WRITTEN STATEMENT OF WITNESS

TO: House of Representatives Committee on the Judiciary
Subcommittee on Commercial and Administrative Law

FROM: Barry E. Adler
the Charles Seligson Professor of Law
New York University School of Law

SUBJECT: Hearing on Lehman Brothers, Sharper Image, Bennigan's, and Beyond: Is Chapter 11 Bankruptcy Working?

DATE: 9/25/2008

The statement that follows has been prepared for the above-captioned hearing to take place on September 26, 2008.

Hearing on Lehman Brothers, Sharper Image, Bennigan's, and Beyond: Is Chapter 11 Bankruptcy Working?

Over the past decade or so there has been a sea change in the process of bankruptcy reorganization for large, publicly traded firms. The traditional Chapter 11 paradigm, applicable in the 1980s and much of the 1990s, was that of a financially troubled debtor in bankruptcy to gain breathing room from creditors. The managers of the debtor before bankruptcy not infrequently remained in control of the debtor in bankruptcy, and sometimes after. During the Chapter 11 case, these managers, speaking for the debtor as an entity, orchestrated a plan through which the firm's debt would be reduced. Creditors, for their part, went along with the debtor often because the alternative was an extended negotiation after which the court might coerce (or "cram down") the debtor's plan anyway. Firms would routinely emerge from bankruptcy subject to a new capital structure regardless of whether there had been a cure for the economic woes that brought the firm into bankruptcy in the first place.[1] Matters are different today as debtor control of bankruptcy has given way to creditor dominance.

A large firm that enters bankruptcy today frequently has already pledged most or all of its assets to one or a number of secured creditors.[2] When the curtain opens on a typical case, a secured creditor has wrested or quickly wrests control of the case from the debtor's managers.[3] A frequent vehicle for such control is the debtor-in-possession (or "DIP") loan,[4] where a creditor, frequently an existing secured creditor, finances the continuing operation of the debtor in bankruptcy but with strings attached; these strings increasingly include vesting the lender with management prerogatives. In fact, all this might be arranged in advance of the bankruptcy filing, as part of a "prepackaged" or "prenegotiated" plan.[5] Not surprisingly, this environment yields a hard landing for the debtors' shareholders and managers. While in the 1980s it was routine for a bankruptcy reorganization to provide shareholders a return even though creditors were not paid in full,[6] such a return—sometimes called a violation of "absolute priority"—is a rarity now.[7] And in recent cases, top managers lose their jobs almost three-fourths of the time,[8] up from just above half of the time in the

[1] Frequently, there was no such cure. LoPucki & Doherty (2002) reports that almost a third of the large, publicly traded firms that reorganized in the United States from 1991 to 1996 went out of business within just five years. Moreover, more than 40% of these firms that reorganized in the Delaware bankruptcy court and 20% of those that reorganized in New York's Southern District filed for bankruptcy a second time within five years. This recidivism rate was much lower elsewhere in the country, but Delaware and New York were prominent bankruptcy venues.

[2] See Ayotte & Morrison (2007).

[3] See Baird & Rasmussen (2002, 2003); Skeel (2003).

[4] See Dahiya, et al. (2003).

[5] See Baird & Rasmussen (2002, 2003).

[6] See Weiss (1990); Franks & Torous (1989).

[7] See Capkun & Weiss (2007); Ayotte & Morrison (2007).

[8] See Ayotte & Morrison (2007).

1980s.[9] Also, although the data are somewhat volatile across time and otherwise difficult to interpret, there is a general consensus that bankruptcy liquidations (including through a going-concern sale) of public companies are more common in this new era of Chapter 11 than in the past. For example, Lynn LoPucki, commenting on a database that he maintains, observes that "41 firms that filed bankruptcy as public companies each with assets exceeding approximately $218 million liquidated in 2002, although no more than 8 such firms did so in any year prior to 1999."[10] Liquidations, when they occur, also mean that a bankruptcy case can be conducted more quickly, with the bankruptcy process converted from a structured negotiation among investors to a forum for the mere distribution of sale proceeds.[11]

Note that the trend of creditor dominance in bankruptcy began before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). There are provisions of BAPCPA, however, that foster the new regime. For example, the Act amends Bankruptcy Code §1121 so that the debtor's exclusivity period to file a reorganization plan cannot exceed 18 months; consequently, even those debtors who escape creditor control at the outset of the reorganization process can no longer control the bankruptcy process indefinitely, regardless of the court's predilections, because once exclusivity ends a creditor can offer a competing plan for approval by the creditors as a group. The new law also amends §§1104 and 1112 to expand or strengthen the grounds for dismissal or conversion of, or appointment of a trustee in, a Chapter 11 case; these grounds are focused on ending debtor control of a case that is not making satisfactory progress towards an economically sound and financially feasible plan of reorganization.

Another provision that can have significant consequences, particularly for retailers, appears in §365(d), which generally gives a debtor who is a lessee only 120 days from the order for relief (in a voluntary case, the date of the bankruptcy petition) to accept or reject an unexpired lease of nonresidential real property. The court can extend this period, for cause, for another 90 days, but any extension beyond this requires the consent of the lessor. Debtor counsel has raised concern that particularly for a large business, such as a department store chain that rents its retail space, 120 days, or even 210 days, may be too short a time to determine which outlets should close and which should remain open. This adds pressure on a debtor to have worked out a bankruptcy resolution prior to filing a petition, consistent with the trend described above.

