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THE MANY FACES OF CHAPTER 11: A REPLY TO PROFESSOR BAIRD

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INTRODUCTION

Professor Douglas G. Baird's contribution to this symposium, *The New Face of*

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Chapter 11,[1] employs two analytical tools that have increased in importance since the adoption of the Bankruptcy Code: economics and empiricism. His symposium article suggests that chapter 11, as we knew it, is over.[2] Baird argues that chapter 11 has a new face and performs a new role because it is no longer used to prevent a firm's imminent financial failure.[3] Relying both on economic theories and two bankruptcy databases,[4] Baird argues that large businesses today use chapter 11 to either liquidate or to facilitate and/or consummate the sale of their assets to another entity, while smaller corporate reorganizations are nothing more than the personal bankruptcies of the self-employed owners.[5] Given this, Baird argues that corporate reorganizations can no longer be justified based on their ability to 'save' firms. *The New Face* then explores the increasing disparity between the bankruptcy world existing in written appellate court decisions and the world found in bankruptcy courts. Baird observes that the disconnect between those dimensions likely will continue and notes that, notwithstanding the impact of appellate decisions, those decisions are unlikely to change the nature (or face) of either the large or small modern business reorganization.[6]

The *New Face of Chapter 11* challenges scholars to view corporate reorganizations in a new light by forcing us to concede (or at least consider) that chapter 11s current faces are not always the same ones it had in equity receiverships under the Act or during the early Code years.[7] That chapter 11 may look a bit different does not necessarily prove that chapter 11 is performing a function, that its new role signals the end of its old uses, that corporate reorganizations no longer exist, or that Congress should amend the Code to prevent the old uses of chapter 11 given the prevalence of these new uses. While many recent corporate reorganizations essentially were liquidations or total mergers/acquisitions (many of which included plans that were pre-negotiated by the firm's principal lenders before the filing),[8] some did not fit this pattern. Instead, those debtors (and their creditors, lenders, or investors) chose to have a bankruptcy court complete the deal. This suggests that a chapter 11 proceeding adds something to the pre-arranged deal that was not available outside a bankruptcy forum.

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[1] Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69 (2004) [hereinafter *The New Face*].

[2] Some arguments made in his symposium contribution appear in recent articles Baird and a co-author wrote. *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 674 (2003) [hereinafter *Chapter 11 at Twilight*]; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) [hereinafter *The End of Bankruptcy*]. Thus, at times, this Essay responds both to the arguments raised in his symposium contribution and to those raised in these recent works.

[3] *The New Face, supra*, note 1, at 74, 76; *The End of Bankruptcy, supra* note 2, at 751.

[4] Lynn M. LoPucki's Bankruptcy Research Database, *available at* http://lopucki.law.ucla.edu; Edward R. Morrison, Bankruptcy Decision-Making: An Empirical Study of Small Business Bankruptcies (2003) (unpublished dissertation, University of Chicago).

[5] *See generally The New Face, supra* note 1; *The End of Bankruptcy, supra* note 2, at 751.

[6] *The New Face, supra* note 1, 92–99.

[7] *Id.; The End of Bankruptcy, supra* note 2, at 756.

[8] *See The End of Bankruptcy, supra* note 2, at 752–55.

While there has not been (nor does there need to be) an end to chapter 11 simply because it uses new faces to accomplish traditional goals, *The New Face's* critique of chapter 11 makes a particularly salient point, given the scandals associated with many of the recent mega-chapter 11 filings.[9] Baird submits that the people who control troubled businesses are often incompetent[10] and that far too many large financially distressed businesses had corporate boards that appear to have been asleep at the wheel as conditions declined.[11] Building upon this thesis in another recent work, Baird issues a challenge to devise a way to dislodge incompetent managers at the right time.[12] This Essay accepts that challenge by suggesting ways to make officers and directors properly perform their fiduciary duties and to give creditors greater powers to dislodge incompetent or poorly performing managers of financially failing firms at an earlier stage.

Part II of this Essay briefly summarizes the principle arguments raised in *The New Face of Chapter 11* and generally argues that chapter 11 is not performing a new role: It is just using difference faces to perform old roles. As support for this argument, Part II notes that the current functions of chapter 11 (to help large firms efficiently liquidate or sell their assets and to help small business owners rid themselves of debt and re-establish themselves in business) are consistent with traditional bankruptcy goals and policies. This Part also notes that some modern firms continue to use chapter 11 for traditional reorganizations, *i.e.*, reorganizations that either have not been pre-arranged or are not complete asset sales. Moreover, it stresses that creditors/investors and debtors continue to embrace the relief provided by chapter 11, thus indicating their conclusion that this uniform corporate reorganization process provides certain benefits that simply are not available outside of a bankruptcy forum.

Part III then accepts Baird's challenge to consider ways to dislodge incompetent managers. This Part notes that chapter 11 (or something similar) will always be needed because only this type of process will give creditors a realistic opportunity to remove poorly performing managers who typically escape ouster outside of bankruptcy. The Essay then proposes methods (including removing incompetent managers, having them supervised, fining them, and barring them from future board service) to both give creditors and investors a way to eliminate incompetent managers and also afford officers and directors greater incentives to make decisions that are in the best interest of financially troubled businesses.

I. THE NEW FACE OF CHAPTER 11

A. Summary

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[9] For a further discussion of these scandals, *see infra* note 85.
[10] *The New Face, supra* note 1, at 81; *The End of Bankruptcy, supra* note 2, at 782.
[11] *The New Face, supra* note 1, at 81.
[12] *The End of Bankruptcy, supra* note 2, at 782.

Baird argues that corporate reorganizations essentially are over for both large and small firms because chapter 11 is no longer used to prevent an imminent financial failure.[13] Specifically, he posits that because (1) creditors (especially the main lenders) have the power to control large businesses (including shutting them down) outside of a bankruptcy forum, (2) the modern business debtor does not have specialized assets that need to be kept together in a particular firm,[14] (3) going concern sales are possible outside of bankruptcy,[15] and (4) most corporate reorganizations of large firms do little more than execute pre-arranged deals, chapter 11s new face does not save large businesses.[16] As for small chapter 11s, he argues that they are used to help self-employed entrepreneurs (like lawyers, morticians, and plumbers) sort out their personal finances, not save the business. Because these businesses have few (if any) physical assets and the owner-manager likely will continue to run the same type of business regardless of what happens in chapter 11, Baird theorizes that these chapter 11s do not help viable small businesses survive as stand-alone entities.[17]

In characterizing chapter 11s new role for large businesses, Baird suggests that the modern firm uses corporate reorganizations under chapter 11 to facilitate or consummate the sale of a firm's assets to another entity.[18] He posits that because the modern corporate reorganization does not serve as a collective forum that allows creditors to decide the future shape of a financially troubled firm, and because chapter 11 was designed to accomplish just that goal, the new face of chapter 11 signals the end of corporate reorganizations. In reaching this conclusion, Baird relies on both the paradigmatic example of a firm that historically reorganized in bankruptcy (the nineteenth-century railroad) and more recent empirical data involving modern corporate debtors.[19] Baird juxtaposes the characteristics of the railroad filings against the characteristics of the telecommunications and "dot-com" filings, observing that the new use of corporate reorganizations does not resemble its old use.[20] The old face of chapter 11, Baird suggests, addressed the financial problems facing firms with assets that had firm-specific value (like railroads with iron rails and wooden ties connecting two cities). These firms needed to reorganize in bankruptcy and preserve their assets for use in their current form because the assets had little value outside of the existing entity.[21]

Baird's conclusion about chapter 11s new face grows from his view that corporate reorganizations were designed to help firms who lacked coherent capital structures. Only those types of entities needed the relief provided in a bankruptcy

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[13] *The New Face, supra* note 1, at 74, 76; *The End of Bankruptcy, supra* note 2, at 751.
[14] *The New Face, supra* note 1, at 70–75; *The End of Bankruptcy, supra* note 2, at 752, 768.
[15] *The New Face, supra* note 1, at 75; *The End of Bankruptcy, supra* note 2, at 777, 786.
[16] *The New Face, supra* note 1, at 76; *The End of Bankruptcy, supra* note 2, at 752, 788.
[17] *The New Face, supra* note 1, at 83–88.
[18] *Id.; The End of Bankruptcy, supra* note 2, at 751.
[19] *The New Face, supra* note 1, at 71, 78; *The End of Bankruptcy, supra* note 2, at 758–60, 779–80.
[20] *The New Face, supra* note 1, at 71, 78; *The End of Bankruptcy, supra* note 2, at 780–81, 787.
[21] *The New Face, supra* note 1, at 78; *The End of Bankruptcy, supra* note 2, at 758–59.

forum because they could not easily be restructured under applicable contract law. Again, using the railroad example, Baird observes that railroads possessed primitive capital structures *i.e.,* they had an incoherent capital structure with different types of investors and there was no single individual or group of individuals who could amass the funds necessary to buy the railroad.[22] Baird argues that the old type of asset-specific firm needed a collective forum to assemble their creditors and preserve their assets in an ongoing entity. This type of firm no longer exists, he posits, because the modern large business either has hard assets that do not have to be dedicated to a particular firm or has intangible assets that do not reside in the firm.[23]

Relying largely on empirical data, *The New Face* examines the types of assets owned by firms who recently have filed for corporate reorganizations and concludes that those assets can be (and have been) easily bought, sold, or leased by other companies. Because those assets are not firm specific, Baird concludes there is no need to reorganize the firm and keep it together post-petition because there is no firm value that needs to be preserved.[24] Indeed, *The New Face* concludes that the primary assets modern firms have are intangible (like intellectual property) or consist of workers' specialized expertise (*i.e.*, human capital) and that these assets often can be used by firms within the same industry and do not need to be preserved in the filing company.[25] In addition, *The New Face* indicates that many large corporate filings involved debtors who were a collection of discrete individual businesses (like movie theatres, nursing homes, or hotels) whose assets easily could be sold piecemeal without destroying the value of the individual businesses.[26]

Baird's premise that the new face of chapter 11 signals the end of large corporate reorganizations relies heavily on his view that once a large business is in distress and in default outside of bankruptcy, creditors (principally the firm's primary lenders) acquire the right to control the firm.[27] These control rights may include the right to fire managers, hire turnaround specialists, or otherwise conduct a market sale that shuts down or radically alters the firm's operating structure.[28] As

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[22] *See The New Face, supra* note 1, at 75; *The End of Bankruptcy, supra* note 2, at 779.
[23] *See The New Face, supra* note 1, at 78, 88; *The End of Bankruptcy, supra* note 2, at 762–63.
[24] *See The New Face, supra* note 1, at 78; *The End of Bankruptcy, supra* note 2, at 762, 767–68.
[25] *See The New Face, supra* note 1, at 87; *The End of Bankruptcy, supra* note 2, at 763.
[26] *See The New Face, supra* note 1, at 78–79.
[27] *See id.*, at 76, 80, 81*; The End of Bankruptcy, supra* note 2, at 779.
[28] *See The New Face, supra* note 1, at 81; *The End of Bankruptcy, supra* note 2, at 782. In *The End of Bankruptcy*, Baird and Rasmussen contend that because of the increased use of security arrangements (like revolving or secured credit facilities) both inside and outside bankruptcy, a firm's lenders—not its managers—control the firm once it becomes financially troubled. The authors describe a secured credit facility as one which gives the lead lender control of the debtor's cash collateral, gives the debtor access to cash only pursuant to a prescribed formula, and lets the lender terminate the arrangement and shut down the firm if there is a default (which the lender can declare if it has reasonable grounds to be concerned about its security). *Id.* at 784. Indeed, while they note that the fear that creditors will irrationally or inappropriately exercise these rights lies at the heart of reorganization law, they dismiss that fear based largely on their underlying belief that creditors and investors make sensible decisions about a financially troubled firm's fate outside of a bankruptcy forum. *Id.* at 779.

support for the conclusion that chapter 11 now serves as the principal forum to conduct a market sale of a large firm's assets (and does not serve as a substitute for a market sale), *The New Face* points to the recent increase in the number of pre-packaged bankruptcies, and filings involving firms who entered bankruptcy proceedings with the sole intent of selling the firm as a going concern, *i.e.*, the pre-negotiated bankruptcy.[29] Because many of the recent large chapter 11 filings involve firms whose creditors had largely decided the firm's fate before the filing—a change from the Act and early Code chapter practice—Baird questions the continued validity of (or need for) chapter 11 to bring all stakeholders to the bargaining table to decide the fate of large businesses.[30]

With respect to small businesses, *The New Face* argues that chapter 11 no longer gives creditors the ability to control the fate of those businesses because there really is no business: There are few employees and, in many instances, no physical assets at all. The primary assets of a small business debtor often consist of workers' specialized expertise (*i.e.*, human capital). In this situation, the business (regardless of its corporate form) is actually the relationships, contracts, and contacts the owner-manager has with customers. Though the corporate form is likely to disappear in chapter 11, that business will continue to exist because the owner-manager will likely stay in business by operating under a new name or corporate identity. Given this, *The New Face* maintains that the financial failure of a business's corporate form has no effect on its future business opportunities because the business is, in reality, nothing more than the know-how of the owner-operator.[31]

Finally, *The New Face* suggests that there is a vast gulf between the day-to-day bankruptcy practice found in bankruptcy courts and the practice as reflected in written appellate opinions. To highlight this disconnect, Baird cites Code section 1125's regulation of a party's attempt to solicit votes for a plan and court interpretations of that provision and contrasts that to the increasingly common practice of creditors pre-negotiating the terms of the large business reorganization in chapter 11.[32] Baird also notes the relative willingness (at least by some courts) to approve critical vendor motions under the doctrine of necessity (notwithstanding the absence of Code authority for such motions) and contrasts that with the likelihood that appellate courts will conclude that such motions cannot be authorized under section 105.[33]

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[29] *The New Face, supra* note 1, at 76; *The End of Bankruptcy, supra* note 2, at 786–87.

