial discrimination action one of the cooks brought.[66] In other cases, the dispute is with a single landlord. The negotiations that take place in chapter 11 could take place elsewhere.

These two types of cases—the larger business that can be sold as a going-concern and the substantial business with crucial owner-manager—are not, however, what we usually encounter in the typical chapter 11. Instead, chapter 11 most often involves much simpler businesses. We have a travel agent or insurance broker who does business in corporate form. There are no employees. The business is run out of the home.[67] The assets consist of little more than a telephone and a personal computer. The business has little connection with the corporate entity. The relationships belong to the individual. If you were happy with the work performed last year and wanted to use the same person again, you would be indifferent to the existence of the corporation. You might reengage her without

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[65] *See Chapter 11 at Twilight*, *supra* note 24, at 687 (stating financially distressed businesses usually do not have any going concern value but if they do sale of business is best way to preserve it). The non-bankruptcy sales of these businesses typically include promises from the old owner-manager to aid in the transition, as well as covenants not to compete. *See* Robert F. Reilly, *Valuation-Big Businesses vs. Small Businesses*, AM. BANKR. INST. J., Sept. 1995, at 29, 30 (finding smaller financially strained corporations will usually include transitional employment agreements as well as non-compete pacts).

[66] *See* MORRISON DATABASE, *supra* note 62.

[67] *See Chapter 11 at Twilight*, *supra* note 24, at 688 (noting typical small business is where there are no permanent employees); *The End of Bankruptcy*, *supra* note 41, at 752–53 (stating typical chapter 11 case involves small business with little hard assets and few permanent employees).

ever knowing that she was doing business in corporate form or that the corporate form she is using this year was different from the one she used last year. The business's intangible assets reside in expertise that the individual possesses. Creditors have no way of reaching it.[68]

For such businesses, the financial failure of the corporation has virtually no effect on the future of the business. The consultant continues to land new jobs. Garden-variety creditors of the corporation have no recourse against her. New customers have no connection with the old corporation. Its failure, of course, may provide information about the ability of the consultant going forward, but the survival of the corporate entity or the fate of anyone who dealt with it is a matter of no consequence to new customers.

The complete separation between the business and the corporation explains why so few corporations that encounter financial distress file for chapter 11. The consultant needs to sort out the affairs of the corporation, but she does not need the corporation to continue her consulting businesses. When the business has no assets, it may be easier to start with a clean slate. What is true for the consultant applies equally to slightly larger businesses. The same group of psychologists can reincorporate, rent new offices, and continue to see the same patients. The creditors will realize the futility of trying to realize anything from several pieces of used furniture or the patients who have not paid the bills they owe to the old corporation.

A substantial number of the businesses in chapter 11 are those of travel and insurance agents, lawyers, chiropractors, undertakers, livery drivers, and other self-employed individuals whose businesses require few assets beyond a car, a desk, and a cell phone. Another substantial group are building contractors. The dry wall contractor, the plumber, the painter, and the electrician often work out of their home. They are likely to hire workers for particular jobs. Beyond a small office staff, they have no permanent employees. The assets they need to do their work again cost just a few thousand dollars.

Most of the businesses in chapter 11 file schedules that list assets worth less than $100,000. Moreover, the value of the assets as scheduled are usually inflated. They include uncollectable accounts receivable. Equipment is listed at book value. Assets include security deposits even when they are less than the rent arrearages. Lawsuits are valued at the amount set out in the prayer for relief. In addition, the owner-manager does not need all the assets to continue working. An excavator whose corporation owns heavy earth-moving equipment can start another business

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[68] *See The End of Bankruptcy*, *supra* note 41, at 754 (recognizing proprietary business methods as common intangible assets in service-based economies); *see also* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 174 (1989) (remarking on substantial non-pecuniary and sentimental investments made by owner-manager in small business). The corporate form does little more than partition assets. In the first instance, the corporation partitions assets. The creditors of the corporation cannot reach the home or the personal bank account of the consultant. On the other hand, these same creditors know that if the corporation has an account receivable, they will be able to reach it before either the consultant or the painter or any of their own creditors. *See* Henry Hansmann & Reiner Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 393–94 (2000) (describing liability and protections of asset partitioning in typical corporate entity).

and rent the equipment. The seller of plastic parts can lose the equipment but continue to do business by subcontracting out the actual fabrication.

Most of the corporations that file chapter 11 petitions are "human capital firms."[69] The "firm" and the person running it are indistinguishable. The nexus of relationships and the organization of production revolve around the owner-manager. The travel agent will continue to be a travel agent and the electrician will continue to be an electrician. They will have the same business opportunities and employ the same people, regardless of what happens to the corporation in chapter 11.

For many small businesses, chapter 11 has only a modest effect on the ability of its owner to continue running the same kind of business. She continues doing the same thing regardless of what happens in the chapter 11, employing the same people and servicing the same customers. The firm often continues *even when the chapter 11 fails*. The data from the Northern District of Illinois illustrates this point. Of those cases in which the chapter 11 petition is dismissed or converted, the owner-manager continues running the same or related business in at least 40% of the cases. More precisely, in more than 40% of the cases the old owners start a new corporation, continue to run another corporation they already owned, or, notwithstanding the conversion or dismissal, strike some kind of deal with their creditors that allows them to remain with their existing business.[70] Not included are those who remain entrepreneurs, but run sole proprietorships or incorporate outside of Illinois. Nor does it take account of those who are unable to run a business for reasons unrelated to the bankruptcy. (At least one of the owners in the sample was put in prison.) Nor does it include those who start a new business in an unrelated field. Nor does it include the half dozen or so who had failed in numerous other businesses in the field and had previous encounters with chapter 11. Even when the business is a restaurant and relatively capital intensive, more than a third still run their own restaurants shortly after their unsuccessful use of chapter 11.

