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The Virtue of Speed in Bankruptcy Proceedings

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The following essay is based on testimony presented before the Bankruptcy Commission in May 1997 in Washington, D.C.

Today I address a single problem associated with Chapter 11 and propose alternative changes in Chapter 11 that might alleviate the problem. There are many ways to criticize the substance of Chapter 11 and the procedure embedded in it. Others will argue today that several of the proposed changes before this Commission are unwise. I leave those specific issues to them; I direct my attention to a change that would alleviate many of the other substantive problems with Chapter 11.

In my opinion the principal difficulty with Chapter 11 is not that it unfairly favors one group or that the priorities which it establishes are misguided. In my opinion the principal difficulty with Chapter 11 is that it gives strong incentives to various Chapter 11 players to distort the priorities that were intended by Congress.

It is wrong to think of Chapter 11’s as principally judicial proceedings. A drawn out Chapter 11 proceeding is best regarded as a beehive of non-judicial activity in which each bee is attempting to seize some part of the available wealth for itself in ways that are often contrary to the priorities set down by Congress in the Bankruptcy Code. Managers (who may have run the business into the ground) profit from keeping the business on life support in Chapter 11 by being paid salary out of assets that would otherwise go to prepetition creditors. Shareholders and unsecured creditors whose claims appear to be under water preserve the possibility, however slim, of some return in a future reorganization by keeping a Chapter 11 alive. Professionals hired by the estate — lawyers, accountants, investment bankers and others — charge by the hour and so may have the strongest incentives to keep the Chapter 11 going.

By comparison with an efficient and expeditious process, the current Chapter 11 is both costly and unfaithful to Congress’ mandate. The additional amounts paid to lawyers, accountants and others to get a result that could have been achieved in shorter time and with lower fees are dead-weight losses. Lingering in bankruptcy doubtless engenders much larger indirect costs, costs that are hard to measure but still palpable. These are the costs of business decisions not made and of other sub-optimal business choices that always occur when a business is under court supervision and subject to the control of warring factions.

Apart from the costs of a continuing Chapter 11, there is also a reallocation of resources among the players in what is often a zero-sum game. If, for example, a business liquidates after lingering in Chapter 11, money that otherwise would and should go to existing creditors will be diverted into the hands of the managers. If a plausible threat of even greater delay can be made by the
shareholders, they too may be able to cajole a distribution from the creditors' purse. Similar stories can be told about other postpetition creditors. These additional direct and indirect costs and these opportunities for reallocation of one person's asset to another's pocket all rise more or less in parallel with the time spent in Chapter 11. The longer the Chapter 11, the greater the direct costs. The longer the Chapter 11, the greater the indirect costs. The longer the Chapter 11, the greater the opportunities for redirection of finite assets from the pocketbooks of creditors to the pocketbooks of managers, professionals, shareholders, and others.

I argue that much of the direct costs, a large part of the indirect costs of Chapter 11 and most of the perversion of the priorities could be avoided by speeding up the process.

At least on the surface, a proposal for speeding up Chapter 11 should be non-controversial. There is no plausible public support for delay. Those who argue that a firm should have an extended period to "reorganize" — that there is a statutory right to wait until the next upturn in the economic cycle — are surely wrong. Nothing in Chapter 11 or its predecessors suggest that a debtor should have a long time to reorganize when a quick reorganization could be achieved by greater effort and by the application of sterner measures. Some cases — those involving mass torts may be examples — may call for a longer period, but those are the exceptions.

Of course, the absence of public support for delay does not foreclose cynical and private support for delay. Every person who profits from the continuation of a Chapter 11 has some incentive to keep it going, even where the continuation perverts the distribution scheme. Privately, therefore, managers, shareholders, unsecured creditors, and professionals who are paid according to time spent have a selfish interest in delay at least to the extent there are assets available that will be taken from others and given to them.

Because the current law gives a substantial incentive to the managers and their agents to prolong the bankruptcy, the Commission should be skeptical about their indorsement of the status quo. As I have suggested in print, to ask Harvey Miller to attack Chapter 11 is like asking Itzhak Perlman to burn his violin. The most successful and renowned bankruptcy lawyers' virtuoso status depends upon manipulation of a complex Chapter 11; they cannot be objective analysts of its vices and virtues. A similar claim might also be made.

In my opinion the principal difficulty with Chapter 11 is that it gives strong incentives to various Chapter 11 players to distort the priorities that were intended by Congress.
First is the possibility of replacing the debtor in possession with a trustee. Mr. Sigal has made this suggestion, as have others, such as Professor Adams. This, too, is the French process and, of course, prior to the adoption of the Bankruptcy Reform Act in 1978 that was the invariable procedure in Chapter X.

