

# SHIFTING PARADIGMS WITHIN CORPORATE BANKRUPTCY LAW: THE HISTORY AND FUTURE OF CHAPTER 11 AND ITS GLOBAL EFFECTS ON BUSINESS RESTRUCTURINGS

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## I. INTRODUCTION

The Chapter 11 business reorganization scheme has historically been instrumental in helping American companies survive financial crises by offering a systematic approach for discharging debts and allowing businesses “to free themselves of large legacy costs or obsolete business models.”<sup>605</sup> However, in addition to the throng of amendments made to the United States Bankruptcy Code since its enactment in 1978, the economic and business structures within the United States have changed, creating challenges for businesses to navigate the reorganization process.<sup>606</sup> Some fear that these fundamental changes in the way that American businesses operate today have made Chapter 11 business reorganization an obsolete principle and an unnecessary remedy.<sup>607</sup> The American Bankruptcy Institute (“ABI”) has tasked a non-partisan commission, which is composed of bankruptcy judges, academics and professionals, with studying these issues and considering potential reforms that would increase the effectiveness and utility of Chapter 11.<sup>608</sup>

The success of business reorganization in the United States has often been attributed to the flexibility of the statutory provisions in the 1978 Bankruptcy Code and its unique “debtor-in-possession” feature.<sup>609</sup> Though other countries have been wary of adopting the “debtor-in-possession” model of Chapter 11, the declining financial conditions of many businesses in Europe have caused some countries, such as the United Kingdom, to experience a shift in paradigms and to adopt elements of the United States business reorganization

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<sup>605</sup> Deborah Ball, *Europe Builds Own Chapter 11*, THE WALL ST. J. (April 5, 2013), <http://www.wsj.com/article/SB10001424127887323296504578398612178796882.html>

<sup>606</sup> Michelle M. Harner, *Legislative Update, ABI Commission to Study Reform of Chapter 11 Will Meet in April*, AM. BANKR. INST. J., MAR. 31, 2012, at 12, 12.

<sup>607</sup> Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129, 130 (2005).

<sup>608</sup> Harner, *supra* note 2.

<sup>609</sup> *Id.*

scheme.<sup>610</sup> The result in the United Kingdom has been a subtle move toward the rehabilitation of failing businesses and away from liquidation, though the old societal attitudes against debt forgiveness have survived recent legislative enactments.<sup>611</sup>

This article analyzes the historical development of modern bankruptcy law with respect to business restructurings in the United States and its influence on reorganization laws in the United Kingdom. It further discusses the issues that have been exposed within the United Kingdom's reorganization system and whether said issues are likely to be affected by a congressional overhaul of the United States Chapter 11 scheme. Part II discusses the progression of modern business reorganization within the United States, tracing its development to the beginning of a capitalist economy that rewarded entrepreneurial risk-taking and consumer spending. It further discusses the progression of business reorganizations in English common law and the modern administrative process by which courts attempt to rehabilitate debtors in the United Kingdom. Part III discusses the likelihood and possible implications of a more "debtor-friendly" overhaul of Chapter 11 and its potential impact on the United Kingdom's bankruptcy system. Whether a European transplantation of even more "debtor-friendly" American bankruptcy principles is likely to parallel the relative success that has defined Chapter 11 in the United States is questionable at best, given that the United States economy has evolved through a markedly unique process.

## II. BACKGROUND

### A. THE HISTORY AND DEVELOPMENT OF REORGANIZATION IN THE UNITED STATES

The modern Chapter 11 scheme sprung from the United States' distinctively capitalist economy, which rewards entrepreneurs and encourages wide consumer spending.<sup>612</sup> Though agrarian production supported the early economic climate of the United States, with the nineteenth century came a burgeoning national economy that was comprised of material goods, such as cotton, lumber, coal, and textiles.<sup>613</sup> The market progressed to one of consumer goods, such as clothing and home goods, as a larger population began to have disposable income to stimulate the growing economy.<sup>614</sup> This rapid expansion necessarily relied upon the credit system, whereby goods were produced and sold through an intricate structure of obligations

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<sup>610</sup> Ball, *supra* note 1; see also Nathalie Martin, *Common-Law Bankruptcy Systems: Similarities and Differences*, 11 AM. BANKR. INST. L. REV. 367, 369 (2003).