In such cases, chapter 11 is not so much about saving businesses as it is about enabling a handful of the millions of self-employed to sort out their finances. In 80% of all chapter 11s, the owner-manager has guaranteed a loan from its institutional lender or has become personally liable for unpaid taxes.[71] Both these obligations prevent the owner-manager from just walking away from the old business before starting a new one. Chapter 11 buys time, even if the case is ultimately dismissed. The owner-manager gains two or three months during which she can hang on to her existing office and try to preserve the status quo while identifying other options. More importantly, chapter 11 creates an environment in

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[69] *See* Douglas G. Baird & Edward R. Morrison, The Human Capital Firm, (unpublished manuscript on file with authors).

[70] *See* MORRISON DATABASE, *supra* note 62.

[71] *See id.; see also* Douglas G. Baird, *Security Interests Reconsidered*, 80 VA. L. REV. 2249, 2263–66 (1994) (discussing institutional lenders as creditors of small businesses); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 7 (1996) (noting bank loans to businesses are normally conditioned on personal guarantees from owner-managers).

which creditors—particularly the IRS and other tax authorities—are willing to compromise their claims.[72]

The cost of providing this benefit falls largely upon the trade creditors and small-time landlords. The filing of the petition cuts off trade creditors from the business's income stream[73] and the automatic stay prevents landlords from reentering the premises.[74] In contrast to tax authorities and institutional lenders, they lack the personal recourse against the owner-manager. Hence, their negotiating positions in chapter 11 are weak.

In short, when we look at chapter 11s as a group, we see little that fits the conventional stereotype of a process that allows viable businesses to survive as stand-alone entities. In the case of the largest businesses, sales of the entire business are common. The overwhelming majority of the remaining cases involve self-employed individuals who can remain self-employed regardless of what happens in chapter 11. The justification for chapter 11 in these cases must come from the value we attach to making their paths somewhat easier. These benefits, however, are sufficiently modest that any justification of chapter 11 must also take account of its costs.

A. *The Costs of Small Chapter 11s*

The costs of chapter 11 are smallest when those who use it emerge and continue as viable businesses. In the Northern District, four in ten businesses emerge from chapter 11 as operating businesses.[75] Most emerge intact under a traditional plan of reorganization. The rest are sold as going concerns or were dismissed after the debtor settled all of its outstanding disputes with creditors.[76] A third of these

[72] *See* IRS v. Energy Res. Co. (*In re* Energy Res.), 871 F.2d 223, 231 (1st Cir. 1989) (describing lack of any limits in Bankruptcy Code in regards to court's power to allocate when creditor is IRS and further noting Congress' "recognition of the compromise nature of Chapter 11's tax debt policy"); *In re* Macher, 303 B.R. 798, 801–02 (W.D. Va. 2003) (holding court order towards IRS to consider offer to compromise is valid exercise of Bankruptcy Court's broad equitable powers); *see also* Ginny Y. Chung, Note, *Taxing Times Ahead: The Impact of the Cottage Savings Regulations on Debtors and Creditors in Workouts*, 12 BANKR. DEV. J. 245 288–89 (1995) (discussing IRS policy to accept offers to compromise when it is beneficial to both IRS and taxpayer).

[73] *See* 11 U.S.C. § 362(a) (2002) (protecting debtor from enforcement of claims and judgments before filing date); *see also In re* Dennis, 17 B.R. 558, 560 (Bankr. M.D. Ga. 1982) (announcing Congress's intent to stop all collection efforts during the automatic stay period); John C. Murray, *The Lender's Guide to Single Asset Real Estate Bankruptcies*, 31 REAL PROP. PROB. & TR. J. 393, 409 (1996) (discussing protection of franchise income after filing for current management).

[74] *See* 11 U.S.C. § 362(a)(3) (preventing any act to obtain possession or exercise control of property after filing petition); *see also* Robinson v. City Hous. Auth., 54 F.3d 316, 317–18 (7th Cir. 1995) (stating stay protects debtor's lease interest, including preventing landlord's use of state eviction proceedings); *In re* Kilby, 100 B.R. 579, 581 (Bankr. M.D. Fla. 1989) (holding landlord in willful violation of section 362 upon attempting to retake possession of leased property).

[75] *See* MORRISON DATABASE, *supra* note 62.

[76] *Id*. It is not easy to tell whether the number of surviving businesses seen here is typical. Most empirical studies do not distinguish operating business in corporate form that enter chapter 11 and those that were never operating businesses (such as single-asset real estate cases) or are cases of individuals. Moreover, they do not differentiate between reorganizations in which the business continues in operation and those in which

businesses did spend more than a year in chapter 11. But the time these businesses spend in chapter 11 is not itself problematic. Sometimes, all that is at issue is the formal closing of the chapter 11 case, a bookkeeping entry of little consequence. The length of the proceeding does not matter if the sale of the business to a third party takes place quickly and the remainder is spent sorting out who gets what. Little may be at stake even when the old owner-manager is staying in place. The businesses themselves require neither new investment nor change of strategic direction. The travel agent or the Subway sandwich shop continues to do business as usual.