[30] In *The New Face of Chapter 11*, Baird indicates that companies including Global Crossing, Comdisco, XO Communications, McLeodUSA, Budget, Unicapital, Exodus, and Iridium used the bankruptcy courts as a way of selling their assets. *See The New Face*, *supra* note 1, at 73 n.13.

[31] *Id.* at 86.

[32] *Id*. at 93.

[33] *Id*. at 96–97. I have suggested in another context that one way to resolve critical vendor motion disputes is to incorporate specific factors in the Code to guide courts' decisions. *See* A. Mechele Dickerson, *Approving Employee Retention and Severance Plans: Judicial Decisionmaking Run Amuck?* 11 AM. BANKR. INST. L. REV. 93 (2003) [hereinafter *Judicial Decisionmaking*].

B. *Chapter 11s Many Faces*

1. The New Faces of Chapter 11 Are Not Inconsistent With Chapter 11s Multiple Goals

Baird's conclusion that the old face of chapter 11 provided a collective and exclusive forum for a firm's stakeholders to negotiate amongst themselves to save a financially troubled firm is, of course, correct. However, saving firms has never been the only goal of chapter 11. Though initially controversial and not confirmable under the Act,[34] chapter 11 liquidating plans have been confirmed despite the objection of creditors ever since the Code went into effect.[35] Legislative history indicates that chapter 11 was designed to give corporate debtors a period during which they could decide whether the firm could (or should) be reorganized, or whether they should be liquidated efficiently and in an orderly fashion.[36] Indeed, the Code explicitly provides for the sale of all or part of a debtor's assets in a chapter 11 proceeding.[37] Stated differently, chapter 11 (unlike its predecessor under the Bankruptcy Act) has never been restricted to being used solely to reorganize an ailing firm; an efficient liquidation has always been a legitimate use of chapter 11. The goal has always been to maximize value, which may be accomplished either through reorganization or orderly liquidation.[38]

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[34] *See* Chandler Act, Pub. L. No. 75-296, § 141, 52 Stat. 840, 887 (1938) (stating judges could reject reorganization plan if they believed bankruptcy petition filed in bad faith); McKeown Act, Pub. L. No. 73-296 § 77B(a), 48 Stat. 911, 912 (1934) (stating same); *see also* John Anderson & Peter Wright, *Liquidating Plans of Reorganization*, 56 AM. BANKR. L.J. 29, 34 (1982) (providing arguments to deny availability of liquidation under Chandler Act).

[35] For example, investors and creditors in *In re Coastal Equities, Inc.* objected to the confirmation of a liquidating plan that was designed to sell the estate's assets then pay certain investors. 33 B.R. 898 (Bankr. S.D. Cal. 1983). The court agreed that chapter 11 is titled "Reorganization," but then stressed that the Code specifically provides for the sale of all or substantially all of the assets of a debtor and the distribution of the proceeds among the creditors. *Id*. at 904; *see also* *In re* Searles Castle Enters., Inc., 17 B.R. 440, 442 (B.A.P. 1st Cir. 1982) (holding creditors' contention that chapter 11 does not provide for full sale of debtor's assets to be without merit); *In re* East Redley Corp., 20 B.R. 612, 614 (Bankr. E.D. Pa. 1982) (confirming liquidation plan despite rejection by class of creditors); *In re* Nite Lite Inns, 17 B.R. 367, 370 (Bankr. S.D. Cal. 1982) (stating primary focus of chapter 11 proceeding is reorganization but noting liquidation plans can be confirmed when requested by debtor or necessitated by justice); *In re* Alves Photo Serv., Inc., 6 B.R. 690, 695 (Bankr. D. Mass. 1980) (confirming chapter 11 proceeding and denying conversion to chapter 7 proceeding over creditors' objections).

[36] *See* H.R. REP. No. 95-595, § 1123 (1977) (stating chapter 11 plan may propose sale of all or substantially all property of estate, and distribute proceeds of sale among creditors and equity security holders, *i.e.,* liquidation plan); *see also* NLRB v. Bildisco 465 U.S. 513, 528 (1984) (stating main purpose of reorganization is to preserve jobs and economic resources and not to liquidate debtor); *In re* Ionosphere Clubs Inc., 98 B.R. 174, 176 (Bankr. S.D.N.Y. 1989) (determining paramount goal of chapter 11 is debtor rehabilitation).

[37] *See* 11 U.S.C. § 1123(a)(5)(D) (2002) (authorizing sale of all or part of debtor's assets in chapter 11 proceeding). *See e.g.*, Danny Thomas Props. II Ltd. P'ship v. Beal Bank, S.S.B. (*In re* Danny Thomas Props. II Ltd.) 241 F.3d 959, 963 (8th Cir. 2001) (stating sale of assets is proper part of reorganization plan).

[38] For appellate court decisions that explicitly discuss and agree that liquidation is an appropriate use of chapter 11, see *In re* Jartran Inc., 886 F.2d 859, 866–67 (7th Cir. 1989) (acknowledging liquidation in

Though the goal of chapter 11 has not changed, its new face for large businesses is now one which helps those firms implement a pre-arranged merger or acquisition.[39] *The New Face* relies on an extensive empirical database to conclude that large firms use chapter 11 to effectuate total asset sales[40] and that these firms increasingly use pre-packaged bankruptcies.[41] However, firms continue to use chapter 11 to reorganize in the more traditional sense of restructuring their balance sheet by eliminating expenses, streamlining operations, and remaining in business.[42]

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chapter 11); *In re* Sandy Ridge Dev. Corp., 881 F.2d 1346, 1352 (5th Cir. 1989) (noting "although chapter 11 is titled 'Reorganization,' a plan may result in the liquidation of the debtor").

[39] Recent filings that took place only after the debtor pre-arranged a deal with new investors include those for Aurora, Budget, Conseco, Rand McNally, Global Crossing, and McLeodUSA. *See The New Face, supra* note 1; *see also Budget Group Inc. Said Monday it had Filed for Chapter 11 Bankruptcy Protection in the U.S. Bankruptcy Court*, UNITED PRESS INT., July 29, 2002; *Lending Unit Sale Set as Revamp of Conseco Begins*, CHI. TRIB., Dec. 19, 2002, at N3, *available at* 2002 WL 104498338 (discussing Conseco restructuring plan selling lending unit to CFN Investment holdings); Andrew Backover, *Global Crossing Files for Chapter 11*, USA TODAY, Jan. 29, 2002, at 1B, *available at* 2002 WL 4717912; Thomas Lee, *Aurora Will Declare Bankruptcy; After Quick Exit, Investment Firm Would Buy Stake*, ST. LOUIS POST-DISPATCH, July 3, 2003, at B1; Ameet Sachdev, *Rand McNally Gives Up Control in Restructuring; Buyout Firm Deal Eases Debt Burden*, CHI. TRIB., Jan. 16, 2003, at N1, *available at* 2003 WL 9692780 (emphasizing prepackaged chapter 11 bankruptcy plan where Rand McNally turns over ownership stake to buyout firm); Dan Stancavish, *Chap. 11 Plan Gives Firm Control of McLeodUSA*, CHI. SUN-TIMES, Feb. 1, 2002, at 57, *available at* 2002 WL 6446075 (discussing filed prepackaged plan which eliminates debt and relinquishes control to buyout firm); Dan Stancavish, *Global Crossing Files for Ch. 11 Bankruptcy*, CHI. SUN-TIMES, Jan. 29, 2002, at Financial, 47, *available at* 2002 WL 6445969 (chronicling take over plan by international conglomerate).

[40] Filings where the debtor's assets were sold entirely include Bethlehem Steel, Integrated Health Care, LTV, Fleming, TWA, Stroud's PSINet, Macy's, and Budget. *See Mergers and Acquisitions: Cendant to Buy Bankrupt Budget Group*, FACTS ON FILE WORLD NEWS DIGEST, Aug. 22, 2002, at 652E1; Sara Bongiorni, *Grocery Supplier to Close, Kill Jobs*, STATE-TIMES/MORNING ADVOCATE (Baton Rouge, LA), June 14, 2003; Terence Chea, *PSINet Continues Selling Operations*, WASH. POST, June 21, 2001, at E05, *available at* 2001 WL 23175671 (same); Brent Felgner, *This Time it's Over: Strouds to Liquidate*, HOME TEXTILES TODAY, May 26, 2003; Kirstin Downey Grimsley & Sharon Walsh, *Federated-Macy Merger Under Investigation*, WASH. POST, Aug. 3, 1994, at F1, *available at* 1994 WL 2433005 (reporting joint reorganization plan intended to pull Macy's out of bankruptcy); James P. Miller, *LTV Sells its Steel Assets to Investor; WL Ross Says it Will Reopen Firm's Plants*, CHI. TRIB., Feb. 28, 2002, at N2, *available at* 2002 WL 2628451 (chronicling sale of assets to distressed property investor); Yuki Noguchi, *PSINet Investors Seek Settlement; Bankruptcy Court Approval Needed on $17.8 Million Deal*, WASH. POST, Apr. 2, 2003, at E05, *available at* 2003 WL 17424987 (discussing sale of assets); M. William Salganik, *IHS Suitors Reach a Deal; THI Would Run Chain, Briarwood Would Own it; Snow Created Time to Think; Proposal Needs OK of Bankruptcy Court*, BALT. SUN, Feb. 25, 2003, at 1D, *available at* 2003 WL 14671640 (reporting total sale of assets after filing); Gus G. Sentementes, *Judge Approves Sale of Bethlehem Steel to Rival*, BALT. SUN, Apr. 23, 2003, at 1D; Frank Swoboda & Don Phillips, *American Airlines Plans to Buy TWA*, WASH. POST, Jan. 8, 2001, at A1, *available at* 2001 WL 2534969 (discussing total sale of TWA assets).

[41] *See The New Face*, *supra* note 1; *see also* United Artists Theatre Co. v. Walton (*In re* United Artists Theatre Co.), 315 F.3d 217, 224 (3d Cir. 2003) (contrasting prepackaged bankruptcies from traditional chapter 11 cases); DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 232 (Princeton Univ. Press 2001) (commenting on increased use of pre-packaged bankruptcy filings by major corporations).

[42] Recent examples of firms who filed for bankruptcy with the stated goal of reorganizing by restructuring include Adelphia Communications, Conseco, NTL, Inc., United Airlines, Worldcom, US Airways, Mattress Discounters, and Kmart. *See Monday Morning*, WASH. POST, Mar. 24, 2003, at E1; *NTL Files Words Largest Debt Default*, L.A. TIMES, May 9, 2002, at Business, Part 3, 4; Keith L. Alexander, *United Plans to File Today for Chapter 11*, WASH. POST, Dec. 9, 2002, at A1; *Conseco Files for Protection*, WASH. POST,

Because chapter 11 was intended to give companies an opportunity to either liquidate or reorganize, the fact that its new face may be primarily one of liquidation does not mean that Congress should amend the Code to mandate that chapter 11 be used only to sell a firm's assets to the highest bidder.[43]

That small business owners use chapter 11 to discharge corporate debt even though they have no intention of saving the business is not a new or unique use of chapter 11. Even the earliest bankruptcy laws were used to allow small business owners who found themselves strapped with debt to discharge those debts.[44] After ridding themselves of those restrictions, such small merchants could then continue their same trades, a practice similar to what *The New Face* suggests takes place now with small business filings.[45] It is not surprising that small business owners use chapter 11 to rearrange their personal finances because the owner has often personally guaranteed the business debt.[46] Without chapter 11, it would be virtually impossible for the owner to continue his trade (as a lawyer, chiropractor, plumber,

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Dec. 18, 2002, at E2; Sallie Hofmeister, *Adelphia Submits Bankruptcy Filing*, L.A. TIMES, June 26, 2002, at Business, Part 3, 1; James F. Peltz, *U.S. Airways Files for Bankruptcy Reorganization*, L.A. TIMES, Aug. 12, 2002, at Part 1, 1; Steven Theobald, *Kmart Shields Itself from Creditors,* TORONTO STAR, January 23, 2002, at News 12; Jon Van, *Worldcom Files for Bankruptcy,* CHI. TRIB., July 22, 2002, at CN1; *see also* Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Reply to Baird and Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645, 647 n.11 (2003) [hereinafter *Nature of the Firm*].

While some of these businesses had pre-negotiated plans, the purpose of the filing was to maintain, not liquidate, the business. Indeed, in citing these examples, I do not necessarily mean to suggest that most large corporations enter chapter 11 without having arranged some sort of deal with their primary lenders. Instead, I cite these to show that chapter 11 can still be justified, in part, based on its ability to give businesses who have not yet arranged a deal with their creditors breathing space to decide how to restructure (not liquidate) and to allow them to take advantage of certain bankruptcy rules that are not available under applicable state laws. Finally, there are older filings (including Federated Department Stores) that could be cited as "traditional" chapter 11s but are not since *The New Face* relies principally on 2002 cases.