<sup>611</sup> Martin, *supra* note 6, at 397.

<sup>612</sup> Nathalie Martin, *The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation*, 28 B.C. INT'L & COMP. L. REV. 1, 3 (2005).

<sup>613</sup> *Id.* at 8.

<sup>614</sup> *Id.*

and relationships.<sup>615</sup> Entrepreneurs could not entertain new business ventures without the ability to pay debts, such as for rent or production costs, at some later time.<sup>616</sup> “In short, credit was in large part what defined capitalism as well as wealth.”<sup>617</sup> This led to the development of a legal culture that tolerated indebtedness and non-payment as a means of encouraging and incentivizing consumers to spend money and entrepreneurs to pursue business ventures.<sup>618</sup>

The course of evolution with regard to business reorganizations in the United States can be analyzed by starting with the treatment of railroad receiverships at the end of the eighteenth century.<sup>619</sup> Because railroads were viewed as a central part of the United States’ new, robust economy, and because railroad companies often underestimated construction costs and timelines and overestimated their freight traffic and passenger projections, federal courts began appointing receivers to assume control of railroads’ failing operations.<sup>620</sup> The railroad companies, receivers, creditors, and the courts worked together to protect and distribute the assets or negotiate a viable reorganization plan.<sup>621</sup> Thus, two major tenets surfaced from the federal courts’ treatment of distressed railroad companies and continue to flow through modern bankruptcy law: (1) the concept that there is a “going concern” value for interested parties added when a debtor is allowed to continue to operate as a business, and (2) active participation by the debtor adds valuable expertise in large, multifaceted business restructurings.<sup>622</sup> The Chandler Act of 1898 codified these two principles and provided for an official forum for rehabilitating debtors in financial distress.<sup>623</sup>

The Chandler Act created two chapters of business reorganizations: Chapter X was designed for publicly traded companies, and Chapter XI was designed for use by “mom-and-pop” businesses.<sup>624</sup> A major distinction between the chapters was that Chapter X debtors were subject to investigation and oversight by the Securities and Exchange Commission (SEC), while Chapter XI debtors were not.<sup>625</sup> The problem with this for the publicly traded businesses was that such regulation caused so many delays that a failing business stood no chance of effective reorganization.<sup>626</sup> Further, a Chapter XI debtor was allowed to preserve its management team during the reorganization process, while the management of a

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<sup>615</sup> *Id.*

<sup>616</sup> *Id.* at 9.

<sup>617</sup> *Id.* at 10.

<sup>618</sup> *Id.* at 11.

<sup>619</sup> See Miller & Waisman, *supra* note 3, at 134, 136. (discussing the suitability of Chapter 11 to the modern American business environment).

<sup>620</sup> Miller & Waisman, *supra* note 3, at 134-35.

<sup>621</sup> *Id.* at 135.

<sup>622</sup> *Id.* 135-36.

<sup>623</sup> *Id.* at 137.

<sup>624</sup> ELIZABETH WARREN, CHAPTER 11: REORGANIZING AMERICAN BUSINESSES 7 (2008).

<sup>625</sup> *Id.* at 7-8.

<sup>626</sup> *Id.*

business that filed Chapter X bankruptcy could be replaced.<sup>627</sup> The disparate opportunities between the two chapters caused publicly traded companies to use Chapter XI instead of Chapter X, frustrating Congress's efforts to keep the two chapters separate, or to avoid using the bankruptcy system altogether.<sup>628</sup>

In 1978, Congress enacted legislation that created Chapter 11 in title 11 of the United States Code, which sought to combine "the flexibility and debtor control that characterized Chapter XI with many of the public protection features central to Chapter X."<sup>629</sup> The result of this was the "debtor-in-possession" model of rehabilitating a distressed business and the effective elimination of SEC oversight.<sup>630</sup> The lack of SEC intervention in Chapter 11 cases removed a significant disincentive for businesses to file for protection by the bankruptcy court.<sup>631</sup>