When we examine the 60% of the remaining businesses, the ones that do not emerge successfully, most striking is the speed with which these cases are dismissed. More than half the time, the bankruptcy judge dismisses the case or converts it to chapter 7 within three months of the filing of the petition. More than three-quarters are dismissed or converted within 5 months. We do not see the owners of small businesses in hopeless condition use chapter 11 to drag out the inevitable for very long. The creditors and the United States Trustee control the process.[77] The failed businesses that last the longest are usually the ones where there is the most uncertainty about the debtor's prospects. In some cases, the bankruptcy judge takes longer to act because active criminal fraud on the part of the debtor makes the business's true state harder to discern.[78]

The benchmark by which to judge the bankruptcy system in small cases is not the sheer numbers saved, but the ability to sort effectively and quickly. Most

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the plan calls for its piecemeal liquidation. Going-concern sales are sometimes scored as liquidations. *See* Md. v. Hechinger Liquidation Trust (*In re* Hechinger Inv. Co.), 335 F.3d 243, 260 (3d Cir. 2003) (listing four potential chapter 11 plan formation scenarios, one being that "[t]he debtor may . . . transfer all of its properties via a going concern sale authorized by a confirmed plan--a liquidating plan."); c*f. In re* Payless Cashways, Inc., 290 B.R. 689, 692 (Bankr. W.D. Mo. 2003) (observing typically "[a] business is a going concern if it is operating, unless it is on its deathbed.").

[77] *See* 28 U.S.C. § 586(a)(3) (2002) (elaborating on duties of United States Trustee); 11 U.S.C. §§ 1103(c), 1106(a) (2002) (same and detailing creditors' authority); Hon. Steven W. Rhodes, *Eight Statutory Causes Of Delay And Expense In Chapter 11 Bankruptcy Cases*, 67 AM. BANKR. L.J. 287, 308–09 (1993) (stating "the United States trustee has complete discretion in determining whether and how to act to advance the goals of case management" and "[a] creditor may file a motion to dismiss or convert, a motion to appoint a trustee, and, after the debtor's exclusive period expires, a reorganization plan."); *see also* Morrison Dissertation, *supra* note 62, at 41–42 (attributing efficiency of Seventh Circuit's Northern District Bankruptcy courts in part to fact that "[a]lone among the bankruptcy courts, the Northern District permits the parties to a case to schedule motions" and "also uniquely, motions are presented orally to the judge, who typically renders a decision by the end of the hearing."). The bankruptcy judge will not act unless a motion is put before her. The timing of the motion is up to the creditors. Some dismissals come later than otherwise only because the creditors are content to continue negotiations with the debtor in chapter 11, rather than pursing it outside. *See generally In re* NRG Energy, Inc., 294 B.R. 71, 85 (Bankr. D. Minn. 2003) (revealing involuntarily chapter 11 bankruptcy forced because very small creditors felt "their interests were not being recognized or heeded in negotiations that were well underway").

[78] For example, hiding $5 million liability. When such activity is found, a trustee is appointed within days. *See, e.g.*, Craig Peyton Gaumer, *Civil Remedies for Bankruptcy Fraud*, AM. BANKR INST. J., July–Aug. 2000, at 8 (noting discovery of debtor fraud in chapter 11 allows creditor to request immediate trustee appointment). *See generally* 11 U.S.C. § 1104(a)(1) (2002) (stating "court shall order the appointment of a trustee . . . for cause, including fraud" at any time prior to plan confirmation).

important is identifying those cases in which the debtor is only playing for time. The evidence from the Northern District suggests that bankruptcy judges can do this job exceedingly well. Indeed, the data are consistent with the conjecture that bankruptcy judges perform this job as well as a market actor subject to the same constraints.[79] The bankruptcy judges seem to rely on several rules of thumb that are good proxies for businesses that can continue as going-concerns. These include:[80]

1. *The 13 O'Clock Rule.* When a clock strikes thirteen, you know both that the clock is broken and that you have to doubt anything it has told you before. Judges are likely to dismiss or convert if those running the debtor firm have made any misrepresentation to the court or have violated a court order, particularly with respect to cash collateral. What matters is not only the seriousness of the violation, but that other misdeeds, as yet undiscovered, may exist as well.
2. *The Cash-flow Rule*. The judge does not regularly receive regular financials from firms in chapter 11, but she will receive statements that show how much cash has come into the business and how much has left. A business that remains cash-flow negative for more than a few months is not likely to make it.
3. *The Two-Strikes-and-You're-Out Rule*. A debtor in bankruptcy must cut square corners. If it fails to file a schedule, miss a section 341 meeting, or fail to pay a fee, the United States Trustee will move for conversion or dismissal. The judge will forgive a single misstep if the debtor's owner-manager quickly appears in court and is sufficiently repentant. But the debtor will not get a second chance.
4. *The Meet-Your-Own-Goals Rule.* At the status conference, the debtor will often put forward the goals that it expects to meet (e.g., a new investor will be found by a particular date). If this goal is not met and major players oppose the debtor's effort to push it back, the bankruptcy judge sees the failure as a red flag, a sign that the firm is not on the path to being reorganized effectively.

