The Ninth Annual Albert A. DeStefano Lecture on Corporate, Securities & Financial Law

Constantine N. Katsoris
Stuart M. Bernstein

William M. Treanor Dean of Fordham University School of Law
Paul Soden

*Fordham University School of Law, ckatsoris@law.fordham.edu
†Bankruptcy Court for the Southern District of New York

Copyright ©2009 by the authors. Fordham Journal of Corporate & Financial Law is produced by The Berkeley Electronic Press (bepress). http://ir.lawnet.fordham.edu/jcfl
PROF. KATSORIS: Good evening, ladies and gentlemen.

For those of you who have never met Dean Treanor, I don’t want you to think that he has aged prematurely. I am not Dean Treanor. He is in Washington, D.C., attending to School business. He has asked me to welcome you on his behalf to this, the Ninth Albert DeStefano Lecture.

Unfortunately, the DeStefano family could also not be with us tonight. They also send their regrets, along with their warmest regards.

These lectures are sponsored by the firm of Becker Ross. With us tonight is a member of the firm, Howard Justvig, Class of 1976.

[Applause]

The lecture series bearing Al’s name has had a most distinguished track record.

For those of you who have never met Al DeStefano, let me briefly describe him to you. He started at Fordham Law School as an evening student, worked during the day, still managed to make the Law Review and graduate at the top of his class. He accomplished all this with a demeanor of kindness, humility, and great integrity.

By honoring Al DeStefano with this lecture series, Fordham honors itself. Through this series of lectures we hope to remind ourselves of our mission, to produce skilled professionals of character, integrity, and compassion, characteristics that epitomize the life and career of Al DeStefano.

Since its inception less than a decade ago, the DeStefano Lectures have covered a wide range of timely yet diverse topics, such as the need for market regulation, the demise of Enron and its auditor Arthur Andersen, strengthening protection for investors, and making our capital markets more transparent.

8. See Fordham Law Corporate Law Center, Highlights of Prior Programs,
After forty-five years of teaching tax, I can appreciate that tax practitioners tend to become narrow-minded and nitpickers. I did not suspect, however, that the same affliction has spread to the bankruptcy bar as well.

In my notice to my friends in referring to tonight’s topic, I didn’t like the Arabic number 11. It is too reminiscent of the tragedy of 9/11 or the gambler’s phrase “seven/eleven,” or the name of the convenience store by the same name. Therefore, in exercising my First Amendment privileges, I thought I would refer to Chapter 11 using Roman numerals. I thought this would be classier, attract more attention, and justify the years of Latin I took as a student at Xavier High School.

Well, you’d think I had violated the sacred code of insolvency. I received numerous nasty calls from bankruptcy practitioners who chastised me for taking the liberty with the Holy text of the Bankruptcy Code, whose chapters are expressed in Arabic numerals.

After serious reflection and much soul searching, I respectfully responded to my critics: “If Roman numerals are good enough for the Romans, it’s good enough for the bankruptcy bar also.”

A brief word about our Corporate Law Center. These lectures are organized by the Center and are published and will be published in the Fordham Journal of Corporate and Financial Law.9

The Chairman of our Corporate Center is Paul Soden,10 who will have the pleasure of introducing tonight’s speaker.

I would also at this time like to acknowledge the extraordinary service of Professor Caroline Gentile,10 who is with us here tonight, and Ann Rakoff11, who is the Executive Director of our Corporate Center, who makes things happen. They don’t happen accidentally.

[Applause]

Before I introduce Paul Soden, however, I would like to highlight a point of personal pride. I had the extreme pleasure and privilege of having taught tonight’s speaker, Judge Bernstein, in tax, as well as the Judge’s wife Andrea and his son Jonathan, all graduates of this Law

10. See supra note 2.
10. See supra note 2.
11. See supra note 2.
School.

Without further ado, I would now like to call upon Paul Soden, who was a student of mine over forty years ago.

[Applause]

Paul, it seems like yesterday, at least to me anyhow.

Paul will tell you a little bit about our Center and introduce tonight's speaker.

Paul.

INTRODUCTORY REMARKS

MR. SODEN: I was hoping to be able to get up after being introduced as a student from forty years ago.

I have one housekeeping detail. Those of you who were in Room 122 before this event, your belongings have been moved to the coatroom in the front of the Atrium.

Thank you for that wonderful introduction, Gus.