Further provisions of the 1978 Code encouraged debtors to file for bankruptcy before their financial conditions worsened beyond the point at which rehabilitation would be impractical or ineffective.<sup>632</sup> Such incentives included: (1) the automatic stay, which prohibits creditors from taking action against the debtor or otherwise seizing assets from the commencement of the bankruptcy case; (2) the debtor's ability to reject executory contracts or unexpired leases; (3) the debtor's exclusive right to propose a reorganization plan and to solicit creditors' acceptances of the plan within 180 days, and; (4) an increase in the debtor's administrative authority.<sup>633</sup> Congress was also careful to consider creditor's interests and the effect of insolvency on such interests.<sup>634</sup> It attempted to balance the protections afforded to debtors with some safeguards for creditors, which included provisions that: (1) allowed for a Chapter 11 case to be voluntary or involuntary on the part of the debtor; (2) made collective acceptance by creditors of a reorganization plan the ultimate goal of Chapter 11 restructuring; (3) required debtors to provide an adequate disclosure statement about the reorganization plan so that creditors could discern the plan's feasibility and intelligently cast their votes.<sup>635</sup>

Despite the series of amendments made to the Code by Congress in 2005 and the abundance of "clawback" provisions that have been the result of efforts by special interest groups,<sup>636</sup> the Chapter 11 model continues to be the process by which businesses are restructured in the United States.<sup>637</sup>

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<sup>627</sup> *Id.*

<sup>628</sup> Warren, *supra* note 20, at 8.

<sup>629</sup> Miller & Waisman, *supra* note 3, at 142.

<sup>630</sup> *Id.*

<sup>631</sup> Warren, *supra* note 20, at 9.

<sup>632</sup> *Id.*

<sup>633</sup> See Miller & Waisman, *supra* note 3, at 143-44 (listing a number of statutory enactments of the 1978 Code).

<sup>634</sup> *Id.* at 144.

<sup>635</sup> See Miller & Waisman, *supra* note 3, at 144 (listing various non-debtor protections included in the 1978 Code).

<sup>636</sup> Miller & Waisman, *supra* note 3, at 150.

<sup>637</sup> See Warren, *supra* note 20, at 9-10.

## B. THE HISTORY AND DEVELOPMENT OF REORGANIZATION IN THE UNITED KINGDOM

Unlike the United States, England was never under pressure to rapidly develop a commercial economy.<sup>638</sup> Thus, its bankruptcy laws were grounded in very different principles than those of early United States bankruptcy law.<sup>639</sup> Historically, insolvency was attributed to an individual's deceitfulness and his general tendency toward moral depravity,<sup>640</sup> and early English bankruptcy laws treated debtors much like criminals who were subject to punishment by their creditors.<sup>641</sup> The penalties for insolvency in sixteenth-century England ranged from incarceration to, in extreme cases, capital punishment.<sup>642</sup> Unlike the early economic climate of the United States, which welcomed the wide availability of credit to the average consumer, credit was generally viewed as a necessary evil that was appropriate only in the commercial context, and the only debtors who were able to obtain a discharge from debts were merchants.<sup>643</sup> The enactment of new bankruptcy laws during the nineteenth century resulted in the formalization of a highly administrative system, in which creditors oversaw the bankruptcy process and had power over essentially all significant issues in an individual bankruptcy case.<sup>644</sup> This creditor-controlled process effectively eliminated the role of the court and the need for judicial intervention, and this is still a defining element of the reorganization models used in the United Kingdom today.<sup>645</sup>

Modern business reorganizations look very different in the United Kingdom than in the United States,<sup>646</sup> given that most European bankruptcy systems have not yet adopted the keystone of Chapter 11, the debtor-in-possession model.<sup>647</sup> Allowing a corporate debtor's management to retain a great amount of control over business decisions is a concept that is still met with abundant skepticism in common law countries.<sup>648</sup> Until 1986, the underlying model for corporate bankruptcy was liquidation, as opposed to rehabilitation.<sup>649</sup> In 1986, when the economic climate of the United Kingdom was colored by deep recessions, there was a shift toward a "rescue culture" in the bankruptcy laws, as Parliament enacted a statute that acknowledged the value of effecting the reorganization of

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<sup>638</sup> Martin, *supra* note 6, at 369.

<sup>639</sup> *Id.*

<sup>640</sup> *Id.* at 370.

<sup>641</sup> *Id.*

<sup>642</sup> *Id.* at 371.

<sup>643</sup> Martin, *supra* note 6, at 372.