Anecdotal evidence from other bankruptcy courts suggests one additional heuristic may also be at work: *The Company-You-Keep Rule*. Bankruptcy judges

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[79] Edward Morrison was the first to put forward this conjecture. Morrison's subsequent test of his conjecture and the statistical techniques he develops along the way (including use of cure models) represent the state of the art in empirical bankruptcy research. *See* Morrison Dissertation, *supra* note 62, at 33–37 (explaining duration and discrete choice models: biostatistical "cure" model, continuous-time real options model and three-period matching model of judicial decision-making); *see also* Douglas G. Baird & Edward R. Morrison, *Bankruptcy Decision-Making*, 17 J. L. ECONS. & ORG. 356, at 367 (finding empirical evidence suggest judges can and do make shutdown decisions well).

[80] The use of such proxies (or "heuristics") is a standard part of expert decision-making. *See* GERD GIGERENZER ET AL., SIMPLE HEURISTICS THAT MAKE US SMART (Oxford Univ. Press 1999) (suggesting theory of "bounded rationality" as key to understanding psychology of decision-making); *see also* Owen D. Jones, *Time-Shifted Rationality and the Law of Law's Leverage: Behavioral Economics Meets Behavioral Biology*, 95 NW. U. L. REV. 1141, 1171 (2001) (citing Gigerenzer as authoritative regarding novel theories of legal decision-making).

may take their cue from the identity of the debtor's lawyer. When lawyers appear frequently before the same court, they develop reputations. Some may be inclined to take on cases that have no merit.[81]

The excellent record of judges in the Northern District of Illinois is likely to be found elsewhere. There are no important differences between the Northern District and other bankruptcy courts. The experience of the judges and the types of cases are largely the same. The biggest difference lies in the unusual motions practice of the Northern District. Parties schedule their own motions. Judges have weekly court sessions on which they will hear every motion filed in any chapter 11 case on their dockets. A creditor that properly serves the debtor and the other relevant parties on Friday will have its motion heard the next Tuesday. This motions practice allows parties to bring matters to the bankruptcy judge's attention more quickly. Moreover, because every motion must be presented to the judge in open court, frivolous motions come at a higher cost. Courts that have a different motions practice (such as one in which the onus is put on another party to demand a hearing) may be less effective. But in this event, the success of the Northern District may be easy to replicate. In any event, the experience in the Northern District suggests the focus of bankruptcy reform in small cases needs to be redirected.

Some proposed reforms put a cap on the time any small business chapter 11 can take. Others focus on limiting the discretion of the bankruptcy judge. Both miss the mark. A solution that imposes a cap on the length of all chapter 11s is likely to be wholly ineffective. Proposed caps are in the range of six months or more. Such a cap is already long past the time when the overwhelming majority of the businesses that do not belong in chapter 11 can be thrown out.

More to the point, such rules betray a lack of situation sense. The modern bankruptcy bench has no desire to see debtors who are merely trying to put off the inevitable. Bankruptcy judges show little tolerance for losers once identified. The experience in the Northern District suggests the problem with current law is not entrusting the bankruptcy judge with too much discretion. The challenge instead is ensuring that motions get to her soon enough so that she can act on her instincts.

The current system, even as practiced in the Northern District, does leave some room for those who cannot successfully reorganize to remain under the radar screen for a short period of time. The bankruptcy judge can do nothing until a motion is brought before her. She can enjoin known recidivists from refiling, but little more. In most cases, a debtor can file a frivolous chapter 11 petition, and it will take some time for the creditor or the United States Trustee to find out about it, file a motion, properly notice the parties, and appear in court. In the absence of some emergency, the process takes several weeks. Pushing such cases through the system more quickly would itself require additional oversight. It is not at all obvious whether the benefits from running the process would be worth the costs.

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[81] *But see, e.g., In re* Allegheny Int'l, Inc., 117 B.R. 171, 179 (W.D. Pa. 1990) (commenting on independence of case outcomes from qualifications of well-known lawyers).

B. Costs and Benefits of Small Chapter 11s

Academic discussions of small chapter 11s have focused on its low success rate and the opportunities it offers for delay. In fact, the number of businesses that reorganize successfully today is significantly higher than commonly supposed. Among other things, standard estimates omit going-concern sales and successful negotiations in which businesses emerge intact without confirmed plans. Moreover, the ability of debtors to use chapter 11 to stall is often overstated. They can remain under the bankruptcy judge's radar screen for a few weeks or months, but not longer.

What is missing in the current debate is a more direct focus on the benefits chapter 11 is providing in the typical case. In the overwhelming majority of cases in which there is not an asset sale, chapter 11 is not about saving businesses or preserving jobs. The typical chapter 11 makes it marginally easier for 10,000 of the six million self-employed individuals in this country to remain self-employed after the business defaults on loans they have personally guaranteed or the business fails to pay taxes for which they are personally liable. Again, the question is not whether they will remain self-employed, but how easy it will be for them to do so. The person who runs the small trucking business or the boat repair shop will likely continue running these businesses with or without chapter 11.

III. BANKRUPTCY'S GUARDIANS

The first two parts of this paper described the current state of corporate reorganizations. Modern bankruptcy judges have become effective and highly competent professionals. In the large case, the bankruptcy judge is the Delaware Chancellor, the superbly professional magistrate who oversees a market for corporate control and ensures that it works effectively. In small cases, the bankruptcy judge is the triage officer who quickly decides which businesses can make it and which cannot. In neither, however, does the bankruptcy judge actively administer the case. She acts only when a party files a motion or makes an objection. Negotiations remain the lifeblood of bankruptcy, and practices evolve out of view to the bankruptcy judge. They are largely invisible to the appellate courts that interpret the Bankruptcy Code. The disputes that generate reported opinions are outside the mainstream, and these interpretations of the law are often out of sync with long-standing practice.