Good evening and welcome to all of you. I thank all of you for taking your valuable time to be with us here this evening.

Tonight we have the privilege of hearing this year's DeStefano Lecture, to be delivered by Stuart Bernstein, Chief Judge of the U.S. Bankruptcy Court for the Southern District of New York.

Before I introduce Judge Bernstein, let me tell you a little bit about the Fordham Corporate Law Center, which is the host for tonight's event.

The Corporate Law Center was founded in 2001 to serve as a focal point for excellence and innovation in business law. Through its activities and programs, the Center draws together academicians, practitioners, managers, legislators, regulators, judges, and students to explore current and emerging topics in business law. In this way the Center seeks to enhance our understanding of both business law and business and to influence public policy debates and legal debates regarding the global economy and international financial markets.

After the Lecture, please take a moment to stop by the registration table in the Atrium - I kept thinking I would say “registration statement in the Atrium.” At that table there is detailed information about the

Corporate Law Center’s programs and public lectures and copies of the *Fordham Journal of Corporate and Financial Law*, a specialized business law journal that was cited in a U.S. Supreme Court decision in the *Arthur Andersen* case.\textsuperscript{13}

We hope you will enjoy tonight’s Lecture and return for many more of our programs in the future. So if you haven’t registered with us, please do so at that table or leave your business card so that we can alert you to programs for the future.

We have a very, very distinguished audience here tonight. At the risk of not mentioning someone—and I beg everyone’s forgiveness who I leave out as I go along here—let me take a minute or two to recognize some of the luminaries in our audience. By the way, as far as I’m concerned, you’re all luminaries.

First, the Fordham Law School faculty and administrators who are here this evening: Dean Sheila Foster,\textsuperscript{14} Dean Mike Schiumo,\textsuperscript{15} Dean Bob Reilly,\textsuperscript{16} Professor Susan Block-Lieb,\textsuperscript{17} Professor Carl Felsenfeld,\textsuperscript{18} and Professor Sean Griffith.\textsuperscript{19}

[Applause]

I also wish to recognize the members of our Corporate Center’s Board of Advisors, and I thank them for their generous support of the Center. With us are Pam Chepiga,\textsuperscript{20} Bob Hollweg,\textsuperscript{21} Gian Laguzza,\textsuperscript{22} the Honorable Loretta Preska,\textsuperscript{23} and Howard Tuckman, Dean of the

\textsuperscript{13} Arthur Andersen LLP v. United States, 544 U.S. 696, 704 (2005).

\textsuperscript{14} Sheila Foster—Biography, http://law.fordham.edu/faculty/10003.htm.

\textsuperscript{15} Dean Michael Schiumo is Assistant Dean for Alumni Relations at Fordham Law School. Development and Alumni Relations Staff, http://law.fordham.edu/alumni/7562.htm.


\textsuperscript{17} Susan Block-Lieb—Biography, http://law.fordham.edu/faculty/1078.htm.

\textsuperscript{18} Carl Felsenfeld—Biography, http://law.fordham.edu/faculty/9991.htm.

\textsuperscript{19} Sean Griffith—Biography, http://law.fordham.edu/faculty/1102.htm.


\textsuperscript{22} Gian-Carlo Laguzza is a Fordham Law School Alumnus. See Press Release, Fordham University, Panel Examines Wall Street’s Ethical Decay (Nov. 21, 2002), http://www.fordham.edu/campus_resources/enewsroom/archives/archive_256.asp.

\textsuperscript{23} Honorable Loretta A. Preska—Biography, http://www.nysd.uscourts.gov/
Fordham Graduate School of Business.\textsuperscript{24}

Additionally, we have with us tonight Dr. Stephen Freedman, Senior Vice President and Chief Academic Officer of Fordham University.\textsuperscript{25}

And as if that were not already a star-studded group, I also extend a special welcome to the esteemed judges of the U.S. Bankruptcy Court for the Southern District of New York who have joined us for this evening.

[Applause]

And of course the Center gratefully acknowledges the law firm of Becker Ross for their generosity in establishing the Albert DeStefano Lecture Series here at the Law School.

There is one person I must single out for recognition. Without this person’s extraordinary dedication, ingenuity, and hard work we would not have had this evening’s program. I thank Ann Rakoff,\textsuperscript{26} the Director of the Corporate Center, for her tremendous contribution to the success of this event.