[43] Though Baird's earlier works indicate his preference for using corporate reorganizations to maximize creditor interests by selling the firm's assets piecemeal, *The New Face* does not argue that chapter 11 should be a liquidation proceeding exclusively. *See infra* note 96; *see also* Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J. L. & ECON. 633, 663 (1993) (theorizing "chapter 11 is simply station to eventual liquidation."); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 128 (1986) [hereinafter *The Uneasy Case*] (reasoning liquidation is most often chosen because it is rarely more optimal than reorganization).

[44] TERESA A. SULLIVAN, ELIZABETH WARREN, AND JAY LAWRENCE WESTBROOK, AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 120 (1989) [hereinafter AS WE FORGIVE] (noting earlier bankruptcy and state debtor-creditor laws focused on entrepreneurs and once prototype debtors were failed merchants who needed to file bankruptcy to start new businesses); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV 5, 14 (1995) [hereinafter *History of Bankruptcy Laws*] (discussing Bankruptcy Act of 1800 limitation of bankruptcy relief to merchants). *See generally* Stacy L. Daly, *Post-Petition Earnings and Individual Chapter 11 Debtors: Avoiding a Head Start*, 68 FORDHAM L. REV. 1745 (2000).

[45] *See History of Bankruptcy Laws, supra* note 44, at 15 (stating high-rolling speculators sometimes used bankruptcy to discharge debts then start their operations anew). *But see* Randolph J. Hines, *Business Bankruptcy Aspects of the Bankruptcy Reform Act*, 6 NORTON–BLA 1 (2001) (discussing obstacles small business owners encounter in rehabilitating under chapter 11).

[46] *See The New Face, supra* note 1; *see also* AS WE FORGIVE, *supra* note 44, at 120; Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *Folklore and Facts: A Preliminary Report from the Consumer Bankruptcy Project*, 60 AM. BANKR. L.J. 293, 309 (1986) (providing statistics on small businesses and their corresponding debts).

etc. . .) or to start another small business (like an insurance company or funeral home) unless he could discharge the business debts before attempting to sort out his personal debts.

2. Bankruptcy Provides Needed Relief Unavailable in Other Forums

By characterizing chapter 11 as a forum designed to help large businesses with specialized assets that need to remain in the firm (but who have not worked out a pre-petition deal to effectuate an ongoing sale), *The New Face of Chapter 11* fails to adequately address the fact that large corporate debtors and their creditors or new investors (who often insist on the chapter 11 filing)[47] seem to have concluded that they need chapter 11 because it provides certain types of relief that simply are unavailable outside bankruptcy. Though *The New Face* correctly asserts that many of the large corporate filings have been pre-arranged, it does not address why corporate debtors and their primary lenders increasingly conclude that they must use chapter 11 to close the pre-arranged deal.[48] If, as Baird contends, creditors can exercise control rights over the firm that would enable them to sell assets or replace management, it is unclear how *any* large business would ever be able to file chapter 11 over the objection of its creditors or why *any* large lender would demand that the firm file for chapter 11.

While it is theoretically possible for a creditor to seize the assets of a financially troubled firm and sell those assets to a competitor or investor, such sales will rarely occur for several reasons. Depressed economic conditions or membership in an industry suffering from financial distress generally will preclude such sales.[49] For example, assume the debtor is in an industry (perhaps telecommunications) where all other members face fiscal difficulties (or are otherwise financially unable to expand their business operations) *or* the economy is so distressed that potential investors do not possess or cannot raise sufficient capital to purchase the debtor's assets. In this hypothetical business climate, the market for the debtor's assets simply does not exist *even assuming* the firm's creditors contracted for the right to control the business once in default. Any sale that occurs during an economic downturn will likely yield an amount significantly lower than the actual value of the

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[47] *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 153–54 (1990); David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309, 311 (2001); Ian Johnson, *Macy Gives Cool Reception to Suitor*, BALT. SUN, Jan. 4, 1994, at 9C.

[48] Baird suggests in another work that the number of large chapter 11s may have increased because chapter 11 allows for sales of assets with clean title and permits senior creditors to extinguish equity interests. *Chapter 11 at Twilight, supra* note 2, at 675 n.6.

[49] *See* Francis G. Conrad, *Development: Dot.Coms in Bankruptcy Valuations Under Title 11 or www.Snipehunt.com in the Dark.noreorg/noassets.com*, 9 AM. BANKR. INST. L. REV. 417, 418–19 (2001) (describing plight of dot.com industry and frequency of chapter 11 filings); Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 109 (1995) [hereinafter *Economic Analysis of Corporate Bankruptcy*] (recognizing limitations of market approach to valuing firm's assets if debtor's competitors also are in distress).

assets if the potential buyers are unable to borrow funds sufficient to pay the full value of those assets. Moreover, even if a willing buyer with sufficient capital exists, it is likely that the time it would take to find this buyer may prevent the debtor from being able to preserve the value of the firm.[50] Finally, a non-bankruptcy sale likely will occur only if one creditor has the right to control the firm. If there is more than one major lender or creditor, then some type of organized proceeding will be needed to force all parties to reach an agreement concerning the firm's financial future.[51]

Another benefit of sales in bankruptcy is that all the debtor's assets may be sold at the same time without the cumbersome proceedings often required by non-bankruptcy law. Under non-bankruptcy law, personal property can be (and often is) sold in a private sale as long as it is commercially reasonable[52] while state laws typically require that non-bankruptcy sales of real property be by foreclosure, often at a public auction.[53] Public sales can be expensive and lengthy and frequently entail a cumbersome notice procedure.[54] Keeping a financially distressed firm afloat, while both complying with the notice requirements and coordinating private and public sales outside of bankruptcy, is especially difficult because the firm lacks the benefit of an automatic stay to prevent other creditors from dismantling the firm while it attempts to sell its assets. A final advantage to bankruptcy sales is that they allow the debtor to sell its assets free and clear of existing liens, something that

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[50] My thanks to Benjamin C. Ackerly, counsel to NTelos (a telecommunications company filing for relief under chapter 11 in 2003) for providing these insights.

[51] *See Economic Analysis of Corporate Bankruptcy, supra* note 49, at 110 (recognizing limitation of certain contract theories to multi-creditor firms and conceding "[o]nce we move to three-party bargaining, the possibility of bargaining failure increases dramatically."); Riva D. Atlas, *U-Haul's Parent Finds Equity Gains in Bankruptcy*, N.Y. TIMES, Aug. 20, 2003, at C1 (reporting Chair of Amerco concluded company had to file for bankruptcy because interests of debtor's creditors "were too diverse to reach an agreement outside bankruptcy court."); *see also Nature of the Firm, supra* note 42, at 662 ("Large, public firms generally have multiple layers of debt and equity, each with a different priority in the assets of the firm . . . . Because these investors have different priorities, their interests conflict with those of each other and those of the firm.").

[52] *See* U.C.C. § 9-610(b) (2000) ("If commercially reasonable, a secured party may dispose of collateral by public or private proceedings."). *See, e.g.*, ALA. CODE § 7-9A-610(b) (2003) ("Every aspect of a disposition of collateral, including the method, manner, time, place and other terms, must be commercially reasonable."); CAL. COM. CODE § 9610(b) (Deering 2003) (stating same); CONN. GEN. STAT. § 42a-9-610 (2003) (stating same); VA. CODE ANN. § 8.9A-610 (Mitchie 2003) (stating same).

[53] *See, e.g.*, ALA. CODE § 35-10-3 (2003) (stating grantee or assignee may foreclose property "by selling [it] for cash at the courthouse door of the county where the property is situated, to the highest bidder."); MINN. STAT. § 580.06 (2002) ("The sale shall be made by the sheriff or the sheriff's deputy at public venue to the highest bidder."); OR. REV. STAT. § 86.755(1) (2001) ("The trustee may sell the property in one parcel or in separate parcels and shall sell the parcel or parcels at auction to the highest bidder for cash."); W. VA. CODE § 38-1-3 (2003) (stating grantor may "sell the property conveyed by the deed, or so much thereof as may be necessary, at public auction."); WYO. STAT. ANN. § 34-4-106 (Mitchie 2003) ("The sale shall be at public venue, [sic] at the front door of the courthouse.").

[54] *See, e.g.*, WASH. REV. CODE § 61.24.040 (2003) (describing procedure and notice requirements, including exact mandatory notices, for deed of trust foreclosure in Washington); *see also* Carl S. Bjerre, *International Project Finance Transactions: Selected Issues Under Revised Article 9*, 73 AM. BANKR. L.J. 261, 309–10 (1999) (stating requirements for foreclosure are often expensive and time consuming); Georgina W. Kwan, *Mortgagor Protection Laws: A Proposal for Mortgage Foreclosure Reform in Hawaii*, 24 HAWAII L. REV. 245, 253 (2001) (stating judicial sale can be very expensive and lengthy process).

generally is not possible outside of bankruptcy.[55]

The Code also allows debtors to increase their assets and eliminate debts in ways that do not exist outside bankruptcy. One primary benefit of filing for bankruptcy is that it gives debtors the protection of the automatic stay, which prevents creditors from seizing the debtors' assets and also prevents landlords from immediately removing debtors from leased premises (something that is especially beneficial for small businesses).[56] In addition, the Code permits both small and large businesses to efficiently breach leases and contracts.[57] Indeed, many of the larger retail debtors used chapter 11 to rid themselves of unprofitable store leases (or to sell profitable leases to a non-debtor party and keep the profits from the sale).[58] Likewise, many companies take advantage of bankruptcy laws that permit them to renegotiate collective bargaining agreements or otherwise reduce their obligations to their unionized workers, or to strip employees of certain pension rights.[59] Debtors in bankruptcy also retain the right to recover preferential payments

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[55] *See* 11 U.S.C. § 363(f) (2002) (stating trustee may sell § 363(a)(b) property "free and clear of any interest in such property" subject to enumerated conditions and limitations); *see* EEOC v. Knox-Schillinger (*In re* Trans World Airlines, Inc.), 322 F.3d 283, 288–89 (3d Cir. 2003) (deciding what kind of claims constitute "interest in the property" under § 363(f) and, as such, are extinguished by § 363(f) sale); Madden v. La Cofske, 72 F.2d 602, 606 (9th Cir. 1934) (stating under Arizona law, in case of bankruptcy, landlord's lien on property is ineffective); Marathon Fin. Co. v. HHC Liquidation Corp., 483 S.E.2d 757, 766 (S.C. Ct. App. 1997) (holding word "interest" in § 363(f) is broad enough to include restrictive covenant).

[56] *See* 11 U.S.C. § 362(a) (2002) (stating automatic stay precludes enforcement of judgment against estate and any act to obtain possession of property of estate).

[57] *See* 11 U.S.C. § 365(a) (2002) (allowing trustee to assume or reject debtor's executory contract or unexpired lease subject to certain limitations).

[58] Chapter 11 filings in which the debtor rejected contracts or leases include Kmart, Federated, Best, Spiegel, Service Merchandise Co., Inc., Macy's, and United. *See Campeau Units Get Extension*, N.Y. TIMES, May 10, 1990, at D5 (discussing landlord's unsuccessful attempt to evict Federated, its bankrupt tenant, based upon alleged breach of lease agreement); *Kmart, Penske Agree on Closings; 550 Auto Centers to Be Shut Down*, CHI. TRIB., Apr. 11, 2002, at N3 (narrating terms of agreement between Kmart and its business partner Penske regarding closing of Penske's auto service centers at more than 550 Kmart locations); Marilyn Adams, *United Gets Extra Time to Renegotiate Leases*, USA TODAY, Feb. 7, 2003, at 3B (reporting United was granted extension of time to decide which of its aircraft leases it wanted to reject); Greg Griffin, *Outlooks Differ on United's Progress*, DENV. POST, May 18, 2003, at K04 (reporting United is closing maintenance facilities and negotiating agreements with its aircraft lessors in effort to reduce $500M from its fleet costs); Danny Hakim & Leslie Kaufman, *Kmart Files Bankruptcy, Largest Ever for a Retailer*, N.Y. TIMES, Jan. 23, 2002, at C1 (narrating analysts' predictions about Kmart's extrication from approximately 350 leases); Roxana Kopetmnan, *Bullock's Closure to Affect City but Few Shoppers; Business: The Store Suffered from Its Location Separate from the Main Part of the Mall. Most of Its 170 Employees Will Be Out of Jobs*, L.A. TIMES, Mar. 4, 1993, at J1 (reporting Macy's announcement of plan to close 11 stores as part of chapter 11 reorganization); Mary Ellen Podmolik, *Bankruptcy Filing for Retailer; Service Merchandise to Reorganize*, CHI. SUN-TIMES, Mar. 17, 1999, at 67 (narrating Service Merchandise Co. is planning to close 134 stores and Texas distribution center); Lorene Yue, *Spiegel to Shut 60 Eddie Bauer Shops; Action Affects 900 Employees*, CHI. TRIB., Apr. 29, 2003, at C3 (reporting Spiegel, Inc. plans to close 81 of stores and request for extension of time to decide which other store leases to reject).

