ABL ADVISOR

Catching Up on Chapter 11 Reform … ABI Commission Enters Second Year

By Robert Keach and Albert Togut | January 15, 2013

As co-chairs of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11 (ABI Commission), we are proud to note that the ABI Commission is entering its second year of operation. Thus, it is an appropriate time to reflect on the reasons for the formation of the ABI Commission, its mission, its activities over the prior year, what it has learned, and its course for the future.

Why the Need for Reform … And Why Now?

It has been over thirty years since the Bankruptcy Code was enacted, and a consensus has emerged that the current law needs an overhaul. The 1978 Bankruptcy Code, as it has been amended on numerous occasions, has served us well for years. Some would contend that the 1978 Bankruptcy Code offered a balance between creditor and debtor interests, establishing what was often described as a "level playing field" for restructurings. When first enacted, supporters of the 1978 Bankruptcy Code argued that it served the interests of all those impacted by a debtor in distress including employees, the surrounding community, the public interest and creditor interests but did so in a flexible way that balanced all interests while meeting the debtor's goal of succeeding in saving its business.

Others did not see the balance. Detractors contended that the 1978 Code was too "debtor-friendly," that it led to long and inefficient cases, and that it provided too much discretion to bankruptcy judges. To the extent that the Code was amended after 1978, the detractors largely prevailed in the legislative battles. For better or worse, most of the changes to the Code since 1978 have (a) exempted categories of claimants or transactions from the reach of bankruptcy law; (b) added additional categories of administrative or priority claims, thus burdening the already strained liquidity of distressed companies; (c) limited or eliminated the discretion of the courts in administering chapter 11 cases; (d) provided for shorter time periods and faster, more-truncated cases; and (e) resulted in more company sales or liquidations than ever before. Supporters of the 1978 Code contend that the many changes to the Code throughout the years have not helped further the goal of restructuring or have had unintended consequences.

However, arguing about what was right or wrong about the Code is, at this juncture, largely beside the point. Primarily, the world, including the financial environment and the operation of the markets, simply changed. At the same time, the Code, even as amended, was not designed to deal with these changes. For the most part, a series of "external" factors drive the need for a rethinking of chapter 11.

Since the Code's enactment, there has been a marked increase in the use of secured credit, placing secured debt at all levels of the capital structure. Many of the 1978 Code's provisions assume the presence of asset value above the secured debt, asset value that is usually not present in many of today's chapter 11 cases. The debt and capital structures of most debtor companies are more complex, with multiple levels of secured and unsecured debt, often governed by equally complex intercreditor agreements. This is not to say that there is anything wrong with the growth of collateralized debt per se; indeed, that growth brought credit to many companies who could not have obtained it otherwise. However, the 1978 Code's baseline assumption of value above the amount of liens on assets was challenged if not cast asunder.

The growth of distressed debt markets and claims trading introduced another factor not present when the 1978 Code was enacted, a factor which challenges certain other premises underlying the 1978 Code. The 1978 Code presumed a creditor body that had an interest in rehabilitation so that there could continue to be a good customer. Today, creditors have a means of monetizing claims more quickly, rather than awaiting the outcome of sometimes lengthy cases but they exit without a concern about the Debtor's viability. Moreover, the development of these markets created consequences that the 1978 Code was simply not designed to deal with.

Many of today's companies are less dependent on "hard" assets (real estate, machinery and equipment or inventory), and more dependent on contracts and intellectual property as principal assets; the 1978 Code does not clearly provide for the efficient treatment of such assets and affected counterparties. Debtors today are more often multinational companies, with the means of production and other operations offshore, bringing international law and choice of law implications. Today's "debtor" is likely to be a group of related, often interdependent, entities. The impacts of these changes on the efficacy of the current restructuring regime have been dramatic.

The way both courts and commentators discuss the purpose of chapter 11 has also changed. Early decisions (and the legislative history of the 1978 Code) emphasized that the primary purposes of the Code were the rehabilitation of businesses, and the preservation of jobs and tax bases at the state, local and federal level. As time passed, these purposes were eclipsed by "maximization of value" as the paramount goal and maximizing value often results in the liquidation of the business for a quick return. More recent discussions of the purpose of Chapter 11 tend to emphasize value maximization to the exclusion of other goals and purposes. This development also calls for a fresh assessment of the purposes and goals of a U.S. restructuring regime.