[Applause]

And now to the main event. On behalf of the Corporate Center, I am delighted to introduce our distinguished speaker.

Stuart Bernstein became a judge of the U.S. Bankruptcy Court of the Southern District of New York in 1993\textsuperscript{27} and was appointed Chief Judge on February 1, 2000.\textsuperscript{28} Prior to his appointment to the bench he had a distinguished career in both private practice and as a U.S. Attorney for the Southern District of New York.\textsuperscript{29}

Chief Judge Bernstein is a member of the Association of the Bar of

\texttt{judge\_info.php?id=26.}


25. Stephen Freedman—Biography, Office of the Senior Vice President/Chief Academic Officer, \url{http://www.fordham.edu/academics/office_of_the_senior/}.

26. \textit{See} Fordham Corporate Law Center, Contacts, \url{http://www.fordham.edu/law/faculty/fisch/contact.html}.

27. Stuart M. Bernstein, Chief Judge of the United States Bankruptcy Court for the Southern District of New York—Biography, \url{http://www.nysb.uscourts.gov/judges/smb.html}.

28. \textit{Id.}

29. \textit{Id.}
the City of New York, the Federal Bar Council, and the National Conference of Bankruptcy Judges. He also serves as a Fellow of the American College of Bankruptcy and as a member of the International Insolvency Institute.

Chief Judge Bernstein is the author of many noted articles and also lectures on behalf of many professional organizations, including ALI/ABA, the American Bankruptcy Institute, the New York State Bar Association, and the Georgetown Law Center.

Chief Judge Bernstein holds a Bachelor of Arts Degree Cum Laude from Queens College and received his Juris Doctor Degree Cum Laude from our own Fordham Law School.

As Chief Judge, he presides over the largest and most sophisticated branch of the federal bankruptcy courts. By virtue of its location in Manhattan, the Southern District Bankruptcy Court regularly handles the largest and most complex bankruptcy proceedings anywhere in the world. Enron and WorldCom are but two examples. Now, in the current economic crisis, the Bankruptcy Court has become ever more the focus of the most compelling economic issues that confront our nation.

Chief Judge Bernstein is celebrated for his expertise. The Almanac of the Federal Judiciary says: "Lawyers rave about Judge Bernstein's legal skills," and his speaking skills are no less highly regarded.

Tonight Chief Judge Bernstein will bring his wide-ranging expertise to bear on whether corporate reorganization under Chapter 11 of the Bankruptcy Code is still a viable possibility in the circumstances we face today.

34. Id.
35. Id.
36. Id.
37. Id.
It is an honor and privilege to welcome you to our podium, Chief Judge Bernstein.

LECTURE: IS CHAPTER XI DEAD?

JUDGE BERNSTEIN: Thank you very much, Paul. Had I known we’d get this turnout, I would have prepared.

[Laughter]

My topic tonight is “Bankruptcy and Corporate Reorganization.”

Frank Borman, the former astronaut and Chairman of Eastern Airlines, once remarked that “capitalism without bankruptcy is like Christianity without hell.”

[Laughter]

Maybe I should be done now.

Bankruptcy recognizes that default is a necessary evil in any system based on credit. One of America’s great contributions to the law was the idea that failure did not necessarily mean death. Through bankruptcy reorganization, a company in financial distress could be resuscitated and continue in business.

Some, however, contend that this is no longer true. They argue that Chapter 11, our principal reorganization law, has changed from a proceeding that once promoted business reorganizations to one that now facilitates the quick sale of the debtor’s assets followed by the liquidation of the debtor.

Thus, Professors Baird and Robert Rasmussen remarked in a 2002 Law Review article: “To the extent that we understand the law of corporate reorganizations as providing a collective forum in which creditors and their common debtor fashion a future for a firm that would otherwise be torn apart by financial distress, we may safely conclude that that era has come to an end.”

The quote suggests that Chapter 11 is dead or, at a minimum, no longer meets its original objectives. To a great extent this is true. How-


ever, as Mark Twain observed in a similar context, the reports of Chapter 11’s death may be an exaggeration.43 If you give me roughly thirty minutes, I’ll try to explain why.

I propose to begin with a discussion of the origin and development of reorganization law leading up to the adoption of the 1978 Bankruptcy Code and then talk about how Chapter 11 has changed.