[59] Chapter 11 filings in which the debtor either rejected or radically restructured its obligations to its workers include Bethlehem Steel, Continental, LTV, TWA, United, and US Airways. *See Daily Briefing*, ATLANTA J. AND CONST., May 3, 2002, at F2 (stating new payment plan for Continental management guarantees no additional pay); *TWA Moves Closer to Emerging from Chapter 11*, BUS. WIRE, Feb. 17, 1993 (reviewing concessions negotiated with TWA employees which allowed TWA to emerge from bankruptcy); Bloomberg News, *Bethlehem Steel Can End Retiree Benefits*, L.A. TIMES, Mar. 25, 2003, at C8 (noting

from creditors that were made within a specified period before the filing,[60] even though those creditors generally would be entitled to keep those payments under applicable non-bankruptcy law.[61] Finally, debtors are allowed to substantively consolidate related corporate entities, if they can prove that it is necessary to treat those entities as one given the complexity of untangling intercompany claims or debts.[62]

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health care and life insurance benefits eliminated in course of bankruptcy proceeding); Melita Marie Garza, *1,300 Jobs Lost with Tentative LTV Deal*, CHI. TRIB., July 10, 2001, at 1N (comparing old labor agreements with new pact providing lower wage increases and job losses); Micheline Maynard & Mary Williams Walsh, *United Delays its Emergence from Chapter 11 Until Next Year*, N.Y. TIMES, Apr. 30, 2003, at C1 (discussing wage and benefit concessions obtained by United in course of reorganization); James P. Miller, *Airline Industry Finally Gets a Dose of Good News*, CHI. TRIB., Apr. 1, 2003, at 1C (detailing wage, benefits and workforce concessions required to pull US Airways out of bankruptcy); Dan Reed, *TWA Workers Fight Back After Demotions, Pink Slips*, USA TODAY, June 17, 2003, at B1 (chronicling disproportionate effect of downsizing on TWA workers).

While many would argue that it is unfair to allow corporate debtors to use bankruptcy to terminate workers, that bankruptcy allows debtors to modify employment contracts helps to create a negotiating environment pre-petition that should force the parties to participate in realistic contract discussions.

[60] *See* 11 U.S.C. § 547 (2002) (stating debtors may recover preferential transfers).

[61] Most states will not require creditors to return preferential payments unless there is proof that the creditor effectively controlled the debtor and, thus, can be viewed as an insider. *See* Mills v. Miller Harness Co., 326 S.E.2d 665, 666 (Va. 1985) (noting general rule allowing debtor to prefer certain creditor over others is subject to exception if preferred creditor controls corporation); Public Util. Dist. No. 1 v. Wash. Pub. Power Supply Sys., 705 P.2d 1195, 1212 (Wash. 1985) (stating same); Tudor v. Tudor, 635 S.W.2d 93, 94 (Mo. Ct. App. 1982) (stating same).

[62] Though not explicitly authorized by the Code, courts often substantively consolidate the estates of debtors or of debtor and non-debtor entities if the debtor can establish that the entities debts and assets and intertwined and it would be difficult (if not impossible) to unscramble those debts or assets. *See, e.g.*, *In re* Julien Co., 120 B.R. 930, 936–37 (Bankr. W.D. Tenn. 1990) (disapproving request for consolidation because court was not satisfied companies were sufficiently intertwined); *In re* I.R.C.C., Inc., 105 B.R. 237, 241 (Bankr. S.D.N.Y. 1989) (approving request for consolidation because companies are "one economic unit"). Worldcom's plan proposed a substantive consolidation of the holding company (WorldCom) with its primary subsidiary (MCI). *See* Bloomberg News, *Judge Gives Worldcom, Creditors Time to Settle,* L.A. TIMES, Sept. 9, 2003, at C3 (referring to "substantive consolidation" of WorldCom debts); Floyd Norris, *MCI Investors Learn Promises can be Broken*, N.Y. TIMES, May 2, 2003, at C1 (noting assets of MCI being used to pay of WorldCom debt).

Perhaps the greatest benefit that bankruptcy offers, which simply does not exist elsewhere, is the ability to swap debt for equity or otherwise replace old equity and give a controlling interest in the business debtor to new investors. *The New Face* stresses that many of the recent business filings involved creditors or new investors who received a majority interest in the reorganized firm and, in the process, wiped out the old equity interests.[63] To accomplish this, the debtor needs to eliminate the existing owners' interest by canceling their stock.[64] Chapter 11 is needed to accomplish this because applicable non-bankruptcy laws will not allow new investors to displace old equity, unless old equity is paid for its ownership interest. While the business could always issue new stock, these shares would be of limited value unless the debtor eliminates the interests of existing stockholders. In addition to their preference to receive valuable stock, many new outside investors (often bondholders or venture capitalists) often are unwilling to provide post-petition financing unless they are given a majority interest in and the right to control the firm in the future.[65]

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[63] See *The New Face, supra* note 1, at 72 (discussing examples of plans which proposed to swap debt for equity).

[64] *See An Exit from Chapter 11*, WASH. POST, Mar. 11, 2002, at E2 (discussing AMF Bowling Worldwide and terms of its emergence from bankruptcy); Associated Press, *Warnaco to Emerge from Bankruptcy*, N.Y. TIMES, Jan. 17, 2003, at C7 (stating Warnaco reorganization plan calls for pre-petition secured lenders to receive about $104 million in cash, $200 million in newly issued second-lien notes and more than 96 percent of newly issued common stock in Warnaco); Bloomberg News, *Aurora Foods, Inc.: Chapter 11, New CEO Part of Agreement*, CHI. TRIB., July 3, 2003, at 2C (stating Aurora plans to convert $400 million in subordinated debt and cash through pre-negotiated chapter 11 filing); *Business: Conseco Files for Bankruptcy Protection*, FACTS ON FILE WORLD NEWS DIGEST, Dec. 18, 2002, at 983G3 (stating Conseco will reduce debt from $6.5 billion to $1.4 billion by turning company's equity over to creditors); Soma Biswas, *Mattress Discounters Can Sleep Easy*, DAILY DEAL, Mar. 4, 2003 (stating bondholders and unsecured creditors will get 100% of stock in reorganized company of Mattress Discounters Corp); Thomas Content, *Harnischfeger Given Reorganization OK; Court Approves Firm's Plan Out of Bankruptcy*, MILWAUKEE J. SENTINEL, May 22, 2001, at 1D (stating under plans of reorganization new shares of common stock will be given to Harnishfeger's creditor's); Josh Friedman, *Leonard Green in Deal for Mapmaker*, L.A. TIMES, Jan. 15, 2003, at Part 3, 1 (discussing plan to swap debt for equity); Nic Hopkins, *Former NTL Chief Awarded $6.6m in Options*, THE TIMES (London), Sept. 30, 2003, at Bus., 30 (indicating award of equity in effort to erase debt); Suzanne Kapner, *Moving Fast, NTL has Plan to Reorganize*, N.Y. TIMES, Apr. 17, 2002, at W1 (discussing restructuring plan focused on swapping debt for equity); James P. Miller, *U.S. Airways Exits Bankruptcy Court*, ORLANDO SENTINEL TRIB., Apr. 1, 2003, at C1 (stating part of restructuring equity in restructured company was distributed to creditors and lenders); Bob Niedt, *The Reorganization of Penn Traffic*, THE POST-STANDARD (Syracuse, NY), May 30, 1999 (stating control of Penn Traffic will be with investors in exchange for loan forgiveness); Reuters, *Rand McNally Leaves Chapter 11 Behind*, CHI. TRIB., Apr. 8, 2003, at 3C (indicating company's plan designed to exchange debt for equity); Reuters, *Sunbeam Corp.: Firm Discloses Equity Plan, U.S. Probe*, CHI. TRIB., Sept. 10, 2002, at 2N (discussing ramifications and aspects of plan to exchange debt for equity); Ameet Sachdev, *Rand McNally Gives Up Control in Restructuring; Buyout Firm Deal Eases Debt Burden*, CHI. TRIB., Jan. 16, 2003, at Bus., 1 (stating Rand McNally turned over major ownership stake to buyout firm in effort to erase debt).

[65] *See* John M. Czarnetzky, *Time, Uncertainty, and the Law of Corporate Reorganizations*, 67 FORDHAM L. REV. 2939, 2982–84 (1999) (stating creditors essentially become owners and decision makers in reorganized firm); Michael Davis, *EOTT Heads for Bankruptcy Court*, HOUS. CHRON., Oct. 10, 2002, at Bus., 1 (indicating company will reduce debt and give creditors control of enterprise); Douglas S. Nishimura, *The Companies Creditor Arrangement Act and the Petroleum Industry: The Blue Range*

Finally, chapter 11 is needed to keep effective management teams together. Certainly, smaller business filings rarely involve significant numbers of employees, and it is possible to preserve team assets outside a bankruptcy forum in certain highly specialized industries.[66] However, without the protections afforded by the automatic stay and other provisions of the Code, a financially ailing business runs the risk of having its management team (which may be its most valuable asset) destroyed if the firm cannot be kept together.[67] Reassembling such a group of employees who are torn apart outside bankruptcy may be difficult if any have departed from the area, as they would have to relocate a second time.[68]

It is plausible, of course, that telecommuting could help keep teams together even if members of the group have moved to different regions. Indeed, many American workers now telecommute,[69] and telecommuting is becoming increasingly popular for employees in certain industries.[70] It is likely that the

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Resource Corporation Proceedings, 39 ALBERTA L. REV. 35, 40–41 (2001) (stating debtor-in-possession financing is typically only provided if lender is assured of ranking security interest and charge on assets).

[66] *See The End of Bankruptcy, supra* note 2, at 773 (citing motion picture industry as efficiently and consistently preserving team assets and arguing firms do not need to reorganize in chapter 11 to preserve value of team of key employees, as team can leave firm and take its expertise to another firm); Susan Christopherson & Michael Storper, *The Effects of Flexible Specialization on Industrial Politics and the Labor Market: The Motion Picture Industry*, 42 INDUS. & LAB. REL. REV. 331, 334 (1989) (stating motion pictures are rarely made by single studio and instead studio acts primarily as investor while independent production company organizes production). *See generally* Gaurang Mitu Gulati et al., *Connected Contracts*, 47 UCLA L. REV. 887 (2000) [hereinafter *Connected Contracts*] (discussing general tendency to create temporary firms to perform discrete projects). The motion picture industry may be somewhat idiosyncratic in its ability to quickly reassemble teams since it does not face the same geographical barriers that most other industry face, as much of that industry is based in just a few California cities.

[67] *See The End of Bankruptcy, supra* note 2, at 776 (indicating challenge of preserving value of team once firm faces financial crisis and conceding turnaround firms go to great lengths to keep good management team intact but suggesting even if team has value, value need not be tied to any particular firm).

[68] *But cf. The End of Bankruptcy, supra* note 2, at 774–75 (stating human capital is largely industry specific by citing increased mobility of workers who have skills readily transferable to other firms within same industry); *id*. at 773 (arguing as long as team can be reassembled easily, firm which it works for at any moment has little value in its own right); *id*. at 769 (indicating even though it may be difficult to maintain successful team, problem is not one necessarily solved by allowing firm to reorganize in bankruptcy because keeping team intact is different from problem of preserving particular firm). *See generally* Ann Davis, *Want Some Extra Cash? File for Chapter 11*, WALL ST. J., Oct. 31, 2001, at C1 (stating executives at bankrupt companies are being awarded lucrative bonuses as incentive to stay with company); Jeff Feeley, *Enron Offering up to $130 Million in Bankruptcy Bonuses*, BLOOMBERG NEWS, Mar. 29, 2002 (stating Enron seeks approval to offer up $130 million in effort to retain key employees).

[69] *See* Christine Romero, *Telecommuting's Popularity on the Rise*, TULSA WORLD, July 20, 2003, at E2 (stating national number of daily telecommuters rose 17%, to more than 28 million last year and is expected to surpass 30 million by 2004). *See generally* Arlene Bryant, *Many in Bellevue Leaving Cars Home*, THE SEATTLE TIMES, Dec. 31, 2000, at B1 (stating study indicated telecommuting is on rise); Don Hunt & Brian Edwards, *A Digital World; Many Properties are Wired for the Information Age*, CHI. TRIB., Aug. 21, 1998, at C32 (stating working from home or telecommuting is on rise).

[70] Telecommuting can be especially beneficial for parents, the disabled, and workers who live far from their jobs. *See, e.g.*, Eve Tahmincioglu, *By Telecommuting;Tthe Disabled Get a Key to the Office, and a Job*, N.Y. TIMES, July 20, 2003, 10, at 1 (quoting human resource management professor who estimates 7% of employed people with disabilities currently work 20 hours or more from home weekly, compared with 4.1 % in 1997); Carl E. Van Horn & Duke Storen, *Telework and the New Workplace of the 21st Century*, U.S.

number of telecommuting workers will increase because of its potential to save both time and money.[71] While certain statistics and surveys seem to indicate an increased acceptance of telecommuting[72] as well as increased productivity by telecommuters,[73] it remains an unusual and non-traditional arrangement largely because the American workplace still values a manager's right to monitor employee work. This is furthered by the fact that management questions whether telecommuting harms cooperation among traditional workers and their telecommuting peers.[74] Indeed, even within high tech industries (which *The New Face* suggests is now the prototype for large business debtors) telecommuting is not the norm.[75] Given this, it is likely that the estimated 28 million full or part-time telecommuters[76] will continue to be overshadowed by their 141 million traditional labor force counterparts for quite some time.[77]

In short, reassembling a team may be impossible once members have moved to

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DEP'T OF LABOR (2000), *available at* http://www.dol.gov/asp/telework/p1_1.htm (reporting data concludes "growth of paid home-based work has been greater among workers with disabilities").