Contrary to the assumption of the Bankruptcy Commission of the 1970s, the argument for ousting management does not depend on the proposition that the trustee will better operate the business than the existing management — though that might be the case. The trustee is a ghost, a threat; he could haunt the dreams of the managers. The statutory authorization of a trustee is the ever present reminder to management they may lose their position if they file Chapter 11, and having filed Chapter 11, that they may at any time be replaced and so lose their continuing salaries and other perquisites. In its conclusion that a trustee could not operate the business as effectively as existing management, the Congress overlooked the fact that the threat of management’s removal might have a stronger effect upon the Chapter 11 than their actual removal and replacement. How many firms would have steered clear of bankruptcy entirely had management been assured that it would not be high. The threat of a trustee should have salutary effects on the managers of a firm contemplating or in bankruptcy and because the managers have greater control of the firm than any others, the threat of a trustee may have the largest and most salutary effect on the incentives of the players in Chapter 11. There are many ways to draft a provision for a trustee. In my view, the stronger the threat, the better the incentive. The barriers to the appointment of a trustee should not be high.

A second possibility for modifying the incentives of the various parties would be to amend section 507 (b). That provision now reads in part as follows:

“If the trustee . . . provided adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a) (1) of this section arising from the stay of action against such property . . . then such creditor’s claim under such subsection shall have priority over every other claim allowable under such subsection.”

In effect, the provision assures that certain secured creditors (who have been provided “adequate” protection that proves not to be adequate) will be treated as first priority claimants and will so prime not only prepetition unsecured creditors, but many postpetition creditors as well. Section 507 (b) could be modified to read as follows:

“A secured creditor shall have a claim under section 507 (a) (1) with priority over every other claim allowable under that subsection. That claim shall equal the difference between (i) the value of the secured creditor’s collateral that would have been available to it at the filing of the petition and (ii) the value of the collateral made available to it during or upon the conclusion of the bankruptcy proceeding, less the value of any amounts transferred to that creditor as adequate protection.”

This proposal would allow a secured creditor to have a priority claim to the extent of the decrease in value of its collateral or for the loss arising from disposition of that collateral during the pendency of the bankruptcy. Because the money would ultimately come out of the pockets of pre- and postpetition unsecured creditors — including the pockets of other administrative expense claimants — all of those persons would find their own interests aligned with the interests of secured creditors.

I am aware that a provision of the kind I suggest will make some professionals squeal like pigs stuck under a wire fence. They will argue that no
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debtor will be able to hire a lawyer or accountant unless that person can be assured of receiving payment ahead of secured creditors to the extent there are free assets. I am skeptical of the accuracy of those assertions and, in any case, unmoved. In my view, the solution for the prospective administrative claimant is to insure a speedy resolution of the Chapter 11 or a quick conversion to Chapter 7 so that the available collateral is not dissipated.

A third possibility is to amend Section 361 to reverse that part of Timbers of Inwood Forest, Ltd., 484 U.S. 365 (1988), that denies lost opportunity costs. Some, I among them, would argue that the courts in general and the Supreme Court in particular have not been true to the promises made to the secured creditors in Section 361 and in the 1978 Senate Report under 361. That section promises the "indubitable equivalent" (and the Report buttresses that promise), but after Timbers the section does not deliver indubitable equivalence. Secured creditors in the LTV bankruptcy that commenced in July 1986 and concluded in May 1993 were deprived of interest for the entire period, an amount that might have doubled their money. If secured creditors were assured of a proper return on the value of their collateral (after the time when they would have been able to liquidate that collateral but for the bankruptcy), we might find the unsecured creditors, shareholders — and possibly even the professionals — aligned with secured creditors in wishing for a hasty resolution of a Chapter 11.

I am certain there are other more clever ways in which the parts of Chapter 11 — particularly the administrative powers and the priority provisions in Chapters 3 and 5 — can be manipulated to modify the incentives of the players in the Chapter 11 game. I invite you to think of those and to consider them, too.

I leave you with two points. First, the Commission should devote careful thought to the question of how Chapter 11's can be speeded either to a successful plan or to a quick conversion to Chapter 7. Speed is an antidote to many of the substantive ills in Chapter 11. That speed will benefit not only secured creditors, but unsecured creditors as well. It will reduce costs and will foreclose distortions of the bankruptcy priority scheme in long-running Chapter 11’s where managers, shareholders and postpetition creditors take payments that should go to others.

Second, the speed of Chapter 11’s will quicken only if the proper incentives are given to the players in Chapter 11 proceedings — to the bees in the beehive. It is not enough to modify the times in Section 1121 or otherwise to depend upon a busy judge to insure that things occur on time. Far better to give the proper incentives to the managers, professionals, secured and unsecured creditors. I indorse the possibility of shortening the period in Section 1121, but I think it better to alter Section 507 (b), reverse Timbers, and to set up a trustee as threat to existing management.

Robert A. Sullivan Professor of Law James J. White, ’62, is a graduate of Amherst College and the University of Michigan Law School. He has practiced privately in Los Angeles, has written on many aspects of commercial law and has published two widely used treatises, Bankruptcy (with Epstein and Nickles, 1992) and Handbook of the Law Under the Uniform Commercial Code (with Summers, 1995, 4th ed.). He is also the author of three casebooks: Bankruptcy (with Nimmer, 1992, 2nd ed.); Banking Law Teaching Materials (with Symons, 1990, 3rd ed.); and Commercial Law (with Speidel and Summers, 1987, 4th ed.). Professor White also was the reporter for the Revision of Article 5 of the Uniform Commercial Code and is involved in the proposed revisions to Articles 2 and 2A. He began his academic career at the Law School in 1964.