Historically, bankruptcy was a quasi-criminal remedy that had the following characteristics:

• It was a creditor’s remedy. In other words, there were no voluntary bankruptcies.44

• It was directed against merchants; ordinary individuals couldn’t be bankrupt.45

• It was limited to liquidation; there was no reorganization.46

• It was generally codified.47

In the early days, it could be very, very harsh. For example, in medieval Italy a merchant’s creditors would come to the market and break his workbench. While the remedy has fallen out of favor, the broken bench, in Latin bancus ruptus, is the linguistic origin of the term bankruptcy.48

Bankrupts were also subject to imprisonment, the pillory, and the lopping off of their ears. And for approximately 115 years English law provided the death penalty for fraudulent bankrupts. Think of how popular that would be today.

[Laughter]

This was the state of the law when the United States Constitution authorized Congress to enact uniform bankruptcy laws throughout the United States.49 As a matter of fact, Roger Sherman of Connecticut opposed the Bankruptcy Clause because he feared it would authorize the

43. Referring to Mark Twain’s famous remark, “[t]he report of my death was an exaggeration.” See Bartlett’s Familiar Quotations 528 (16th ed. 1992) (originally published in a Note to a London correspondent of the New York Journal, June 1, 1897).


45. Id. at 9.

46. Id. at 8, 20-21.

47. Id. at 7-8, 10, 12-13.


government to impose the death penalty. 50

As attitudes toward credit changed over time, compensation replaced retribution as the goal of bankruptcy law. During the 19th century America enacted four bankruptcy laws, 51 the first three lasting a total of only sixteen years before they were repealed by popular demand. 52

But neither these laws nor the Bankruptcy Clause have anything to do with the origin or the development of reorganization law. Instead, the law of corporate reorganization originated independently as a common law device to fill a need that bankruptcy law, when there was one, just couldn’t handle.

By the middle of the 19th century, America’s railroads, our first great corporations, were growing at a rapid rate. They were also failing at a rapid rate, or starting to fail at a rapid rate. 53 Everybody agreed that the railroads were necessary and had to keep running. 54 In addition, they weren’t worth much in liquidation. The typical railroad had issued several series or tranches of bonds, each tranche secured by a discrete section of track and other assets. 55 So your bond might be secured by six miles or six feet or 600 miles of track in the middle or nowhere. Your mortgage was essentially worthless unless your collateral was part of an operating railroad system. 56

To meet this situation, the railroad lawyers borrowed from the common law of foreclosure and receivership law and crafted the equity receivership, which is the direct descendent of modern reorganization law. 57

In a nutshell, here’s how it worked. Following a bond default, a creditor filed a creditor’s bill and the federal court appointed a receiver to oversee the railroad’s property. The railroad’s management partic-

50. Id. at 13.
51. Id. at 14.
52. Id.
55. End of Bankruptcy, supra note 41, at 759.
56. Control Rights, supra note 53, at 927.
57. End of Bankruptcy, supra note 41, at 759.
ipated in the ongoing operation of the railroad because the creditors and the court thought that their experience was valuable. A creditor would then file a foreclosure bill. Creditors formed committees, called protective committees, and deposited their bonds or securities with the protective committee. Once the committees negotiated a plan, the court scheduled the sale, the committee credited the face amount of the debt, won the auction, and the creditors became the new owners of the railroad. 58

One overarching idea drove the equity receivership practice: the railroad was more valuable as a going concern than in liquidation, a fairly novel concept for the courts at the time. 59 This belief, shared by the stakeholders in the case, was instrumental in the success of the railroad receiverships and became the bedrock principle of reorganization law.

The principles of corporate reorganization were first codified in the early years of the Great Depression and eventually enacted as part of the Chandler Act of 1938. 60 The Chandler Act had three reorganization chapters: X, XI, and XII, written as Roman numerals.