Blackletter law tells us that trustees are to be appointed "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor."[82] But trustees are rarely appointed in large cases. We have seen some of the greatest corporate frauds in history land the company in bankruptcy court in the

[82] 11 U.S.C. § 1104(a)(1) (2002); *see, e.g.*, Bellevue Place Assocs. v. Caisse Centrale Des Banques Populaires, No. 94-C-5089, 1994 U.S. Dist. LEXIS 17409 (N.D. Ill. Dec. 6, 1994) (affirming appointment of trustee based on section 1104(a)(1)).

last few years, yet we see no trustees being appointed. Enron, WorldCom, and Adelphia continue under the control of the debtor-in-possession. The chief restructuring officer (CRO), a creature that does not exist in either the Bankruptcy Code or reported decisions, has displaced the trustee. The lenders who control the reorganization prefer this mechanism to curb abuse to the one the trustee would provide.

Another illustration of the divergence between practice and theory revolves around interpretations of section 1125 and the dynamics of large corporate reorganizations. Section 1125 prevents parties from engaging in "solicitation" of acceptances or rejections before the court has approved a disclosure statement.[83] Ordinary trade creditors and public investors are in no position to know the true financial condition of the debtor. By providing them with a disclosure statement before asking them to vote on a plan, the Bankruptcy Code helps them make sensible decisions.

The contours of section 1125 are straightforward. A party cannot circulate a draft disclosure statement to all creditors, informed and uninformed alike, if the draft will have the effect of fixing in place the views of the less sophisticated.[84] If the draft renders many small trade creditors incapable of later evaluating the approved disclosure statement on its own terms, circulating the draft is a "solicitation" within the meaning of section 1125.[85] By the same measure, parties should not be able to solicit acceptance of their own plan under the pretext of soliciting a rejection of some other plan. It is one thing to point out deficiencies in the debtor's plan. It is quite another to focus unsophisticated creditors' attention on another, unreviewed, plan, and tell them that to vote in favor of it, they must first reject the plan before them. Solicitations must be directed to the plan that is on the table, not to some other.[86]

These principles are not controversial. A creditor can freely discuss a draft plan of reorganization with the creditors' committee and can consult with other professional investors without fear of violating section 1125. You can urge

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[83] *See* 11 U.S.C. § 1125(b) (2002):

> An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information. The court may approve a disclosure statement without a valuation of the debtor or an appraisal of the debtor's assets.

Id.

[84] *See id*. *See generally In re* Farmland Indus., Inc., 286 B.R. 888, 892 (Bankr. W.D. Miss. 2002) (noting compliance with Bankruptcy Code procedure as integral).

[85] *See generally* 11 U.S.C. § 1125(e) (2002) (stating solicitation for acceptance or rejection of plan must be made in good faith); Century Glove, Inc. v. First Am. Bank of N.Y., 860 F.2d 94, 97, 102 (3d Cir. 1988) (requiring proper solicitation, made in good faith, only after creditor receives "adequate information" which has been approved by the court).

[86] *See In re* Temple Ret. Cmty., Inc., 80 B.R. 367, 369 (Bankr. W.D. Tex. 1987) (reasoning particular solicitation was invalid because it was alluding to future plan and not present plan).

creditors to vote against a plan on the ground that other courses of action provide them with a better pay-off.[87] On the other hand, a competitor that has been in litigation with the debtor for many years should not think it has license to distribute a letter extolling the virtues of its own plan under the guise of soliciting rejection of the debtor's plan.[88] Drawing the line between these two kinds of activities might seem hard, but it has not been.

Section 1125, however, does not mesh well with the way in which deals are negotiated inside of bankruptcy. Indeed, it seems to limit the ability of sophisticated investors to strike deals with each other once the bankruptcy petition has been filed. As noted in Part I, one in four large firms enter chapter 11 only after the debtor reached general agreement with key creditors about the plan of reorganization. Many of the creditors will have already bound themselves to support a particular plan. Nonbankruptcy law permits such lock-up agreements.[89] By contrast, once the case is filed, section 1125 by its terms seems to prohibit them until the court has approved a disclosure statement.[90]

One-on-one discussions with another stakeholder rarely generate controversy, even if the communication is a draft plan. Negotiations per se are unproblematic. Nor do you violate section 1125 by obtaining informal assurances from a creditor to support your plan. But such informal assurances are sometimes not enough. The holder of a particular claim may be a bank today and a vulture investor tomorrow. Ensuring that you can rely next month on the support you garner this week by

[87] *See Century Glove*, 860 F.2d at 100–01 (expressing once adequate information is presented communication is not limited between creditors thus negotiations about unfilled plan is not barred); *In re* Aspen Limo Serv., Inc., 198 B.R. 341, 348 (D. Col. 1996) (agreeing creditors are free to engage in open negotiations and are not generally required to receive court approval for solicitations of acceptance or rejection of another's plan once adequate information has been provided); *In re* Gulph Woods Corp., 83 B.R. 339, 342–43 (Bankr. E.D. Pa. 1988) (pressing oral communication between interested parties should not be prohibited as creditors are smart enough to read materials at their disposal and decide how to vote).