<sup>644</sup> *Id.* at 373.

<sup>645</sup> *Id.*

<sup>646</sup> *Id.* at 390.

<sup>647</sup> Alan Tilley, 'U.S. Invasion' Influences European Insolvency Practices: Major Hurdles Remain to Chapter 11-type Restructurings, THE JOURNAL OF CORPORATE RENEWAL (Sept. 2, 2004), <http://www.turnaround.org/Publications/Articles.aspx?objectID=3650>.

<sup>648</sup> Martin, *supra* note 6, at 390.

<sup>649</sup> *Id.* at 392.

a business as opposed to liquidation.<sup>650</sup> “In enacting the 1986 law, the House of Lords stated that the Rescue Culture, which seeks to preserve viable business, was and is fundamental to much of the (Insolvency) Act of 1986.”<sup>651</sup>

Despite the sentiments behind the 1986 laws, however, the form of “rescue culture” adopted by Parliament diverges greatly from the Chapter 11 model of reorganization to the extent that: (1) existing management is replaced, and (2) the process is one that favors creditors by affording them great decision-making power.<sup>652</sup> The English bankruptcy process continues to be highly administrative in nature, and debtors are presumed to be ineligible for a discharge.<sup>653</sup> Most commonly, a court-appointed administrator proposes a plan, which must be voted upon and approved by the creditors in order for the corporate debtor to avoid liquidation, and there is little judicial intervention.<sup>654</sup> If the creditors vote in favor of the administrator’s plan, the business’s management is usually replaced immediately, a practice that stands in stark contrast to the archetypal “debtor-in-possession” of Chapter 11 reorganizations.<sup>655</sup>

Thus, despite the fact that the United Kingdom recently overhauled its bankruptcy laws in an effort to promote rehabilitation and restore a deteriorating economy, corporate insolvency is still addressed through highly creditor-driven administrative processes that can make rehabilitation challenging for a failing business.<sup>656</sup>

### III. ARGUMENT

#### A. A CHANGING ECONOMIC LANDSCAPE AND THE PROSPECT OF A CONGRESSIONAL OVERHAUL OF CHAPTER 11

The ABI Commission is currently in the process of achieving its objectives of identifying and exploring issues with the current Chapter 11 design by holding a series of public hearings.<sup>657</sup> At its inception, the Commission identified two primary explanations for the proposed reform: (1) the Code does not reflect the changes the United States economy and business world have sustained since the enactment of the 1978 Code, and; (2) because of these changes, there has been a sharp increase in distressed-debt trading to third parties whose primary objectives of maximization of value can often conflict with the debtor’s goal of reorganization.<sup>658</sup>

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<sup>650</sup> *Id.*

<sup>651</sup> Martin, *supra* note 6, at 393 (internal quotations omitted).

<sup>652</sup> *Id.* at 397.

<sup>653</sup> *Id.* at 368.

<sup>654</sup> *Id.* at 393-94.

<sup>655</sup> *Id.* at 395-96.

<sup>656</sup> *Id.* at 396.

<sup>657</sup> See Diane Davis, *Judge, Practitioners Tell ABI Commission Areas of Bankruptcy Law in Need of Overhaul*, DAILY REPORT FOR EXECUTIVES, Nov. 2012, <https://advance.lexis.com/GoToContentView?requestid=e317c721-dc08-4e39-f9a1-aec7e5e33ae&crd=30308c48-cd67-953d-45d-4337a2b34daa>.

<sup>658</sup> Robert Keach & Albert Togut, ABI Commission, Field Hearing (June 7, 2013) (transcript available at <http://commission.abi.org>).