Chapter X, largely drafted by the SEC, was meant to deal with the reorganization of large publicly owned corporations with complex capital and debt structures. 61

Its history is an interesting story by itself and may sound familiar in light of current events. By this time, the Great Depression, there was enormous suspicion and distrust surrounding the equity receiverships in the reorganization bar. 62 The equity receivership was developed by Wall Street lawyers, and many believed primarily for their benefit and the investment banks that had underwritten the bonds and who they represented. 63

The reorganization bar was the most elite in the nation. Paul Cravath was one of the leading reorganization lawyers of his time. Most

---

58. See N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913) (outlining reorganization procedure plaintiff followed); see also Tabb, supra note 44, at 22.
59. See Barton v. Barbour, 104 U.S. 126, 135-36 (noting that the liquidation of a railroad would be to the detriment of the public as well as creditors).
60. Tabb, supra note 44, at 22.
61. See Barbara E. Nelan, Multiple Plans "On the Table" During the Chapter 11 Exclusivity Period, 6 BANK. DEV. J. 451, 459-60 (discussing Chapter X).
63. Control Rights, supra note 53, at 934.
of the cases included the predecessors of Cravath, Swaine & Moore, Sullivan & Cromwell, or Davis Polk. 64

Ironically, the reorganization bar’s chief nemesis was a former Cravath associate who had worked on railroad reorganizations, William Douglas. Douglas was by now a Yale law professor. He was selected by the SEC to head the study on protective committees, which were often dominated by insiders of the railroad. 65 Aided by his second in command, Abe Fortas, Douglas, who eventually became the SEC Chairman, produced a multi-volume scathing report 66 directed at the Wall Street domination of the reorganization practice, the cozy connection between the reorganization professionals and the railroad’s management, and the payment of excessive fees.

The populous mistrust of Wall Street, the New Deal reform atmosphere, and the heavy Democratic majorities in Congress led to the adoption of Chapter X of the Chandler Act. 67

Generally, Chapter X displaced management, put control of the case in the hands of a mandatory trustee, and gave the SEC a substantial role. 68 For these reasons it wasn’t especially popular for a corporation contemplating reorganization. 69

In contrast, new Chapter XI (that’s also Roman numerals) was designed for smaller, privately owned businesses and was much kinder and gentler. 70 The debtor remained in control of the assets of the case, no trustee was appointed, and the debtor had an unlimited right to propose a plan, total exclusivity. 71 However, Chapter XI offered more limited relief and, in particular, the Chapter XI debtor couldn’t reor-

68. Id. at 169.
69. Id. at 170.
70. Id.
ganize its secured debt in Chapter XI.\footnote{72}{Miller & Waisman, supra note 67, at 170.}

And finally, the Chandler Act also included Chapter XII, which dealt with certain types of real estate bankruptcies.\footnote{73}{Id.}

Everyone understood that public companies were supposed to file under Chapter X, but nothing in the Chandler Act specifically required them to file under Chapter X as opposed to Chapter XI. It should come as no surprise that corporate managers of public companies opted for Chapter XI, and in a variation on Gresham's Law, Chapter XI was driving Chapter X out of use.\footnote{74}{Id. at 171.} The SEC often fought the debtor's selection, but with only limited success.

In the process, Chapter XI was transformed from a proceeding intended for mom-and-pop businesses into a chapter used by Fortune 500 companies. In 1975, W.T. Grant Company, a publicly traded corporation, became the first billion-dollar company to file a Chapter XI case.\footnote{75}{Id. at 172.}

The Chandler Act lasted for forty years, until the adoption of the current Bankruptcy Code in 1978. The 1978 law merged the three reorganization chapters into a single one under Chapter 11 (Arabic Chapter 11).

Chapter 11 incorporated many of the debtor-friendly provisions of the old Chapter XI and rejected the more unpopular aspects of Chapter X.\footnote{76}{Id. at 176.}

Under new Chapter 11, the debtor's management remained in possession, trustees and examiners were appointed only for cause, the role of the SEC was substantially reduced, the debtor enjoyed limited exclusivity that the court could, and often did, extend for cause.\footnote{77}{Id. at 176-77.} The plan could reorganize all type of debt. Creditors could waive the absolute priority rule.\footnote{78}{See Allan C. Eberhart & Lawrence A. Weiss, The Importance of Deviations from the Absolute Priority Rule in Chapter 11 Bankruptcy Proceedings, 27 FIN. MGMT. 106, 107 (1998) (noting that previous researchers all acknowledge that creditors may waive their priority rights).} The plan proponent could cram a plan down in many cases over the rejection by a class.\footnote{79}{See John C. Murray, The Lender's Guide to Single Asset Real Estate
The 1978 Code\textsuperscript{80} was based on the railroad paradigm [that] a company was worth more alive than dead.\textsuperscript{81} In addition, although maximizing creditor recoveries was certainly an important goal, it was not the only goal, nor necessarily the most important. Thus, it surprised no one when the Supreme Court in its 1984 \textit{Bildisco} decision that "the fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."\textsuperscript{82}

So this was the state of the law in 1978. Under the new Chapter 11, the debtor was not just in possession, it was in charge. Ideally, it reached an agreement with its creditors, confirmed the plan, and emerged from Chapter 11 with the same owners. The employees kept their jobs and the trade vendors kept a customer.