[71] *See* PR Newswire, *Global Survey Predicts Upsurge in Telework* (July 15, 2003), *available at* http://www.findarticles.com/cf_dls/ m4PRN/ 2003_July_15/ 105437281/ p2/article.jhtml?term= [hereinafter *Global Survey*] ("Last year alone, the company's teleworking employees avoided commuting over 154 million miles to work, saving approximately 7.4 million gallons of gasoline and over 70,000 tons of carbon dioxide from being emitted into the air."); Romero, *supra* note 69, at E2 (noting Management Recruiters International estimates employers can save $10,000 per employee by reduced absenteeism and job retention costs); *see also* Van Horn & Storen, *supra* note 70 (reporting same), Press Release, Cox Business Services, *Broadband-Enhanced Teleworking Options Fuel Work-Life Balance Growth for Americans, available at* http://www.hy-life.com/hy-life/pressroom/release_063003.asp (June 30, 2003) [hereinafter *Work-Life Balance*] (estimating based on absenteeism alone, employers may save 441 billion dollars from teleworking).

[72] *See* Brad Allenby et al., *Organizing Around Networks, Not Buildings 2002/2003 AT&T Employee Telework Research Results, available at* http://www.att.com/telework/article_library/survey_results_2003.html (last visited May 18, 2004); *see also* Van Horn & Storen, *supra* note 70 (stating "The ranks of teleworkers could increase dramatically in the coming years if technology continues to improve and if workers and their managers fully embrace new models of work."); *Global Survey, supra* note 71 ("The survey indicates more than 80 percent of companies worldwide expect to have employees who telework or work remotely in the next two years, up from 54% today.").

[73] *See* Allenby et al., *supra* note 72 (stating several AT&T employees are switching to virtual offices to increase productivity and "productivity gains are the most significant" benefits of telework); *see also Work-life Balance, supra* note 71 ("According to the International Telework Association and Council (ITAC), teleworking reduces turnover by 20 percent on average, boosts productivity by 22 percent.").

[74] *See Telecommuting Wrong and Telecommuting Right*, Spherion, *at* http://www.spherion.com/staffing/pov/telecommute.jsp (last visited May 18, 2004); *see also* Rauen v. U.S. Tobacco Mfg. Ltd. P'ship, 319 F.3d 891, 896 (7th Cir. 2003) (failing to recognize telecommuting as reasonable accommodation for disabled employees because "[t]he reason working at home is rarely a reasonable accommodation is because most jobs require the kind of teamwork, personal interaction, and supervision that simply cannot be had in a home office situation.").

[75] *See, e.g.*, CNN.com Career Exclusive, *Study: Telecommuting is a wish, not reality* (Aug. 23, 2001), *available at* http://www.cnn.com/2001/career/trends/08/23/telecommuting/ (discussing survey by techies.com finding 48% of people surveyed, who were disproportionately telecommuters, actively telecommute and 9% describe themselves as full-time telecommuters and observing even among techies telecommuting is not "a hugely widespread practice.").

[76] Romero, *supra* note 69, at E2.

[77] *See Labor Force*, OCCUPATIONAL OUTLOOK QUARTERLY, Winter 2001-02, Vol. 45, Number 4, at 37, *available at* http://www.bls.gov/opub/ooq/2001/winter/qrto6.htm (last visited May 18, 2004).

take jobs in other regions, and maintaining the team from a distance by telecommuting is unlikely. Given this, chapter 11 is needed to maintain good management teams and preserve the value of this asset.

3. Chapter 11 Is Designed To Do More Than Protect Contract Rights

Baird's underlying premise in his symposium contribution (also a premise in other earlier works) appears to be that the sole purpose of chapter 11 is to maximize value to creditors.[78] By narrowly characterizing the goal of corporate reorganizations as preserving specialized assets in a particular firm to increase value to investors or creditors, *The New Face of Chapter 11* ignores, or at least severely discounts, other goals of chapter 11.[79] While another recent work of Baird's concedes that corporate reorganizations may need to consider other interests,[80] this work ultimately concludes that most interests can be protected by contract.[81]

As others have argued in the past, while protecting creditors' interests is a major goal of chapter 11, it was never intended to be the sole purpose. Chapter 11 was intended to protect the interest of employees, taxing authorities, and tort creditors who may have been harmed by the firm's actions.[82] While higher-ranking

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[78] *See, e.g.*, Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815 (1987) [hereinafter *Loss Distribution*].

[79] *See, e.g.*, Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333, 335 (1992) (rejecting exclusive economic analysis and arguing in favor of approach which considers economic and non-economic value of those affected by firm's financial crisis); *see also Loss Distribution*, *supra* note 78, at 820 (discussing distinctions between differing accounts of goals of chapter 11); *cf.* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 777 (1987) (rejecting exclusive economic approach as one giving simple answers but avoids issues pervading resolution of real problems).

[80] *See The End of Bankruptcy, supra* note 2 at 779 (considering rights such as cash-flow rights, control rights, including shifting nature of control rights).

[81] *Id*. at 780 (concluding law of corporate reorganizations matters only when capital structure of firm fails to lodge control rights in hands of someone who can exercise them competently and maintaining investment contracts rarely fail to allocate control sensibly, and investors will not likely agree to contracts that misallocate power).

[82] H.R. REP. NO. 598, at 607 (1977), *reprinted in* 1978 U.S.C.C.A.N., 5963, 6179:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure its finances so that it may continue to operate, provide employees with jobs, pay its creditors, and produce return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.

Id.; see Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 154 (1998), *citing* NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS (1997), 566–67 ("A common refrain in discussions of Chapter 11 is that it is intended to rehabilitate businesses 'for the benefit of both debtors and creditors [and] to preserve jobs and other ties within communities.'"); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 AM. BANKR. L.J. 499, 553 (1999) [hereinafter *Financial Characteristics*] (noting Congress' keen awareness of how bankruptcy law may affect jobs and local communities); *see also* Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 YALE L.J. 437, 468 (1992) [hereinafter *Untenable Case for Repeal*] ("In the hearings leading up to the 1978 Code, Congress singled out a number of beneficiaries of its distributional decisions, making repeated references to protecting jobs and saving troubled businesses.").

employees have both the incentive and power to protect their personal self-interests during the employment negotiation process, most low-level employees lack both the incentive and the clout to effectively bargain with their employers.[83] Indeed, the losses lower-level Enron employees suffered demonstrates the need for a collective procedure to protect the interests of rank-and-file workers.[84] In addition, given the allegations of fraud involved in many of the recent mega-filings,[85] even if control rights are properly allocated to creditors or employees before the fraudulent acts take place, those who have those control rights may not be able to protect their interests.[86]

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[83] *See* Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5, 6 (1996) ("[m]ost employees accept employment on the basis of severely limited information and have little ability to protect themselves in advance of an employer's possible default."); *see also* Donald C. Dowling, Jr., *The Intersection Between US Bankruptcy and Employment Law*, 10 LAB. LAW. 57, 61 (1994) (asserting employment contracts are rare except for "highly compensated executives who had the foresight and bargaining power to secure definite-term contracts.").

[84] *See* Nancy Rivera Brooks, *Enron Execs Were Paid to Remain*, L.A. TIMES, Dec. 7, 2001, sec. 3, at 3 (contrasting average $110,000 retention bonus given to Enron executives to average $4,500 severance pay for lower-level workers); *see also Judicial Decisionmaking*, *supra* note 33, at 103–11 (2003) (analyzing responses considered by Congress to eliminate perception of inequitable treatment); Jeff St. Onge & Daniel Taub, *U.S. Judge OKs Enron Severance Package*, L.A. TIMES, Aug. 29, 2002, sec. 3, at 3 (describing Enron's settlement with discharged employees).

[85] For example, Andrew Fastow (Enron's former chief financial officer reported to have engineered Enron's off-the-book partnerships) was charged with fraud, money laundering, conspiracy and obstruction of justice. *See* Kurt Eichenwald, *Ex-Enron Finance Chief is Indicted on 78 Counts*, N.Y. TIMES, Nov. 1, 2002, at C2 (reporting indictment of grand jury). L. Dennis Kozlowski (former chairman and chief executive officer of Tyco) was criminally indicted for tax evasion, grand larceny, falsifying business records, and securities fraud. *See* David Leonhardt, *Is That Your C.E.O. Cashing Out?*, N.Y. TIMES, Apr. 6, 2003, at C1 (noting Tyco executives had actually bought $45 million dollars of Tyco stock in year Kozlowsky was indicted). Finally, WorldCom, and Adelphia executives were arrested on fraud charges, K-Mart executives were accused of misrepresenting earnings and channeling millions of dollars to executives who left or were discharged from the company, and Conseco Inc. filed for bankruptcy while it was facing a federal investigation of its accounting practices. *See* Jennifer Dixon, *Subsidiary Bought 2 Planes, Purchase Came Just Before Cash Ran Out*, DETROIT FREE PRESS, June 20, 2002, at A6 (discussing Kmart subsidiary's purchase of two corporate jets two months before Kmart declared bankruptcy); Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1 (describing charges brought against WorldCom executives); Jane Hoback & Gil Rudawsky, *Former Conseco Exec Confident Firm Will Climb Out of Chapter 11*, ROCKY MTN. NEWS (Denver), Jan. 4, 2003, at C6 (explaining Conseco's filing of bankruptcy); Amy Merrick, *Kmart Studied Executive Conduct as a Focus of Its Internal Probe*, WALL ST. J., Jan. 27, 2003, at A3 (giving account of Kmart's internal investigation); Andrew Ross Sorkin, *Corporate Conduct: Prosecution; Founder of Adelphia and 2 Sons Arrested*, N.Y. TIMES, July 25, 2002, at C1 (detailing charges against Adelphia executives).

[86] Similarly, while Baird and Rasmussen contend in *The End of Bankruptcy* that some stakeholders, like localities or taxing authorities, may not need to be protected by bankruptcy laws because they can protect their interests by contract, this protection obviously is not available to tort creditors. *See The End of Bankruptcy, supra* note 2, at 780 (arguing corporate reorganizations are unnecessary when investors can contract to protect themselves). Many of the largest corporate filings in this country involved tort creditors and some (like Johns Manville and Dow Corning) filed for bankruptcy solely to resolve pending or increasing tort judgments. *See* Stuart Auerbach & Peter Behr, *Stretching the U.S. Bankruptcy Laws*, WASH. POST, Oct. 2, 1983, at G1 (stating Manville Corp. ducked behind "the protective walls of the bankruptcy court in August 1982 - not to escape creditors, but to block the rising tide of lawsuits by the victims of asbestos disease."); *see also* Susan Harrigan, *Dow Corning Files for Bankruptcy; Move Casts Doubt on Implant Settlement*, NEWSDAY (N.Y.), May 16, 1995, at A35 (commenting Dow Corning's decision to file

C. Conclusion

Bankruptcy, *as we knew it,* may no longer exist for large businesses who seek to reorganize under chapter 11 as a result of the changing capital structures utilized by many large corporations. It may not "save" many smaller businesses because the primary assets of those operations may be a human being and her contacts with other human beings (*i.e.* the customers). These assets likely will not remain with the small business debtor and will, instead, be used by another entity (controlled by the same person who controlled the bankrupt entity) that lacks the debts of that original entity. However, chapter 11s role remains one that helps large businesses avoid piecemeal liquidations and gives small business owners a second (or third, or fourth) chance to stay in business. Thus, while every corporate reorganization might not bring all stakeholders to the bargaining table to decide how to save a financially troubled firm, some still do and—in any event—saving firms by reorganizing them is but just one goal of chapter 11. Even if chapter 11s new face is one that primarily liquidates firms or implements pre-negotiated deals, this does not mean that chapter 11s old face has disappeared or *should* disappear, or that chapter 11 no longer provides benefits that do not exist outside of bankruptcy. That it wears a different face while pursuing traditional goals does not (and should not) mean that these new faces signal the end of the old goals or that corporate reorganizations are (or should be) over.

Chapter 11, or another type of uniform federal debt reorganization process, will always be needed as long as firms are managed by entities other than their creditors. While it is unclear whether chapter 11 has new faces, or just wears new makeup on its old face, *The New Face* aptly insists that we rethink the goals of chapter 11 in light of its new uses. Though rethinking chapter 11s goals does not mean there is (or need be) an end to bankruptcy as we know it, Baird's participation in this symposium undeniably makes a significant contribution to the current bankruptcy debate about the role of manager incompetence in a firm's financial failure. He has stressed in another article that, in some instances, the managers who exercise control rights "are simply not up to snuff" and may indeed be incompetent.[87] Since such managers will not exercise control rights in a way that leads to sensible business decisions, Baird asserts that the challenge is to "devise a robust mechanism to dislodge them at the right time."[88] Baird notes that "[i]ncentives alone do not ensure a successful decisionmaker" and suggests that there should be a way "to allocate control rights in a way that ensures that the managers can stay when they perform well but are ousted when they do not."[89] The remainder of this Essay

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chapter 11 petition "plunged into uncertainty" a proposed $ 4.2 billion settlement potentially involving 400,000 claimants with Dow Corning and other breast implant makers).