Because the economic and business climates in the U.S. have changed significantly since 1978, there appears to be at least some need for a “reinvigorated, rehabilitation-oriented process” in Chapter 11 bankruptcy law.<sup>659</sup> Since the 1978 Act, there has been a significant amount of amendments made to the Bankruptcy Code, as groups with varying interests have fought for certain “clawback” protections against some of the Code provisions that improved the position of debtors.<sup>660</sup> Among the interest groups who have influenced and effected subsequent amendments to the Code are certain financial institutions, commercial property owners, and equipment lessors.<sup>661</sup> This expansion of creditors’ reach and authority within the bankruptcy context, along with structural changes in the United States economy, has caused fundamental changes in the reorganization process since the 1978 Code’s enactment.<sup>662</sup>

Both the increases in distressed-debt trading and the rising dominance of lenders who provide debtor-in-possession financing have contributed to the changing landscape of business restructurings.<sup>663</sup> Since the enactment of the 1978 Code, there has been a substantial rise in the usage of secured debt to finance business operations.<sup>664</sup> Corporate debt structures have become increasingly more elaborate, containing several layers of secured and unsecured debt.<sup>665</sup> This change can be explained in part by the economic shift that the United States has experienced, from a predominantly manufacture-driven economy to a service and information economy.<sup>666</sup> The manufacturers who remain are much less dependent upon tangible assets, such as equipment and cash, and they are more dependent upon their contractual relationships or intellectual property.<sup>667</sup> According to Harvey R. Miller and Shai Y. Waisman, “[t]he globalization of the economy and the growth of financial markets have fueled distressed-debt trading, a phenomenon that has upset the symbiotic relationship between a debtor and its creditors.”<sup>668</sup> Unsophisticated creditors now see an option in selling their claims to distressed-debt traders at a discount so that they can avoid having to navigate the complexity of the Chapter 11 process.<sup>669</sup> Rather than foster a long-term relationship with the debtor by encouraging and aiding in the rehabilitation of a business, distressed-debt traders purchase claims with the goal of reaping profits as quickly and efficiently as possible, which may mean controlling the reorganization process by sitting on the creditors’ committee.<sup>670</sup>

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<sup>659</sup> Miller & Waisman, *supra* note 3, at 180.

<sup>660</sup> *Id.* at 150.

<sup>661</sup> *Id.* at 151.

<sup>662</sup> *Id.* at 152.

<sup>663</sup> *Id.* at 153.

<sup>664</sup> Keach, *supra* note 53.

<sup>665</sup> *Id.*

<sup>666</sup> *Id.*

<sup>667</sup> *Id.*

<sup>668</sup> Miller & Waisman, *supra* note 3, at 152 (internal citations omitted).

<sup>669</sup> *Id.*

<sup>670</sup> *Id.* at 153.

Consequently, creditors committees that oversee a Chapter 11 case now include distressed-debt traders, who often have vastly different agendas than those that the original creditors might have had.<sup>671</sup> In the case of a failing business with little to no equity in its assets, a debt trader is more likely to advocate for the liquidation of the business than for its rehabilitation.<sup>672</sup> The ABI has characterized the impact of such structural shifts as including “more business liquidations than reorganizations, greater loss of jobs, and greater loss of state and local tax bases as a consequence of business liquidation.”<sup>673</sup>

Another change that has not yet been specifically addressed by the ABI but has emerged alongside the increase in distressed-debt trading has been a growth in the debtor-in-possession financing (“DIP financing”) industry.<sup>674</sup> As business debt began to include more layers of secured and unsecured debt, negotiations with DIP lenders over loan agreements became more one-sided.<sup>675</sup> The DIP lender’s leverage is significantly improved by a business’s pre-petition liens and its ensuing need for financing in order to effectively reorganize, and this sway has allowed DIP lenders to impose strict covenants and conditions that can be so limiting that they essentially give the lender control over the reorganization.<sup>676</sup> This control by the DIP lender with respect to Chapter 11 has led some to criticize the reorganization process for becoming “increasingly dominated by the ‘creditor-in-possession.’”<sup>677</sup> The concern in this regard is that extended reorganizations present a risk to the DIP lender that it will not receive a favorable return on its investments, and the lender may thus favor the liquidation of a business as opposed to rehabilitation.<sup>678</sup>

While it is not yet clear what the ABI intends to propose with respect to reforming the Code, it recognizes that “[a] better set of tools is required.”<sup>679</sup> To encourage reorganization over liquidation, the Chapter 11 system must provide debtors and all interested parties with a more neutral forum so that rehabilitation is a more viable option going forward.<sup>680</sup>

B. THE LIKELY EFFECT OF A DEBTOR-FRIENDLY OVERHAUL OF CHAPTER 11 ON THE UNITED KINGDOM

While the United Kingdom has adopted certain elements of Chapter 11 in efforts to adequately address its business and financial

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<sup>671</sup> Keach, *supra* note 53.