[88] *See* Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (*In re* Figter Ltd.), 118 F.3d 635, 639 (9th Cir. 1997) (stating bad faith indicated by ulterior motive, which includes purpose of destroying enterprise by advancing interests of competing business); *see also In re* Crosscreek Apartments, Ltd., 211 B.R. 641, 643–44 (Bankr. E.D. Tenn. 1997) (explaining good faith standard determination made after taking all relevant facts into account including creditor's self interest); *In re Aspen Limo Serv.*, 198 B.R. at 345, 347–48 (mentioning parties should proceed with caution when presenting information with purpose of proposing competing plan).

[89] Non-bankruptcy law, of course, does impose limits. For example, lock-ups are impermissible to the extent that they limit the ability of a firm's directors to exercise their fiduciary duties at some later time. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936 (Del. Sup. Ct. 2003) (noting contract invalid and void to extent it requires board action limiting exercise of fiduciary duty); Ace Ltd. v. Capital Re Corp., 747 A.2d 95, 105 (Del. Ch. 1999) (inhibiting board from exercising fiduciary duty renders provision invalid and unenforceable). In bankruptcy, the general obligation of the directors to act in a way that maximizes the value of the estate entirely supplants this duty.

[90] Only recently, however, have courts squarely questioned this well-established practice. In an unreported decision in *NII Holdings Inc*., for example, Judge Mary Walrath, of the Bankruptcy Court for the District of Delaware, saw as completely unproblematic a lock-up agreement executed just before bankruptcy, but struck down the same agreement entered into by a different creditor just after the filing. Daniel J. DeFranceschi, *Delaware Bankruptcy Court Announces Bright-Line Rule for Use of Lock-Up Agreements in Chapter 11 Cases*, AM. BANKR. INST. J., Feb. 2003, at 16 (indicating necessary to have fully executed lock-up agreements in hand prior to filing case if want to use lock-up agreements in pre-negotiated case).

obtaining a writing that binds the party is useful. But obtaining a binding commitment to vote in a particular way is not "negotiating."

Some courts have found that obtaining binding post-petition agreements to "support" a plan of reorganization fall short of a "solicitation" within the meaning of section 1125.[91] In their view, "solicitation" refers only to the formal voting process itself.[92] Section 1125 does not affect settlements that parties reach, even when those settlements include stipulations that oblige a creditor to support a particular plan.[93] Such an interpretation is completely consistent with the spirit behind section 1125. The sophisticated professionals who are parties to these agreements are equally well-informed. We have big boys on both sides on the agreement. They do not need the protections that a disclosure statement is intended to provide.

But you should not assume that all courts will incline to this view. The leading case on section 1125 distinguishes between "negotiations" and "solicitations,"[94] and lawyers have tried to shoehorn (often unconvincingly) binding agreements into the category of "negotiation." Instead, they may be better off arguing that, rather than a "solicitation," what they have is a "settlement." But in no event can one obtain a binding commitment with complete confidence in a contentious chapter 11. A court approaching section 1125 for the first time can easily reach the conclusion that you need to get a disclosure statement approved before you can ask someone to make a binding commitment to vote in favor of your plan. The statute provides no safe harbors for either "negotiations" or "settlements." Such an interpretation of section 1125 may run counter to some practices that have emerged in recent years and be inconsistent with sensible bankruptcy policy, but some courts, especially appellate courts, have little sympathy for interpretations of the Bankruptcy Code that are out of step with what seems the plain language of the statute.[95]

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[91] *See, e.g.*, *Century Glove*, 860 F.2d at 101 ("We agree with the district court that 'solicitation' must be read narrowly."); *In re* Kellogg Square P'ship, 160 B.R. 336, 340 (Bankr. D. Minn. 1993) ("However, there is no significant reason not to apply *Century Glove's* rationale to the debtor in reorganization, so as to limn [sic] the concept of 'solicitation' as coeval with the formal polling process."); *see also In re* Texaco Inc., 81 B.R. 813, 816 (Bankr. S.D.N.Y. 1988) (finding agreement not to support other future plans is not solicitation to reject current plan).

[92] *See, e.g.*, *In re Texaco*, 81 B.R. at 816 ("Section 1125(b) relates to the voting process with respect to filed plans."); *In re* Snyder, 51 B.R. 432, 437 (Bankr. D. Utah 1958) ("The terms 'solicit' and 'solicitation,' as used in section 1125(b) of the Code, must be interpreted very narrowly to refer only to a specific request for an official vote either accepting or rejecting a plan of reorganization.").

[93] *See In re Kellogg*, 160 B.R. at 340 (adopting narrow interpretation of solicitation set forth in *Century Glove*). *See generally* Douglas E. Deutsch, *Ensuring Proper Bankruptcy Solicitation: Evaluating Bankruptcy Law, the First Amendment, the Code of Ethics, and Securities Law in Bankruptcy Solicitation Cases*, 11 AM. BANKR. INST. L. REV. 213, 228 (2003) (noting legislative history states "[T]he Code was designed to create a structure that will favor settlement. Congress stated that the Bankruptcy Code was not designed to 'impose a rigid financial rule for the plan' but was instead intended to leave parties 'to their own to negotiate a fair settlement.' Case law also seems to recognize this mandate.") (internal footnotes omitted).