Chapter 11 filings quickly rose to five times the annual filings under the three reorganization chapters during the final years of the Chandler Act.\textsuperscript{83}

And then two things happened to Chapter 11, although not necessarily connected.

First, starting in the mid-1990s, Chapter 11 filings began to decline at a fairly steep rate.\textsuperscript{84} The sharp decline, particularly in the last few years, may be explained by the increased availability of credit, and reflect that until recently companies could manage to borrow their way out of immediate financial distress.\textsuperscript{85} I’ll leave it at that.

\textit{Bankruptcies}, 31 REAL PROP. PROB. & TR. J. 393, 461 (1996) (noting that a plan can be forced on the impaired class that votes against the plan if it does not discriminate unfairly and is fair and equitable to the dissenting class).


81. \textit{See} Miller & Waisman, \textit{supra} note 67, at 154 (commending the railroad paradigm as a “new line of thought” and a “novel, highly successful concept of reorganization and rehabilitation”).


84. Harvey R. Miller, \textit{Chapter 11 in Transition—From Boom to Bust and into the Future}, 81 AM. BANKR. L.J. 375, 384 (2007) [hereinafter \textit{Chapter 11 in Transition}] ("Stated differently, in 1994, 1.77\% of total bankruptcy cases filed were chapter 11 cases. In 2003, that figure was 57\%.").

Second, and of greater concern, the character of the cases changed. Creditors began to exert more influence and many more cases culminated in the sale of the debtor’s assets followed by the liquidation of the debtor.86

The question is: What caused these changes? Several reasons have been given. Let me suggest three.

The first is what we call the clawback. Many trade associations and organized creditor groups thought the Code was too debtor-friendly and lobbied for changes. Beginning in 1984, Congress started to clawback the rights and powers granted to the debtor.87 Since then, it has enacted a host of special-interest legislation that has favored various creditor groups or other constituencies at the expense of the debtor and the reorganization process.88 These include, among others, commercial lessors,89 personal property lessors,90 aircraft lessors,91 shopping center owners,92 financial institutions,93 unions,94 and retirees.95 I can’t think of any pro-debtor change during the same period.

The amendments relating to the commercial leases provide a stark example of the effect of these amendments. The 1978 Code gave the debtor until confirmation to assume or reject is unexpired leases.96 Subsequent amendments reduced the debtor’s time97 and severely restricted the court’s authority to extend it no matter what the circumstances.98 The debtor now gets at most 210 days to assume or reject unless the

86. See Douglas G. Baird & Robert K. Rasmussen, Chapter 11 at Twilight, 56 Stan. L. Rev. 673, 675, 691 (2003) [hereinafter Chapter 11 at Twilight] (noting that “creditor control is the dominant theme” and that “the dominant feature of the large corporate Chapter 11 today is the asset sale”).
88. See Chapter 11 in Transition, supra note 84, at 387-88.
89. Id.
90. Id.
91. Miller & Waisman, supra note 67, at 178.
93. Id.
94. Id.
95. Id.
96. Miller & Waisman, supra note 67, at 178-79.
landlord consents to a longer extension. This sounds like enough time, but it may not be. The decision to assume or reject may depend on the outcome of litigation with the landlord, or in a more complex case involving a chain of retail stores with hundreds of leases the decision may depend on the availability of financing and how the lease fits into the debtor’s business plans.

These factors are no longer relevant. Absent landlord consent to further extensions, the debtor must make its assumption/rejection decision. And if it can’t make the decision to assume, it will lose its lease, and quite possibly its business.

Another recent change drastically affects the debtor’s liquidity. Prior to the 2005 amendments, any vendor that delivered goods pre-petition was an unsecured creditor subject to any reclamation rights that the vendor might have. The 2005 amendments grant administrative claim status to vendors that deliver goods within twenty days of the petition date in the ordinary course of business. This means that those vendors have to be paid in full no later than confirmation.