These BAPCPA provisions among others (including some directed specifically at expediting small business cases) reflect the belief that if a debtor cannot be reorganized quickly, there may be no viable business to save, in which case the best resolution is a swift turnover of assets to the debtor's creditors, who can maximize their return with an efficient disposition such as an auction of the firm's assets. And as noted, this statutory approach dovetails with the change in bankruptcy practice that began prior to the recent code revisions.

[9] See Gilson (1990).

[10] See LoPucki (2003) at 646, fn. 5.

[11] See Ayotte & Morrison (2007).

All this raises the critical question of whether the new era of Chapter 11 is for the better. That is, did the judges who established the precedent of permissible creditor control and the Congress in 2005 get it right? Although no system is perfect, there is reason to believe that the answer to this question is "yes."

This is not to deny that the failure of a business imposes costs on all involved, including suppliers, employees, and local communities. It is a mistake to assume, however, that these hardships can be avoided by a return to bankruptcy practice that more aggressively promotes reorganization. A new financial structure will not long help a debtor that is economically inviable. Firms do not enter bankruptcy randomly and while some good businesses find themselves in Chapter 11 because of a mere improper capital structure—one with too much debt—many, perhaps most, fail for old-fashioned reasons: a poor business plan badly executed. Put simply, bankruptcy law cannot help a debtor who entered bankruptcy because it offers an expensive product that customers do not want. Such a business will fail in or out of bankruptcy, reorganized or not, and if a futile reorganization attempt delays the day of reckoning and consumes resources that creditors could otherwise capture and reinvest society is not well served.

Let me illustrate this last point with an example provided to me by Todd Zywicki, a colleague in academia. Todd tells a story about a strip mall near his house. There was a Montgomery Ward in the strip mall as the anchor tenant for a Petsmart and other stores. In 1997, Montgomery Ward entered bankruptcy having been battered by competition from K-Mart, Target, and Wal-Mart. But Ward did not go gentle into that good night. Instead it endured a prolonged bankruptcy reorganization, closed many, but initially not all of its outlets, and emerged two years later, in 1999. During that time, the store near Todd's home became rundown, perhaps because the debtor was unsure whether or not this location was one that would be restored or allowed to close. In addition, because this Ward location was such a weak store, as an anchor tenant it failed to draw foot traffic to the mall and the neighboring Petsmart was forced to close its doors. Finally, following Christmas 2000, the company finally gave up and closed all of its outlets, laying off all of its employees. The Montgomery Ward store near Todd was replaced by a Target outlet, which not only thrived but drew in customers for the mall's other stores, which also thrived. Had Montgomery Ward closed down in 1997 rather than 2000, the store's employees would have been deprived work at Ward for three years; this is true. But perhaps more jobs would have been created or saved at the Targets that replaced them and the Petsmarts that might have survived.

To be sure, not every liquidation is a good one, and one cannot know with certainty that the swift liquidations of Bennigan's and Sharper Image, for example, were efficient. But a precept of finance is that higher returns to creditors at the time of collection implies lower interest rates for debtors at the time to borrow. That is, in a competitive credit market, the higher the expected return, the lower a creditor's cost, the lower the price for money. So it may well be best that creditors quickly dispatch failed firms so that they have a maximum incentive to finance new ones. Even if one focuses myopically on the plight of working families and their communities, this may well be optimal, as healthy businesses provide greater opportunities for income than the sick and dying.

Finally, as an aside, I want to say a (very) few words about the Lehman bankruptcy. The salient feature of the Lehman case is the nature of the firm's assets, which include at the holding company or subsidiary level a number of financial contracts—forward contracts, swaps, and the like—that are provided special treatment under the Bankruptcy Code. Specifically, these contracts fit under safe harbors that permit counterparties of a debtor in bankruptcy to net their positions without fear of interference by the debtor's bankruptcy process. These provisions are designed to protect the functioning of the *markets* in these contracts rather than to advance the interests of the debtor in bankruptcy. Consequently, a discussion of what makes the Lehman case interesting is inapposite to a general discussion of Chapter 11, which is the focus of my intended contribution here.

References

Ayotte, K.M. and Morrison, E.R., 2007. "Creditor Control and Conflict in Chapter 11." 2nd Annual Conference on Empirical Legal Studies.

Baird, D.G., and Rasmussen R.K., 2002. "The End of Bankruptcy." Stanford Law Review 55:751–789.

_____ 2003. "Chapter 11 at Twilight." Stanford Law Review 56:673–699.

Capkun, V. and Weiss, L.A. 2007. "Bankruptcy Resolution and the Restoration of Priority of Claims." American Law & Economics Association 17th Annual Meeting.

Dahiya, S., Kose J., Puri M., and Ramirez G., 2003. "Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence." Journal of Financial Economics 69:259–280.

Franks, J. and Torous, W. 1989. "An Empirical Investigation of U.S. Firms in Reorganization." Journal of Finance 44: 747.

Gilson, S. 1990. "Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default." Journal of Financial Economics 27: 355.

LoPucki, L. 2003. "The Nature of the Bankrupt Firm: A Response to Baird and Rasmussen's *The End of Bankruptcy*." Stanford Law Review 56:645.

LoPucki, L. and Joseph W. Doherty. 2002. "Why are Delaware and New York Bankruptcy Reorganizations Failing" Vanderbilt Law Review 55: 1933.

Skeel, D.A. 2003. "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11." University of Pennsylvania Law Review 152:917–951.

Weiss, L. 1990. "Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims." Journal of Financial Economics. 27: 285.