<sup>672</sup> *Id.*

<sup>673</sup> *Id.*

<sup>674</sup> Miller & Waisman, *supra* note 3, at 153.

<sup>675</sup> *Id.* at 154.

<sup>676</sup> *Id.*

<sup>677</sup> *Id.*

<sup>678</sup> *Id.* at 157.

<sup>679</sup> See Keach, *supra* note 53.

<sup>680</sup> Miller & Waisman, *supra* note 3, at 179.

conditions,<sup>681</sup> the underpinning of Chapter 11's suitability to the American bankruptcy system is attributable to the United States' distinctly capitalist economic expansion.<sup>682</sup> Chapter 11's debtor-friendly principles may not be best transplanted where negative attitudes toward indebtedness have pervaded history and have survived the evolution of laws.<sup>683</sup>

The difference between the evolution of bankruptcy schemes in common law countries, like the United Kingdom, and that of the United States can be explained by the divergent histories and economic goals of each system.<sup>684</sup> Where debt forgiveness was viewed as a critical component of a rapidly growing and vibrant economy in the United States, it was not so embraced by early English society.<sup>685</sup> The relatively recent bankruptcy overhaul in the United Kingdom in 1986 was an effort to recognize the value and benefits of adopting a "rescue culture" in dealing with insolvent businesses, but the old attitudes toward debtors continue to seep through the new laws.<sup>686</sup> Filing for bankruptcy continues to carry more stigmas in the United Kingdom than in the United States,<sup>687</sup> as insolvency is still considered a personal failure.<sup>688</sup> In fact, "[d]espite the strongest imaginable support for rescue culture in the legislative history of the 1986 law, English society still has tremendous resistance to rescue culture."<sup>689</sup>

The transplantation of the Chapter 11 paradigm and its suitability to a country's reorganization system must be carefully considered with the country's particular social and economic climate in mind.<sup>690</sup> While the goals of Parliament has apparently been with the good intention to reduce the stigma of insolvency by modernizing and liberalizing the United Kingdom's bankruptcy scheme, deep-seeded cultural values may significantly delay the effectiveness of such laws as well as the implementation of new laws, if not impede them altogether.<sup>691</sup> Thus, implementing a more debtor-friendly reorganization system may reflect the United Kingdom's modern economic structure, but it still may not be accepted on account of its persisting social climate.<sup>692</sup>

#### IV. CONCLUSION

As the above discussion demonstrates, the Chapter 11 model for business restructuring has had a presence in the global community, influencing countries with creditor-friendly bankruptcy

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<sup>681</sup> Ball, *supra* note 1.

<sup>682</sup> See Martin, *supra* note 8, at 3.

<sup>683</sup> *Id.* at 5.

<sup>684</sup> Martin, *supra* note 6, at 403.

<sup>685</sup> *Id.*

<sup>686</sup> *Id.* at 404.

<sup>687</sup> Ball, *supra* note 1.

<sup>688</sup> Martin, *supra* note 8, at 38.

<sup>689</sup> Martin, *supra* note 6, at 393 (internal citations omitted).

<sup>690</sup> Martin, *supra* note 8, at 76.

<sup>691</sup> Martin, *supra* note 8, at 52.

<sup>692</sup> *Id.*

systems, like the United Kingdom, to enact legislation with the goal of preserving and rehabilitating businesses. The United Kingdom's recent adoption of Chapter 11 principles may indicate that the country will eventually have a restructuring process that mirrors that of the United States, but the likelihood that the old attitudes against rehabilitation will survive any "debtor-friendly" movements is significant, given the evolution of bankruptcy law from early English debtors' prisons to the United Kingdom's current creditor-controlled administrative processes. The motivations and influences on the evolution of the modern Chapter 11 are manifestly different than those of the modern business restructuring system in the United Kingdom. An eventual overhaul of Chapter 11 appears to be on the horizon, given the ABI's identification of significant structural changes to the United States' economy and debt traders' recent domination of the reorganization process. However, any changes adopted by the United States that extend significant power to the corporate debtor while diminishing that of its creditors will be unlikely to have any significant impact upon the United Kingdom's current reorganization model until the country makes greater strides toward embracing the American "rescue culture."