In testimony before Congress earlier this month, the attorney for the Creditors Committee in the Circuit City case identified this change as a substantial factor in the failure of the case. Pre-petition vendors in that case had filed administrative claims totaling $350 million, which the debtor estimated would come in at $215 million. The debtor just didn’t have the time to resolve these claims and the money to pay the ones that would ultimately be allowed.

Although the clawback has hurt the chance to reorganize, the more significant changes have occurred outside the Bankruptcy Code.

106. Id. at 26, 113.
107. Id. at 26.
Nowadays a debtor usually enters Chapter 11 over-leveraged, cash strapped, and its assets fully encumbered. Only the pre-petition lender will provide V.I.P. financing, often as a defensive measure to protect its collateral.

The lender has enormous bargaining power, which it uses to impose terms that restrict the debtor’s power to propose a plan without the lender’s consent, establish deadlines, and usually short ones, to file a plan or sell the debtor’s assets; limit disbursements to those approved by the lender; and require the debtor to hire a chief restructuring officer (CRO). The CRO is a person approved by the lender who serves as a de facto trustee with the authority to circumvent management, make executive decisions, and negotiate with the various constituencies on behalf of the debtor.

This situation has spawned the phenomenon known as the “creditor in possession.” Control of the case passes to the secured lender and the debtor, effectively neutralized, often becomes a bystander.

Secured creditors usually prefer a quick sale of the debtor’s assets to a drawn-out reorganization process because they are concerned that their collateral will decline over time. That’s why they imposed deadlines in the DIP financing agreement.

As a result, the sale under Section 363 of the Bankruptcy Code has become the exit strategy of choice in many Chapter 11 cases. In fact, many sales are negotiated pre-petition and the bankruptcy is filed in order to effectuate the transaction.

Distressed claims trading has also influenced the prospects of a successful reorganization. Claims traders buy claims to make a profit, and in some cases to acquire control of the bankruptcy case.

108. Miller & Waisman, supra note 67, at 182.
109. Id. at 185.
110. Id.
111. Id.
112. Id.
113. Miller & Waisman, supra note 67, at 185-86.
114. Id. at 186-87.
115. Id. at 198.
116. Id. at 182, 185.
117. Id. at 194-95.
118. Chapter 11 at Twilight, supra note 86, at 675.
119. Donald S. Bernstein, U.S. Chapter 11 Today: A Funny Thing Happened on the Way to the Court-house, in INTERNATIONAL COMPARATIVE LEGAL GUIDE TO:
Before claims trading, the debtor's vendors, who were the creditors, had an interest in keeping the debtor in business as a customer. Traders that buy the vendors' claims do not have the same interest. Furthermore, whatever their motive, the sooner the debtor exits Chapter 11 the sooner the trader can turn its investment into cash.

The pressure to emerge from Chapter 11 early, perhaps too early, may be a contributing factor to recidivism, the filing of a so-called Chapter 22, and sometimes a Chapter 33.

So does creditor control and more Section 363 sales followed by liquidation mean that Chapter 11 is no longer necessary or viable as a means of reorganizing a business? I'm not convinced that it's ready for the trash heap.

In the first case, there are companies that still reorganize the old-fashioned way: they make a deal with their creditors and emerge as an operating company with the same management.

Even where the property is sold, Chapter 11 adds value. The debtor can transfer the property, possibly as a going concern, free and clear of liens and interests. In addition, the debtor can assume and assign its leases as part of a sale, despite the existence of lease provisions that prohibit or restrict assignment.

Our experience with bankruptcy sales also undercuts the argument made by some that the railroad paradigm no longer exists and that we can no longer assume that the assets of a going concern are more valuable than those in liquidation.

Critics of Chapter 11 contend that in a service-based economy a company's hard assets generally consist of office furniture and computers. Unlike railroad tracks that were dedicated to the railroad's business, the same office furniture and computers can be used in any

---

120. Chapter 11 at Twilight, supra note 86, at 683 (stating that the 2002 bankruptcy of Pillowtex Corp. "on its face . . . support[s] the traditional account of Chapter 11" as the company emerged from bankruptcy and continued to run the sample plants, employ the same workers, and so forth).


122. 11 U.S.C. § 363().


124. The End of Bankruptcy, supra note 41, at 766.
service business. The only going-concern premium in such a business is the relatively small cost of deploying the assets, getting them from point $A$ to $B$ and assembling them in the business.