[94] *Century Glove*, 860 F.2d at 100–01 (finding negotiations are attempts at compromising over tentative plan while solicitation is request for binding support).

[95] *See, e.g.*, Perlman v. Catapult Entm't, Inc. (*In re* Catapult Entm't, Inc.), 165 F.3d 747, 754 (9th Cir. 1999) ("Policy arguments cannot displace the plain meaning of the statute; that the plain language . . . may be bad policy does not justify a judicial rewrite.") (interpreting section 365(c)).

Many other practices follow this same pattern. They evolve and remain largely unchecked until a district or appellate court is asked to square the practice with the Bankruptcy Code. Critical vendor orders provide the most recent example. Critical vendor orders have become commonplace. If the case is filed on Thursday, the workers owed paychecks on Friday are merely general creditors to the extent of their unpaid wages. To be sure, they are entitled to priority under section 507,[96] but nothing entitles them to be paid before anyone else, whether they have priority or not. Paying the workers, however, is routine in large cases, as are payments to other pre-petition creditors found to be "critical."

In many instances, the logic of honoring some pre-petition claims is so compelling that no one objects. In the chapter 11 of *Marvel*, the largely teenage subscribers to the business's comic books had paid their subscriptions in advance and were therefore general creditors. Their subscriptions should be put on hold, and they should await the plan of reorganization. They must participate in the process like any other creditor. The sheer silliness of asking thousands of 13-year-olds to participate in a chapter 11 reorganization may have kept the issue from arising. But blackletter law does not provide an obvious alternative.

For a time, too many bankruptcy judges seemed inclined to issue critical vendor orders without much inquiry. The emerging trend in the bankruptcy court, however, seems to be one in which such orders are subject to tough scrutiny. The debtor has to explain why honoring the pre-petition obligation will in fact make the general creditors as a group better off.[97] The decisions of even these bankruptcy courts, however, may not withstand appellate scrutiny especially if they rely exclusively on the powers of the court under section 105.[98]

As Judge Easterbrook put it in *Kmart*, "[a] 'doctrine of necessity' is just a fancy name for a power to depart from the Code."[99] The uncertainties around the doctrine of necessity have led some courts to refuse to sign any critical vendor orders and instead require the debtor to file a motion under section 363 in which it asks the court for permission to buy assets outside the ordinary course of business.[100] In such

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[96] *See* 11 U.S.C. § 507 (2002) ("The following expenses and claims have priority…wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual.").

[97] *See In re* CoServ, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002):

> The debtor must show three elements are present. First, it must be critical that the debtor deal with the claimant. Second, unless it deals with the claimant, the debtor risks the probability of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's pre-petition claim. Third, there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim.

Id.; Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411 (2003) (reviewing standards set out in *Coserv*).

[98] *See, e.g.*, *In re* Kmart, 359 F.3d 866, 871 (7th Cir. 2004) (Section 105(a) "does not create discretion to set aside the Code's rules about priority and distribution; the power conferred . . . is one to implement rather than override.").

[99] *Id.*

[100] *See* 11 U.S.C. § 363 (2002); *In re* Federated Dep't Stores, No. 1-90-00130, 1990 Bankr. LEXIS 122, at **5–6 (Bankr. S.D. Ohio Jan. 15, 1990) (indicating bankruptcy court has power under section 363 to

a case, the debtor is not honoring a pre-petition debt at all, but rather striking an unusual bargain by which it is getting post-petition goods or services. The Bankruptcy Code has no ban on such payments. The Achilles heel for critical vendor orders has always been the absence of explicit statutory authorization.[101] Section 363 may provide the necessary cover.[102] More important for our purposes, however, is recognizing that practices that depart from the Code, such as paying pre-petition priority wages, have become deeply engrained and will remain a part of bankruptcy practice as long as no one objects.

Third-party releases provide a third example of a separation between bankruptcy practice and bankruptcy law as understood in the appellate courts. Professionals may insist that the plan release them from liability arising out their own negligence. Courts may be willing to allow such clauses to the extent that they are needed to facilitate the retention of qualified professionals in the first instance.[103] Some practices, however, are again hard to square with conventional doctrine. A debtor seeks to sell a subsidiary free and clear of all claims even when the subsidiary itself has not filed for bankruptcy. In theory, the only asset of the estate is the debtor's equity interest in the subsidiary. Only this equity can be sold free and clear. Any sale should leave the rights of the creditors of the subsidiary unaffected. But the legal separation between corporate groups is not always respected. But even if such transactions could not withstand appellate scrutiny, they may go forward nevertheless, excepting only the liabilities of those that filed objections. Such practices continue until someone appears who is intransigent and refuses to compromise. In a world in which negotiations and side-deals dominate, such a person may never appear.

Appellate decisions, when they are handed down, are taken seriously. But they have a dynamic that is not always easy to predict. We can see this by looking at two of the most hotly debated issues of the 1980s and see how they have affected

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authorize debtor to expend funds outside ordinary course of business where such expenditures are in best interests of estate); Joshua A. Ehrenfeld, Comment, *Quieting the Rebellion: Eliminating Payment of Prepetition Debts Prior to Chapter 11 Reorganizations*, 70 U. CHI. L. REV. 621 (2003) (discussing statutuory justification for pre-petition payments under section 363).