[87] *See The End of Bankruptcy*, *supra* note 2, at 782.

[88] *Id*.

[89] *Id*. *See generally* Kevin J. Murphy, *Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options*, 69 U. CHI. L. REV. 847, 868 (2002) (comparing two theories on managerial power with respect to management's decision on executive compensation); Franklin G. Snyder, *More Pieces*

suggests ways to give managers[90] incentives to better protect the interests of financially ailing businesses and to give creditors, investors, or new owners earlier control rights in businesses who have filed for relief in chapter 11.

II. USING CHAPTER 11 TO DISLODGE INCOMPETENT MANAGERS

A. *Replacing or Supervising Managers*

Managers of the chapter 11 businesses involved in the recent accounting and fraud scandals appear to have caused, or at least significantly contributed to, the firm's financial failure.[91] However, bankruptcy law is premised on the belief that financial failures are caused by factors that lie beyond the control of the business and its managers. As such, these factors cannot be predicted or explained (*i.e.*, exogenous risks) and are not caused by choices the managers made (*i.e.*, endogenous risks).[92] For that reason, bankruptcy laws do not automatically penalize managers simply because a business files for bankruptcy. In contrast, some non-bankruptcy state laws *do* penalize managers who intentionally engage in acts that harm the company.[93] However, except in a limited number of jurisdictions that

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of the CEO Compensation Puzzle, 28 DEL. J. CORP. L. 129, 138 (2003) (stating types of directors usually selected to corporate boards will often put CEO's interests in front of shareholders' interests).

[90] For the purposes of proposals in the next section, I define manager to include both high ranking corporate officers and board directors.

[91] *See* Hoback & Radawsky, *supra* note 85, at C6 (reporting Conseco filed for bankruptcy while facing federal investigation of its accounting practices); Merrick, *supra* note 85, at A3 (explaining how K-Mart executives created "retention loan" program gave almost $29 million to executives who left or were discharged from company, then fabricated true scope of program to board); *Two Ex-Officials of WorldCom Plead Guilty*, N.Y. TIMES, Oct. 11, 2002, at C10 (describing how WorldCom improperly accounted for $7 billion in expenses leading to bankruptcy); *SEC Charges Adelphia and Rigas Family with Massive Financial Fraud*, SEC NEWS DIG., July 24, 2002, *available at* 2002 WL 10534992 (discussing allegations Adelphia's founder and three sons used company assets as collateral for private loans, made payments for personal use, made extraordinary payments to family members for "services" and "products" sold to company, excluded billions of dollars in liabilities by concealing in off-balance sheet affiliates, and exaggerated Adelphia's earnings and falsified operations statistics).

[92] *See The Uneasy Case, supra* note 43, at 133–34 (describing traditional view of corporate reorganizations); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 Yale L.J. 1043, 1043 (1992) (explaining how bankruptcy scholars view bankruptcy as creation of extrinsic factors).

[93] Directors who engage in acts of self-dealing that harm either the company or its creditors can be fined for breaching the duty of loyalty. For example, a director/shareholder who pays himself a salary but neglects to pay creditors' debts breaches his fiduciary duty to creditors. Moreover, directors consistently are deemed to have breached their duties to creditors if they withdraw substantially all assets from the firm without leaving sufficient resources to pay the firm's debts, dissipate assets, put firm assets at risk, or if they divert firm assets to themselves, other insiders, or preferred creditors. *See* Pepper v. Litton, 308 U.S. 295, 307–09 (1939) (discussing how directors' fiduciary obligation intends to protect entire community and providing instances where salary claims of directors have been disallowed by court because it was not equitable to other creditors); Pierce v. United States, 255 U.S. 398, 402 (1921) (stating corporation cannot "disable itself from responding" to those with valid claims by "distributing its property among its shareholders."); *In re* Ben Franklin Retail Stores, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998) (explaining directors owe duty to creditors to not "divert, dissipate or unduly risk assets necessary to satisfy their claims.").

recognize the theory of deepening insolvency,[94] neither bankruptcy nor applicable state laws penalize incompetent managers or penalize managers who fail to take appropriate steps to protect a firm from bankruptcy. Because the Code assumes that managers do not cause a firm's insolvency, domestic managers do not face the sanctions that directors of non-U.S. companies face, including the risk that they will be forced to compensate creditors for losses caused by the firm's insolvency or that they will be removed or disqualified from current or future board service.[95]

A return to the pre-Code practice of automatically replacing the management of large companies when the company files for bankruptcy would be unwise because it would discourage managers from placing a firm under the protection of bankruptcy laws even when a filing clearly is in the firm's best interest.[96] For the same reason, it would not be prudent to adopt the non-U.S. practice of automatically removing managers when the firm initiates an insolvency proceeding. However, as long as non-bankruptcy laws permit managers to run (and potentially commit fraudulent or negligent acts concerning) firms, creditors will need some type of unified proceeding both to stop the firm from hemorrhaging and to oust incompetent managers. Thus, in rethinking the goals of chapter 11 and in attempting to find ways to help dislodge incompetent managers, we must revisit the assumption that managers are not primarily to blame for corporate failures.

If managers either caused the firm's financial problems or are incompetent, then creditors, employees, shareholders and other parties in interest in a large business reorganization should have the option of having a competent outside party supervise or otherwise be involved with management of the firm for the following reasons: (1) to ensure that it should be in chapter 11 (rather than simply liquidated in a non-bankruptcy forum); (2) to quickly remove incompetent managers; and (3) to

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[94] Jurisdictions increasingly are willing to find directors or a firm's financial advisors who prolong an insolvent firm's corporate life by causing the firm to sink deeper into insolvency breach their fiduciary duties to creditors if they provide misleading financial information that either causes creditors to extend credit or prevents creditors from any possible recovery of their claims. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–50 (3d Cir. 2001) (concluding "deepening insolvency" may give rise to cognizable injury); *In re* Flagship Healthcare, Inc., 269 B.R. 721, 732 (Bankr. S.D. Fla. 2001) (holding fiduciary duty was owed and breached by negligent performance of services); *In re* Ben Franklin, 225 B.R. at 656 (noting directors who cause corporation to incur unnecessary debt may be liable to creditors for breach of duty). This theory is similar to the trading while insolvent or trading at the risk of creditors penalty imposed on directors of British, Australian, Canadian and French companies. *See infra* note 95.

[95] Specifically, British, Australian, Canadian and French directors may be forced to contribute their personal assets to the firm's insolvency proceeding if they are found to have "traded while insolvent". *See* Insolvency Act, c.45, § 214 (1986) (Eng.); Australian Companies Act, § 588 (1993) (Austl.); *see also* Andrew West & François-Xavier Lucas, *France, in* DIRECTORS' DUTIES AND LIABILITIES 38, 41, 45 (Paul J. Omar ed., 2000) (discussing liability under French laws for losses sustained due to directors' conduct); Tracy C. Sandler & Stephanie Ben-Ishai, *Director Liability in Canadian Insolvencies*, American Bankruptcy Institute Annual Spring Meeting (April 18-21, 2002), *available at* WL 041802 ABI-CLE 399, 414 (discussing directors' duties in Canada).

[96] Chapter X of the Bankruptcy Act mandated the automatic displacement of existing management and the appointment of a trustee for large companies. *See* 11 U.S.C. § 556 (1976) (repealed 1978) (noting "[u]pon the approval of a petition, the judge shall, if the indebtedness of a debtor, liquidated as to the amount and not contingent as to liability, is $250,000 or over, appoint one or more trustees.").

generally help ensure that the reorganization is an efficient one. To provide a method to dislodge incompetent managers, to protect the control rights of creditors, and to give new owners earlier control rights over the reorganizing business, there should be a rebuttable presumption that a bankruptcy trustee or examiner will be appointed to supervise existing management and to determine whether they are competent to continue running the firm. Alternatively, a turnaround specialist or chief restructuring officer ("CRO") should be retained to help guide the firm through the bankruptcy case. If a majority of the creditors consent to having existing management remain in place unsupervised, then no trustee, examiner, or CRO should be appointed.

Having a uniform federal reorganization proceeding supervised by a judge is beneficial because it provides one forum to help expose managers incompetence and fraud, assess their competence and conduct, then decide whether that conduct warrants sanctions. Even scholars who generally believe that markets (rather than courts) should decide how to allocate a financially ailing debtor's assets agree that judges are more qualified to police misbehavior by parties.[97] While *The New Face* argues that the modern creditor (especially the primary lender) has increasingly powerful control over large businesses, it does not consider why so few creditors actually remove either the officers or directors of financially failing firms before the bankruptcy filing. While there are some instances of poorly performing managers being replaced at the insistence of either shareholders[98] or major lenders,[99] and shareholders increasingly are demanding greater rights to name or remove directors,[100] removals are rare, even in pre-negotiated or pre-packaged

[97] *See, e.g., Economic Analysis of Corporate Bankruptcy, supra* note 49, at 92–93 (generally advocating market processes but conceding "[j]udges are particularly adept at policing misbehavior by the parties" and concluding "giving bankruptcy courts a central role in policing misbehavior is an important and appropriate focus of the bankruptcy laws."); *see also The New Face, supra* note 1 (observing bankruptcy judges perform job of weeding out meritless small business cases as well as market actors who face restraints similar to those facing judges).

[98] Chris Kauffmann, *Two Directors Leave Marine Bank Board; Chairman Richard Bolinger Says Ned Curtis Left to Concentrate on His Own Company, and Robert MacWilliam Departed for Health Reasons*, PRESS J., June 24, 2003, at B8 (discussing shareholder removal of nine directors); David Warsh, *Swedish Import May be Just What Business Needs*, CHI. TRIB., July 4, 1993, at C4 (stating directors of IBM, Digital Equipment, General Motors, Salomon Brothers, and American Express resigned as result of pressure from big institutional investors); Barnet D. Wolf, *Board of Directors*; *2 Founders Return to National Century*, COLUMBUS DISPATCH, May 30, 2003, at E1 (reporting shareholder removal of one of three directors); *Courses Help Director's Sharpen Their Skills in the Boardroom*, CHI. TRIB., Apr. 9, 1995, at M9 (stating shareholders have recently increased pressures to remove poor-performing managers).

[99] *See* Joe Gardyasz, *Touch 1 May Sell Telemarketer*, BISMARK TRIB., July 18, 1998, at B1 (noting Founder and CEO of Touch 1 replaced at request of company's secured creditors); Jeff Manning, *Judge Dismisses Claim Ex-Wilshire Executives Improperly Got Funds; Other Charges are Still Pending in the Case Against Andres Wiederhorn and Larry Mendelsohn*, THE OREGONIAN, July 25, 2000, at A1 (explaining after gaining majority on board of directors, creditors fired founder and CEO of Wilshire); Brenda Witherspoon, *Morning Briefcase*, DALLAS MORNING NEWS, Feb. 14, 1997, at 4D (stating Mercury Finance had replaced its chief executive to please creditors).

[100] *See* Edward Iwata, *Shareholders Win in Hanover Settlement*, USA TODAY, May 14, 2003, at B3 (noting as part of settlement of lawsuit, shareholders with more than 1% of company stock acquired right to nominate two independent directors to company's slate of candidates during proxy season); *see also*

reorganization proceedings controlled by firm lenders. In fact, the managers of the most recent mega-firms that filed a chapter 11 petition were not fired by creditors' pre-petition and were not replaced until after the filing,[101] despite the appearance of criminal conduct.[102] This suggests, at least, that the control rights that creditors theoretically have outside of bankruptcy may not effectively protect the firm from incompetent managers.

Some of the recent chapter 11 filings unfortunately suggest that creditors, shareholders, and other stakeholders may be unable to exercise *any* control rights they contractually bargained for if the firm's managers are operating the firm incompetently or fraudulently and the directors are not monitoring these managers. While empirical data cited in *The New Face* suggests that bankruptcy judges quickly dispose of meritless small business cases,[103] and quickly confirm plans in the large chapter 11 cases,[104] *The New Face* does not address in depth the typical case progression for debtors whose managers are accused of either committing

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Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1, 55 (1989) (stating rationale for removing management is management's wrongful actions which increase financial losses); *cf*. Simon Romero, *El Paso Claims Victory in a Proxy Dispute*, N.Y. TIMES, June 18, 2003, at C1 (while shareholder of El Paso Corporation failed to replace company's current leadership with his own nominees, El Paso viewed shareholder action as important example of shareholders advancing their concerns over corporate performance).