Practice suggests, however, that the bankruptcy stakeholders still believe in the railroad paradigm and conduct themselves accordingly. It’s the rare secured creditor that wants its collateral back pursuant to its pre-petition agreement.\textsuperscript{125} Rather, the secured creditor prefers to sell its collateral in the bankruptcy court as part of a going-concern sale of the entire business.\textsuperscript{126}

To obtain this benefit the secured creditor is willing to fund the administrative expenses of the case, which can be substantial.\textsuperscript{127} In short, the creditor puts its money where its mouth is in the belief that Chapter 11 will maximize recovery.

Finally, not all Section 363 sales are necessarily bad or inconsistent with the objectives of Chapter 11. A sale doesn’t mean that the auctioneer comes into the factory and sells the assets one light bulb at a time. As I have indicated, sales can transfer all, or substantial all, of the assets as a going concern. In that situation, the business continues to operate in the hands of a new owner, employing many or all of the debtor’s former employees.

Let me give you an example from my own experience. One of the first cases I had involved a department store chain of around thirty stores.\textsuperscript{128} After the debtor tried unsuccessfully to develop a standalone plan, it decided to sell its assets, its operating stores.

There were several bidders at the auction. In the end, two department store chains purchased most of the stores. The stores continued to operate under new ownership and new names, most of the employees kept their jobs, and the unsecured creditors ultimately recovered 84

\textsuperscript{125} See generally Patrick E. Mears et al., Strategies for Secured Creditors in Workouts and Foreclosures 278 (John B. Spitzer ed., A.L.I.-A.B.A. 2004) (noting that while some secured creditors will liquidate their collateral immediately in a going-concern sale, the hope for enhanced recovery often compels the lender to negotiate with the other constituencies).

\textsuperscript{126} Id.

\textsuperscript{127} See 11 U.S.C. § 506(c) (2006) (authorizing the trustee in a bankruptcy proceeding to recover reasonable expenses from property securing a secured claim in a transaction that benefits the holder of such claim).

\textsuperscript{128} Press Release, Strick & Co., Update Regarding May/penney Purchase of Woodward & Lothrop (Aug. 9, 1995) (announcing the Honorable Stuart M. Bernstein’s approval of the sale of retailer Woodward & Lothrop’s assets to a consortium).
percent.

Critics of Chapter 11 would probably view the sale of the assets and the liquidation of the debtor as an example of what’s wrong with Chapter 11.\textsuperscript{129} I would call it a pretty good result consistent with the goals of Chapter 11.

In conclusion, I agree that Chapter 11 has changed, generally to the benefit of the creditors and at the expense of the debtor and the chances for reorganization.

To return Chapter 11 to its roots, I suppose, Congress would have to claw back the clawback, restrict the rights of secured creditors or create a source of unsecured DIP financing, and limit or outlaw claims trading. None of these are likely to happen.

Yet, Chapter 11 can, and often does, serve its intended goals of reorganization and job preservation. Going-concern sales under Section 363 can transfer an operating business to new owners. Frankly, there is little difference between that result and the confirmed reorganization plan that extinguishes the existing equity and issues new stock to the creditors. In fact, that’s essentially what happened in the railroad receivership cases.

Chapter 11 isn’t perfect, and some contend it’s outdated. But as long as we have credit we will have defaults. I haven’t heard a better alternative to Chapter 11, and, based on today’s newspaper stories about the automotive industry, a lot of people seem to agree.

Perhaps Winston Churchill’s observation about democracy applies here. Chapter 11 may be the worst method for dealing with companies in financial distress, except for all the others.\textsuperscript{130}

Thank you very much.

[Applause]

MR. SODEN: Thank you, Judge Bernstein. That was absolutely wonderful. I’ve learned a tremendous amount about Chapter 11. Of course, if you ask Gus Katsoris, he’d tell you that’s not a very high threshold in my case.

Thank you all for coming this evening.

\textsuperscript{129} See End of Bankruptcy, supra note 41, at 751.

\textsuperscript{130} See A. Mechele Dickerson, The Many Faces of Chapter 11: A Reply to Professor Baird, 12 AM. BANKR. INST. L. REV. 109, 126 (conceding that bankruptcy may not always preserve the value of its creditors or “save” businesses, but establishing and justifying several strengths and benefits of the Chapter 11 process).