Moreover, given the added complexity — and a statute that often does not have the tools or clear answers to deal with the problems that arise — even the cases that do reorganize may be less efficient, and more costly.

Practitioners and the courts have achieved amazing and creative results despite the statute's shortcomings. However, recognition that the world has changed in significant ways since the enactment of the 1978 Code, and the related concerns, bring the restructuring community to consider the need for a thorough reevaluation of the Code. A better set of tools is required.

What is the ABI Commission, Its Mission and How is it Doing its Work?

The charge of the ABI Commission is nothing less than the study of the need for comprehensive chapter 11 reform, by which we mean consideration of starting from scratch and re-inventing the statute. Accordingly, the Commission's mission statement is equally ambitious:

In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the commission will study and propose reforms to chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors — with the attendant preservation and expansion of jobs — and the maximization and realization of asset values for all creditors and stakeholders.

More than a year ago, then ABI President Geoff Berman tasked us to assist him in assembling a working group of the "best and the brightest" from among chapter 11 practitioners, academics, bankers, and congress, to study possible business bankruptcy law reforms. With the ABI Commission, we feel we have accomplished that task. A full list of the Commission's members and their affiliations can be found by clicking here.

The commission is also ably assisted by its reporter, an eminent bankruptcy scholar in her own right, Michelle M. Harner, Professor of Law and Co-Director of the Business Law Program at the University of Maryland Francis King Carey School Of Law. Professor Harner oversees the work of the advisory committees, provides critical research assistance, records the deliberations of the commission, and will assist in the production of the commission's final work product. The work of the commission is also underwritten by grants from the ABI Anthony H.N. Schnelling Endowment Fund and the ABI.

The commission, in a series of meetings, selected a number of topics for initial study. For each topic, the commission has selected an advisory committee of distinguished judges, academics, and practitioners to assist the commission in the study of the topic, research the topic and possible reforms, and, where warranted, to develop the arguments for reform alternatives. Over 120 of the best minds from the judiciary, academia, the bar, financial advisory services, and the worlds of finance and banking have agreed to serve on the committees. These committees are organized and now in the midst their important work. A full list of the various topics, and the advisory committees, can be found by clicking here. The ABI Commission may also address other issues at the commission level as well.

The Field Hearings

The commission realized that, despite the breadth of knowledge and experience on the commission and its advisory committees, many others around the country — from the bar, the judiciary, academia, the financial professions, business and elsewhere — have critical information, experience, knowledge, data and ideas to contribute to this important process. Accordingly, to access this wealth of knowledge, information, data, ideas and experience, the commission decided to hold field hearings around the country to hear and collect testimony

on various issues.

The ABI Commission held six public field hearings in 2012, in Washington, D.C., New York, San Diego, Boston, Phoenix and Tucson. In those hearings, the commissioners heard testimony from, and asked questions of, more than twenty witnesses from various organizations and industries affected by potential restructuring reform. The witness testimony covered various topics, including secured lending, the effect of reform on the credit markets, claims trading, the interface of procedural rules and substantive restructuring reform, sales of businesses via chapter 11, debtor-in-possession lending, credit bidding, the role of creditors' committees, middle-market and small business issues, and governance of restructuring companies.

The testimony has been illuminating on a number of fronts. Among many other insights, the ABI Commission has heard that it must consider the impact of reforms on the broader market for credit, both for distressed and healthy companies. The Commission is fully mindful of that guidance.

The Path Forward

The ABI Commission will hold at least seven additional field hearings in 2013, with two sessions scheduled for Las Vegas, two events in New York, and three hearings scheduled for Washington, DC. The Commission is also soliciting and accepting written submissions on all issues. We hope to hear from every interest affected by potential restructuring legislation. Throughout 2013, the commission will also receive the work of its various advisory committees on a host of topics and subtopics.

Armed with this information, the commissioners will discuss each topic, and debate and search for consensus for reform. The final result will be a comprehensive report, part blueprint for reform and part catalog of open issues and current options, to be considered in updating Chapter 11.

The target date for this report is April 2014. At the end of the day, the Commission's work may lead to consideration of reform legislation, but legislation fully informed by the careful and thorough process of the Commission, and the input of the entire insolvency community. We could not be more excited and energized about both the quality and the quantity of the contributions of that community to date, and the future of this study.

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