[101] WorldCom's CEO (Bernard Ebbers) was replaced after filing in late April 2002. *WorldCom Pins Hopes on IP Data Services, available at* http://www.computerworld.com/managementtopics/xsp/isptelecom/story/0,10801,71617,00.html (last visited May 18, 2004). Likewise, the CEO of Adelphia was replaced after the filing in May 2002. *See* David Lieberman, *SEC Filing Reveals Rigases' Use of Adelphia's Assets*, USA TODAY, May 27, 2002, *available at* http://www.usatoday.com/money/telecom/2002-05-28-adelphia.htm (May 28, 2002); *see also Case Against Fastow Points Higher; Complaint Seen as Foundation for Prosecution of Top Enron Executives*, WASH. POST, Oct. 3, 2002, at E1 (CEO of Enron resigned under pressure from creditors in Enron's bankruptcy case); Seth Schiesel, *Most of Board at WorldCom Resign Posts*, N.Y. TIMES, Dec. 18, 2002, at C7 (majority of WorldCom board resigned because creditors committee in bankruptcy case found resignations to be absolutely essential). *See generally* Lisa M. Fairfax, *Form Over Substance?: Officer Certification and the Promise of Enhanced Personal Accountability Under the Sarbanes-Oxley Act*, 55 RUTGERS L. REV. 1, 11–12 (2002) (stating arrest of top-level executives displays their intimate involvement in accounting fraud).

[102] *See supra* note 85 and 101; *Kmart Reports Evidence of Wrongdoing, available at* http://money.cnn.com/2003/01/25/news/kmart_wrongdoing (Jan. 25, 2003) (reporting evidence of wrongdoing by top management prior to Kmart's chapter 11 filing).

[103] *See The New Face*, *supra* note 1, at 89–90. *See generally* Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 185 (2000) (noting chapter 11 procedures are "inefficient or too cumbersome" for successful reorganization of small businesses); Richard A. Greene, *Recent Developments in Small Business Bankruptcy Law*, 7 J. SMALL & EMERGING BUS. L. 215, 217 (2003) (observing "small businesses flounder in reorganization cases because of the expense and time needed.").

[104] *See* Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 600–01 (1993) [hereinafter *Patterns in Reorganization*] (finding 96% confirmation rate for large, public companies who reorganize); *Financial Characteristics*, *supra* note 82, at 500 (deeming chapter 11s complex structure more suitable for businesses with "sufficiently large assets and debt to support an expensive restructuring."). *See generally* Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231, 255–56 (2001) [hereinafter *Race to the Bottom*] (reporting high confirmation rates for large companies).

fraudulent acts or of being incompetent.[105] Unless managers agree to resign, however, the rigidity of existing bankruptcy rules makes it hard to replace them unless creditors or investors provide proof of fraud, dishonesty, incompetence, or gross negligence in management of the firm's affairs.[106]

Under the current test for appointment of a trustee, the court must find that current management has displayed fraud, dishonesty, incompetence, or gross negligence in managing the debtor's affairs.[107] Though this gives courts the authority to remove incompetent managers or managers who are currently engaged in fraudulent acts, as *The New Face* observes, trustees are rarely appointed in mega-cases largely because of concerns about the expense of such an appointment and the potential disruption to the business by replacing existing management.[108] Creating a presumption that existing management will be either replaced or supervised by a trustee, examiner, or CRO would not harm existing practice. Indeed, adopting this proposal would be consistent with recent practice in large business filings since, as *The New Face* notes, bringing in outside experts (like CROs, turnaround specialists or new chief operating officers) to either help or replace management is becoming common.[109] Moreover, existing empirical data suggest that, in any event, few managers survive large corporate reorganizations,[110] and that those directors who

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[105] While Baird states that large businesses entering chapter 11 without a pre-negotiated plan take considerably longer than pre-negotiated or pre-packaged filings and indicates that bankruptcy judges in small business cases take longer to act if there is active criminal fraud, he does not otherwise discuss what tends to happen in cases where there are allegations of manager fraud. *See The New Face*, *supra* note 1, at 89. Baird concludes that, in general, bankruptcy judges largely sort cases correctly since meritless small business filings rarely linger in bankruptcy courts. *Id*. Given this, he suggests that it would not be wise to curb the judges' decision-making authority, a suggestion I raised in a recent work as well. *See Judicial Decisionmaking, supra* note 33, at 104–07 (supporting judicial discretion in retention/severance programs); *see also* Harriet Thomas Ivy, *Means Testing Under the Bankruptcy Reform Act of 1999: A Flawed Means to a Questionable End*, 17 BANKR. DEV. J. 221, 242–43 (2000) (finding judicial discretion necessary in chapter 11 cases).

[106] *See* 11 U.S.C. § 1104 (2002). The Bankruptcy Code contemplates that the debtor will remain in possession. *See, e.g.*, 11 U.S.C. § 1107.

[107] *See* 11 U.S.C. § 1104(a)(1); *see also* Cajun Elec. Power Co-op. v. Central La. Elec. Co., Inc. (*In re* Cajun Elec. Power Co-op.), 69 F.3d 746, 749 (5th Cir. 1995) (characterizing appointing trustee as extraordinary remedy); *In re* Nautilus of N.M., Inc., 83 B.R. 784, 788 (Bankr. D. N.M. 1988) (placing burden of proof, by clear and convincing evidence, on party seeking removal of debtor-in-possession); *In re* William Smith Constr. Co., 77 B.R. 124, 126 (Bankr. N.D. Ohio 1987) (stating same). *See generally* 7 COLLIER ON BANKRUPTCY ¶ 1104.02[1] (Lawrence P. King. et al. 15th ed. 2002) (presuming debtor's managers, who are most familiar with business, best suited to run business during reorganization).

[108] *See The New Face, supra* note 1, at 92–93; *see also* Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 548, 560 (3d Cir. 2003) (noting trustees are exception and rarely exist in chapter 11); 7 COLLIER ON BANKRUPTCY ¶1104.02[1] (2002) (characterizing appointment of chapter 11 trustee as "extraordinary" remedy).

[109] *See The New Face, supra* note 1, at 81; *see also* Panel Discussion, *The Judge's Role in Insolvency Proceedings: The View from the Bench; The View from the Bar*, 10 AM. BANKR. INST. L. REV. 511, 523 (2002) (explaining turnaround specialists are usually installed as interim management).

[110] *See* Stuart C. Gilson, *Bankruptcy, Boards, Banks and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355, 371 (1990); Stuart C. Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241, 245 (1989); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723–24 (1993) (finding change in CEOs of large, corporate debtors in

have not resigned will be replaced.[111] Recent filings suggest that trend will continue.[112]

An additional reason to create a presumption that managers will be supervised and potentially replaced is that it gives the new owners quicker control over the company. As *The New Face* indicates, many corporate reorganizations are used to transfer ownership of a financially troubled company to a third-party.[113] Given this ownership change, replacing directors has become common, especially once the plan is confirmed.[114] Creating the presumption that officers and directors will be either supervised or replaced removes some control rights from the people who actually run the business pre-petition (and perhaps post-petition as well) and gives those rights to the firm's creditors, existing shareholders, or new investors immediately after the bankruptcy filing.[115] Because the new owners likely will

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ninety-one percent of cases studied); *Patterns in Reorganization, supra* note 104, at 610 (discussing rapid turnover of corporate managers in chapter 11 reorganizations of publicly held companies); *Untenable Case for Repeal, supra* note 82, at 449 (finding seventy-one percent of managers of firms filing for bankruptcy lost their jobs).

[111] *See* John D. Ayer, *The Role of Finance Theory in Shaping Bankruptcy Policy*, 3 AM. BANKR. INST. L. REV. 53, 83 n.99 (1995) (discussing statistics regarding replacement of board of directors); *Chapter 11 at Twilight, supra* note 2, at n.72 (citing LoPucki database indicating significant board turnover of chapter 11 businesses emerged in 2002); Brian L. Betker et al., *"Warm with Sunny Skies": Disclosure Statement Forecasts*, 73 AM. BANKR. L.J. 809, 826 (1999) (estimating boards change 70% of members during reorganization).

[112] For example, after Enron filed for bankruptcy it named a corporate bankruptcy rescue specialist as its interim chief executive officer to replace longtime Board Chair and CEO Ken Lay, who stepped down under pressure from creditors. *See* Tom Fowler, *The Fall of Enron: Bankruptcy Expert Named Enron CEO: Stephen Cooper to Replace Lay, Faces Tough Task of Reorganizing Fallen Giant*, HOUS. CHRON., Jan. 30, 2002, at A1. The person named as the bankruptcy rescue specialist was employed by a firm that had worked with other chapter 11 debtors, including Polaroid, Sunbeam, and Federated Department Stores. *See* Noelle Knox, *New Enron CEO Turns Company Focus to Future While Workers Cope with Loss and Uncertainty*, USA TODAY, Feb. 18, 2002, at B3. Kmart replaced its chairman and named a former Chief Operating Officer (COO) of Sears, Roebuck and Co. as its President and COO (and later CEO) to fill the vacancy created when Kmart's President was ousted after 15 months in the job but ultimately appointed a CRO. *See Kmart Executive To Get Millions*, Jan. 24, 2002, *available at* http://www.clickondetroit.com; *New Team Takes Full Command at Kmart*, DETROIT FREE PRESS, Mar. 12, 2002, *available at* http://www.freep.com; *see also* Rachel Katz, *Restructuring Kmart Names New CEO: President Julian Day Replaces James Adamson in Taking Firm out of Chapter 11*, L.A. TIMES, Jan. 20, 2003; *Kmart Announces Appointment of Senior Officers to Guide Company Through Reorganization*, PR NEWSWIRE (Troy, Mich), Mar. 11, 2002; Lorene Yue, *New Head of Kmart Installs 'Heavyweight' Turnaround Team*, DETROIT FREE PRESS, Mar. 12, 2002, *available at* http://www.freep.com. Adelphia Communications appointed as its new Chief Financial Officer (CFO) a person with expertise in turning around struggling companies. *See Adelphia Pins Hopes on Turnaround Expert*, ORLANDO SENTINEL, Mar. 22, 2003, at C3. Finally, after ousting its CEO, WorldCom hired as its CRO and CFO two executives of a restructuring firm. *See* Elizabeth Douglass, *WorldCom Hires Turnaround Experts*, L.A. TIMES, July 30, 2002, Part 3, 3.

[113] *See The New Face, supra* note 1, at 74; *see The Uneasy Case*, *supra* note 43, at 127 (stating sale of ownership rights to third-party is common form of bankruptcy proceeding); David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723, 768 (1997-1998) (discussing advantages of eliminating corporate reorganization and auctioning off firms once they file for bankruptcy due to advantages of third-party sales).

[114] *See The New Face*, *supra* note 1, at 81; *supra* note 111 and accompanying text.

[115] *See Nature of the Firm, supra* note 42 (suggesting board of directors, not DIP lenders, control most large business reorganizations); Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business*

replace any existing directors who have not yet resigned once they are in control and they will demand the resignation of poorly performing officers, creating the presumption that managers will be supervised gives some new owners a slightly earlier opportunity to decide whether to replace officers. This affords all creditors an opportunity to replace poorly performing officers and directors well before the plan is confirmed.

Finally, giving creditors or new owners the explicit authority to have new interim management (such as a CRO) appointed also would help to eliminate some of the disconnect between the day-to-day practice in bankruptcy courts (where CROs are common, at least in large cases) and the practice as reflected in the Code (where CROs are not explicitly authorized) or appellate decisions (where CROs are rarely mentioned).

B. Encouraging Managers to File Earlier Bankruptcy Petitions

Managers have no incentive to file an early bankruptcy petition because they know that, in most instances, they will be replaced or forced to resign[116] and any ownership interests they have in the firm will become virtually worthless.[117] Moreover, if they know they have violated criminal laws, they will have an incentive to delay filing hoping to delay or prevent prosecution. Similarly, if they are in the process of misappropriating funds or are attempting to sell their interest in the business before filing, they have an incentive to delay to make sure they can reap inappropriate financial benefits from the firm before turning it over to creditors in bankruptcy.

To encourage managers to file earlier bankruptcy petitions and to give competent directors an incentive to monitor their fellow directors' behavior once a firm approaches insolvency, directors should have a duty to file a timely petition. Courts should find that they have breached that duty if they fail to place firms in bankruptcy within thirty days of either (1) when the directors knew that the firm would be unable to pay its probable liability on its existing debts as they matured or (2) when they knew (or should have known) that the firm's current liabilities exceeded the fair market value of its current tangible assets.[118] Directors who breach

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Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 BANKR. DEV. J. 1, 23–24 (1989) (discussing reasons why chapter 11 usually places officers and directors in operating control during reorganization). *See generally* A. Mechele Dickerson, *A Behavioral Approach to Analyzing Corporate Failures*, 38 WAKE FOREST L. REV. 1, 40 (2003) [hereinafter *A Behavioral Approach*] (urging timely filing of bankruptcy duty in order to force directors to consider all interests of firms' constituents).

[116] *See supra* note 111 and accompanying text.

[117] *See* Lynn M. Lopucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729, 733 (1993) (recognizing owner-manager interests in insolvent companies are valued at virtually nothing which may result in owner-managers taking unjustified risks). *But see* Atlas, *supra* note 51, at C1 (reporting shares of one company tripled in two months after it filed for relief under chapter 11).