[101] *See, e.g.*, Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) (stating "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); Neal Mitchell Assocs. v. Braunstein (*In re* Lambeth Corp.), 227 B.R. 1, 7 (B.A.P. 1st Cir. 1998) (indicating bankruptcy court's discretion is broad but not absolute); *In re* Chicago, Milwaukee, St. Paul and Pacific R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986) (stating bankruptcy court judge did not have "free-floating discretion" to create rights outside Code).

[102] In *Kmart*, Judge Easterbrook did not exclude the possibility of post-petition payments to pre-petition creditors if the record showed the prospect of benefit to other creditors. *See In re Kmart*, 359 F.3d at 874.

[103] *See* United Artists Theatre Co. v. Walton (*In re* United Artists Theatre), 315 F.3d 217, 229–30 (3d Cir. 2003) (finding such indemnification provisions reasonable contract terms within marketplace for professionals but refusing to adopt purely market determined reasonableness tests); *In re* DEC Int'l, Inc., 282 B.R. 423, 424 (W.D. Wis. 2002) (ruling such provisions are not unreasonable per se but cautioning courts to review indemnification provisions on case by case basis). *But see In re* Allegheny Intern., Inc., 100 B.R. 244, 247 (Bankr. W.D. Pa. 1989) (finding provision exempting bankers from indemnification solely for actions or omissions which constituted gross negligence or willful misconduct overly broad and modifying indemnification provision between debtor and investment bankers).

small cases. *United Savings Assoc. v. Timbers of Inwood Forest Assoc.*[104] held that an undersecured creditor was not entitled to the time value of its claim as a component of adequate protection.[105] In the course of finding that time value did not warrant protection, *Timbers* made it clear that nominal values had to be protected.[106] This part of the opinion turned out to be what mattered. When the collateral is personal property, time value matters less than protection against depreciation. *Timbers* had another effect as well. During the course of finding that the secured creditor was not entitled to adequate protection for the time value of its undersecured claim, the Supreme Court underscored the right of the secured creditor to have the stay lifted if an effective reorganization was not in prospect.[107] Bankruptcy judges took this lesson to heart. What the secured creditor lost in protection for time value, it more than made up in the bankruptcy judge's insistence that the debtor get its act together.

These features of *Timbers*, when put together, make it an opinion that has substantially strengthened the hand of the creditor that holds equipment as collateral. When the chapter 11 is focused upon the debtor sorting out its problems with the IRS or its landlord, the debtor may continue to pay the secured creditor as if the chapter 11 had never taken place. The debtor wants to avoid a contentious hearing in which it argues that it should be able to pay the secured creditor slightly less, but exposes itself to the risk that the secured creditor will counter that a reorganization is not in prospect.

Debates over new value have had a similar effect in small cases. During the course of arguing that debtors should be able to retain an interest in the reorganized business if they contributed new value in money or money's worth, common ground was again established that the absolute priority rule applied with full force. Indeed, those who promoted the debtor's ability to contribute new value went out of their way to argue that it was not an exception to the absolute priority rule, but rather a natural corollary to it. The overall effect of *Bank of America National Trust and Savings Assoc. v. 203 North LaSalle St. P'ship*[108] and *Norwest Bank Worthington v. Ahlers*,[109] has been to make the absolute priority rule more firmly embedded in chapter 11 than it has ever been.[110]

Timbers, *Ahlers*, and *LaSalle* together have had a significant impact on the dynamics of small business bankruptcies. If the debtor is losing money and cannot explain how things are going to change, the judge will dismiss the case. The debtor will not be able to confirm a plan that satisfies the absolute priority rule. The debtor now usually comes to court with a request to use cash collateral only after it has

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[104] 484 U.S. 365 (1988).
[105] *Id.* at 382.
[106] *Id.* at 370.
[107] *Id.* at 381.
[108] 526 U.S. 434 (1999).
[109] 485 U.S. 197 (1988).
[110] *See generally* John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 967–68 (1989) (discussing Supreme Court's acceptance of principle of absolute priority as binding in *Ahlers*).

already obtained the secured creditor's blessing. The risk of facing off in open court and arguing about whether an effective reorganization is in prospect is a risk that the debtor is unwilling to run, especially as the debtor's problems in small business cases are often not with the institutional lender, but rather with the IRS.

CONCLUSION

When we take several steps back from these three worlds of modern chapter 11, we can make several predictions about its future. First, we can celebrate the skill and professionalism of the modern bankruptcy judge. Given the task with which they are charged, the available evidence suggests that they are performing at a high level in both large and small cases. Even those who are skeptical about the value of chapter 11 can find little fault with the way in which bankruptcy judges carry out the tasks with which they are assigned.

Second, we are most unlikely to return to a world of traditional reorganizations. Today's businesses simply do not resemble railroads. We could enact rules that limit the ability of creditors to control cases in chapter 11 to the extent they do now, but the effect of such changes may simply be to reduce the number of large chapter 11s. In small cases, there is no pressure to move back to a world in which failing businesses use chapter 11 merely to play for time.

As judges become increasingly sophisticated, we may see the overall number of chapter 11 petitions continue to decline and the number of large chapter 11s remain stable or even increase. The odd dance between appellate courts and the day-to-day practice of bankruptcy law is likely to continue to generate unexpected consequences. Such decisions, however, are likely not enough to change the basic dynamic at work, one that is subsuming large chapter 11s into corporate law generally while small corporate reorganizations become merged with the personal bankruptcies of the self-employed.