[118] I elaborate on these arguments in another article. *See generally A Behavioral Approach*, *supra* note 115, at 42–45 (establishing liability for directors who delay filing for bankruptcy); *see also* Geyer v.

this duty should be fined in an amount equal to three times the highest directors' fee paid (or the value of the property given in lieu of a fee) in the three years before the filing to force directors to reimburse the business (at least in part) for failing to protect it.[119]

Forcing managers to concede early on that the business cannot survive (either because it needs to be sold to new owners or needs to radically restructure its debts or operating structure) also helps to avoid the final period problem. The final period makes managers indifferent to market controls once the firm becomes insolvent. This problem arises when a person fears that she is about to lose her job and senses that she will be unable to secure equal or better employment.[120] Once the firm becomes insolvent, the final period bias will give directors (especially insiders) an incentive to engage in high-risk activities to save the firm, as they may know (or at least suspect) that their future financial opportunities are limited. That is, inside directors of insolvent firms will want to delay filing a bankruptcy petition for the firm since most will know (or at least suspect) they will be replaced if the firm files for bankruptcy.[121] Similarly, given the damaged reputation that inside directors may suffer because of the public scrutiny of their conduct, they will seek to delay the filing if they believe there is even a remote chance of saving the business.[122]

As stated earlier, chapter 11 remains designed to help businesses either reorganize and continue in business, or liquidate efficiently. Earlier filings should increase the likelihood that the business can successfully reorganize, as firms

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Ingersoll Publ'ns Co., 621 A.2d 784, 787 (Del. Ch. 1992) (supporting insolvency in fact over statutory filing as appropriate trigger for fiduciary duties towards creditors).

[119] *See A Behavioral Approach*, *supra* note 115, at 46 (discussing appropriate penalties for directors failing to protect firm); *see also* Zipora Cohen, *Directors' Negligence Liability to Creditors: A Comparative and Critical View*, 26 J. CORP. L. 351, 352 (2001) (arguing for director liability in close corporations). *See generally* Ramesh K.S. Rao, et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 67 (1996) [hereinafter *Duty a la Lyonnais*] (stating directors have little incentive to file for bankruptcy because of self-interested financial motivation to avoid losses owed to them by employer).

[120] *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 DUKE L. REV. 1397, 1426 n.132 (2002) (noting managers and shareholders interest are not aligned during final period because of job instability and unfavorable market labor dynamics); *Connected Contracts, supra* note 66, at 903 (identifying managerial incentives to take high risk occur when bankruptcy imminent); Gaurang Mitu Gulati, *When Corporate Managers Fear a Good Thing Is Coming to an End: The Case of Interim Nondisclosure*, 46 UCLA L. REV. 675, 694 (1999) [hereinafter *Interim Nondisclosure*] (illustrating how bankruptcy lends itself to managerial neglect motivated by fear of job loss).

[121] *See supra* note 111; *see also Duty a la Lyonnais, supra* note 119, at 67 (identifying balancing which exist between self-protection and investor interest); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1396–97 (2000) (discussing why managers faced with insecure employment will attempt to delay filing for bankruptcy even if transferring cost to investors).

[122] *See* Cohen, *supra* note 119, at 352 (claiming shareholders can replace directors or make corporation vulnerable to takeovers); *Interim Nondisclosure, supra* note 120, at 694–95 (asserting managers no longer fear harm to reputation during final-period); *see also A Behavioral Approach, supra* note 115, at 23 (indicating directors value prestige and status, and will consider embarrassment and harm to their social esteem in corporate decision making).

entering chapter 11 which are too highly leveraged often fail to reduce sufficient debt in the reorganization to save the company.[123] Likewise, an earlier filing of a company that is not as highly leveraged should decrease the likelihood that the business will need to file another chapter 11 petition in the future.[124]

C. Debarring Unfit Managers

Finally, under certain circumstances, incompetent managers who have caused harm to the business because of this unfitness should be declared unfit and barred from serving on current or future boards. Upon motion of an interested party or the court in either a breach of fiduciary duty suit involving an insolvent business or in a federal bankruptcy or state receivership proceeding, there should be a rebuttable presumption that the directors of insolvent firms are unfit for board service and that they should be disqualified from future board service for a period fixed by the authority that issues the disqualification order. In determining whether a director is presumptively unfit, courts should consider whether greed, sloth, or incompetence caused the director to allow the financial implosion of the firm. If these factors contributed to the director's lax monitoring, he/she should be found unfit for board service and should be barred from current and future service.[125]

Relying on market controls or other non-legal remedies to eliminate incompetent directors has not worked and will continue to be ineffective. The market is not likely to protect shareholders from unfit directors primarily because

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[123] *See A Behavioral Approach, supra* note 115, at 33 (observing empirical data highlight highly leveraged firms frequently fail to reduce debt enough in bankruptcy restructuring to emerge as viable concerns); *see also Race to the Bottom, supra* note 104, at 270 (discussing prevalence of serial filings particularly for highly leveraged companies who file in Delaware and New York bankruptcy courts); *Patterns in Reorganization, supra* note 110, at 608–09 (revealing data suggesting large companies frequently "emerge from Chapter 11 with too much debt" and "the general refiling rate for companies that have emerged from Chapter 11 is extraordinarily high."). *But cf.,* Robert Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283, 285–86, 293–94 (2001) (disputing Lopucki and Kalin's assessment that Delaware's courts allow firms to emerge with inordinate debt and hypothesizing any high refiling rate may increase overall social welfare).

[124] *See A Behavioral Approach, supra* note 115, at 35 n.128 (detailing TWA and Phar-Mor, Inc. as well-publicized examples of serial filers, and collecting articles on serial refilings); *see also Race to the Bottom, supra* note 104, at 244, 265 (finding debtors who filed in Delaware had higher refiling rates and attributing refiling rate to "Delaware bankruptcy court's laissez-faire approach to confirmation."). *See generally* Noel S. Cohen, Note & Comment, *Serial Chapter 11 Filings: Finding Method in the Madness*, 17 BANKR. DEV. J. 461, 462–63, 485–96 (2001) [hereinafter *Serial Chapter 11 Filings*] (reviewing background and purpose behind multiple chapter 11 filings, and discussing other approaches to determining validity of serial filings); James D. Key, Comment, *The Advent of the Serial Chapter 11 Filing and Its Implications*, 8 BANKR. DEV. J. 245, 255–64 (1991) (detailing early serial chapter 11 cases and courts' responses).

[125] *See* A. Mechele Dickerson, *A Behavioral Approach to Unfit Directors* (unpublished manuscript, on file with author). *See generally* S.E.C. v. Posner, 16 F.3d 520, 522 (2d Cir. 1994) (affirming district court "banishment" of defendants from ever "acting as officers or directors of any public company"); Michael Dailey, Comment, *Officer And Director Bars: Who Is Substantially Unfit To Serve After Sarbanes-Oxley?*, 40 HOUS. L. REV. 837, 849–51 (examining court's power to bar directors and officers for "unfitness" under section 305 of Sarbanes-Oxley Act of 2002 and noting "Congress wanted to make sure that this 'extraordinary remedy' was exercised with caution.").

shareholders generally lack information about the fitness (or unfitness) of directors. Additionally, even with full information, small individual shareholders have no incentive to mount an expensive campaign to remove an unfit director or to prevent that director from being appointed to a board.[126] Once directors are elected, it takes significant effort to have them removed—especially if it is a public business—given the large number of shareholders needed to prevent a director from joining a board or to call a special meeting to remove one who is already on the board.[127]

Relying on either the market or on business norms to protect the business from unfit directors also is problematic, both because the market tends to have a very short (and forgiving) memory and because some directors may simply be shameless.[128] That is, despite the highly publicized, scandalous financial improprieties involving the recent collapse of large and (at that time) reputable corporations,[129] some of their directors refused to voluntarily resign from other boards, or to decline invitations to join future boards.[130] Likewise, while some

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[126] *See* Stephen M. Bainbridge, *Director Primacy: The Means And Ends Of Corporate Governance*, 97 NW. U. L. REV. 547, 558, 569–71 (2003) (observing "most shareholders are rationally apathetic" which "precludes small individual shareholders from playing an active role in corporate governance."); *see also* Jayne W. Barnard, *The Securities Law Enforcement Remedies Act of 1989: Disenfranchising Shareholders in Order to Protect Them*, 65 NOTRE DAME L. REV. 32, 51–52, 64 (1989) (noting cumbersome setting involved in voting against incumbent management in proxy voting even where shareholder is willing to undertake costs of challenge); Lucian Arye Bebchuk, *The Case For Shareholder Access To The Ballot*, 59 BUS. LAW. 43, 44–45 (2003) (arguing need for reforming corporate elections as "[a]ttempts to replace directors are extremely rare" given financial disincentives posed by mounting proxy fights). *But see* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 523–25 (1990) (surveying shareholder passivity problem and arguing shareholder monitoring of directors fundamentally has not been effectively tried).

[127] *See* MODEL BUS. CORP. ACT § 8.09(a) (1984) ("[A] court . . . may remove a director of the corporation from office in a proceeding commenced either by the corporation or by its shareholders holding at least 10 percent of the outstanding shares of any class if the court finds that (1) the director engaged in fraudulent or dishonest conduct, or gross abuse of authority or discretion, with respect to the corporation and (2) removal is in the best interest of the corporation."); *Activist Shareholder Benefit Boards, ISS Panelist Say*, INVESTOR REL. BUS., Mar. 19, 2001 (advocating appointment of shareholders to boards of directors because of personal stake in company, which would protect against bad decisions of independent management).

[128] *See, e.g.*, Joshua Green, *Savage Business*, AM. PROSPECT, June 17, 2002, at 14 (showing pressure on Enron board members to resign positions in other corporations). "[A] vexing dilemma [arose]: What do you do when a system governed by shame encounters a business man who's shameless?" *Id*. *But cf., e.g.*, *In re* Enron Corp. Sec., 235 F. Supp. 2d 549, 658 (S.D. Tex. 2002) ("Skilling…would rather abandon ship now than resign in shame in 2 years.").

[129] *See supra* notes 85, 91.

[130] *See, e.g.*, Green, *supra* note 128, at 14 (depicting story of one stubborn executive, Frank Savage). Frank Savage, a former Enron director remained on the boards of Qualcomm and the Lockheed Martin Corporation, even after the Enron scandal broke. *Id.; see also* Jim Hopkins & Edward Iwata, *WorldCom Directors' Credibility Doubted*, USA TODAY, June 11, 2003, at 3B (discussing Frank Savage's resistance to resign). Another director, Ronnie Chan, remained the Chair at Hang Lung Group and Motorola. *Id*.; Rob Kaiser, *Enron Director to Yield Motorola Seat*; *Chan Won't Seek Re-election; Foes Step up Pressure*, CHI. TRIB., Mar. 1, 2002, at 3N; Stephen Seawright, *Chan Urged to Drop Overseas Directorships*, S. CHINA MORNING POST (Hong Kong), Feb. 15, 2002, at Business Post 3. Former WorldCom directors remained on the boards of the News Corporation Limited, Valence Technology, CAPCure (Bert Roberts), MicroStrategy Incorporated (John Sidgmore), Martek Biosciences Corporation, MedImmune Inc., and White Mountains Insurance Group Limited (Gordon S. Macklin). *See Brazilian Bonds up for 2d Day*, WASH. POST, Aug. 16, 2002, at E2 (commenting on Bert Robert's retirement); Reed Abelson, *Enron's Many Strands: The*

directors have in the past voluntarily resigned after the SEC investigated their companies, many appear to have done so only as part of a settlement with the SEC, not because they were shamed into doing so.[131] Because criminal convictions and public notoriety do not adequately ensure that incompetent managers will be harmed in the market (by losing board compensation) or will be shunned (by being automatically removed from, not added to, boards), and because some managers appear impervious to shame, another remedy (such as being labeled unfit and barred from current and future board service) is needed to help dislodge incompetent managers.

CONCLUSION

That chapter 11 has one face in mega-cases, a different one in smaller business filings and yet another in reported appellate decisions is not such a bad thing. These variations prove the flexibility and versatility of chapter 11 and indicate that it will be able to handle the wide range of issues raised in both small and large business failures for another 25 years. As long as all faces continue to pursue the goal of giving organizations time to decide whether to have an orderly liquidation or to continue in business (with or without the same owners or the same corporate name or form), how the faces allow the pursuit of those goals is largely irrelevant. The strength of *The New Face* is its recognition of these multiple faces and its challenge to courts and scholars to ensure that these faces continue to advance the goals and policies of bankruptcy laws.

Directors; Endgame? Some Enron Board Members Quit or Face Ouster at Other Companies, N.Y. TIMES, Feb. 9, 2002, at C5 (illustrating resilience of corporate directors in keeping positions in other corporations after leaving scandalous ones); Shannon Henry, *So Many Hats for so Few Heads*, WASH. POST, Aug. 15, 2002, at E1 (noting circumstances surrounding John Sidgmore's resignation).

[131] *See, e.g.*, SEC v. First Pac. Bancorp, 142 F.3d. 1186 (9th Cir. 1999) (authorizing district court to permanently bar bank chairman from acting as officer or director of public company); SEC v. Gulf Res., Inc., T.C.M. (CCH) ¶ 99, 174 (D.D.C. 1983) (ordering compliance with subpoenas duces tecum); SEC v. Rusco Indus., Inc., T.C.M. (CCH) ¶ 93, 144 (S.D.N.Y. 1971) (enjoining officer from conduct related to his conviction for securities fraud).