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Where Have All the Chapter 11s Gone and Who's to Blame?

BY KENNETH A. ROSEN

The business of bankruptcy has slowed down. The number of Chapter 11 cases being commenced is fewer and they are further between.[1] As a result:

- Competition among professionals has ratcheted up. Firms who have never chased a creditors committee are now entering the "committee business." Firms already in the "committee business" increasingly look downstream to pursue smaller cases than they ever did in the past.
- The Bankruptcy Court is suffering staff reductions and the number of judicial slots left vacant increases.
- Bankruptcy Court law clerks find it is difficult to secure post-clerkship positions. Firms that hired law clerks routinely, either are not hiring, or at best are deferring hiring decisions.
- Prospective clients are demanding more services at lower cost because they know that a professional is more likely to reduce rates and take a smaller retainer in order to win the engagement.

So, what's the problem?

For years, many have blamed the lack of Chapter 11 filings in courts other than Wilmington and the Southern District of New York (SDNY) on bankruptcy judges. For some, bankruptcy judges not sitting in Wilmington, Del., and the SDNY are (allegedly) too stringent on fee applications filed in their "home" jurisdictions. For others, there is the belief that Wilmington and SDNY bankruptcy judges have extraordinary abilities, such as handling "mega cases" and quick 363 sale processes. It is true that Wilmington and SDNY judges are both fair and smart. However, I have found plenty of reasonable and erudite bankruptcy judges sitting in venues across the country. And, court sophistication does not explain why the bankruptcy courts in both Wilmington and SDNY have experienced a decline in the number of their filings, 14.2 and 9.3 percent respectively.[2]

Others blame "cheap money" as a reason for the disappearance of large Chapter 11 cases. The Federal Reserve's decision[3] to keep interest rates at historically low levels is an important factor. With current interest

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[1] *See* U.S. Courts, Judicial Business 2014 "Table 6. U.S. Bankruptcy Courts, Bankruptcy Cases Filed, Terminated and Pending, Fiscal Years 2010-2014" and "Table 7. U.S. Bankruptcy Courts, Cases Filed by Chapter of the Bankruptcy Code, Fiscal Years 2010-2014" *http://www.uscourts.gov/Statistics/JudicialBusiness/2014/us-bankruptcy-courts.aspx* (last viewed Apr. 8, 2015) (noting that eighty-nine of ninety bankruptcy courts across the United States reported fewer filings in 2014 than in 2013 and "chapter 11 filings declined 20 percent" with 7,658 filings in 2014 versus 9,564 in 2013. *Compare*, number of Chapter 11 filings in 2010, 2011 and 2012 were 14,191, 11,979 and 10,597, respectively).

[2] *See* U.S. Courts, Judicial Business 2014 "Table F. U.S. Bankruptcy Courts, Bankruptcy Cases Commenced, Terminated, and Pending During the 12-month Periods Ending September 2013 and 2014" *http://www.uscourts.gov/uscourts/Statistics/JudicialBusiness/2014/appendices/USBankruptcyCourts.pdf* (last viewed Apr. 8, 2015) (noting that the number of total number of bankruptcy filings decreased by 14.3 percent and 9.2 percent between 2013 and 2014 in the District of Delaware in the Southern District of New York, respectively).

[3] Board of Governors of the Federal Reserve System. "Current FAQs. Why are interest rates being kept at a low level?" *http://www.federalreserve.gov/faqs/money_12849.htm* (last viewed Apr. 8, 2015) (noting that the Federal Reserve has

rates being maintained at low percentages, companies now have the ability to access cash at low-cost and/or amend financing agreements to eliminate the need to file for Chapter 11 protection in the near future. However, as Warren Buffet once wrote to his shareholders: ''After all, you only find out who is swimming naked when the tide goes out.''[4] Just because cash is cheap, does not negate a company's need to ultimately restructure its balance sheet. For example, in recent years, I have found companies increasingly encouraged by their secured creditors to pursue assignments for the benefit of creditors (ABCs) and/or Article 9 ''surrenders.'' Alternatively, companies that are seeking Chapter 11 protection are pre-negotiating their debt restructuring and, like Athena emerging from Zeus' skull at birth, filing creditor-approved plans of reorganization on the same day as their Chapter 11 petitions.

There is also an increasing trend of Chapter 11 filings consisting of little more than a ''363 sale process'' – where a debtor will file a motion to sell estate assets along with its Chapter 11 petition. The debtor typically proposes transferring its assets to a stalking horse bidder offering to pay an amount that is deemed sufficient to repay the first secured creditor. Occasionally, the bid will include a small sum to be paid to the debtor's professionals. Post-sale, these Chapter 11 cases are converted to Chapter 7 (liquidation) or more likely, dismissed altogether. As a result, the debtor is quickly liquidated without knowing whether it can be successfully reorganized as a downsized or reconfigured business with a smaller balance sheet. Alternatively, the debtor's business is sold as a going concern stripped of legacy costs, pension obligations, excessive debt and various contracts. In this instance, the ''damage'' resulting from prior management's and stockholder's decisions is effectively shifted to unsecured creditors, current and former employees, the federal and state governments, other employers (MEPPs), unions, etc. As a result, any benefit or ''upside'' created by a Chapter 11 process is not made available for creditors to share. It all goes to the acquirer. The idea of spending time in a Chapter 11 process in order to rebuild value that can ultimately be shared with creditors under a negotiated plan of reorganization is gone.

I have also observed instances where debtors will commence a Chapter 11 case to fix their balance sheet and/or operational issues (i.e., reject onerous leases and contracts). However, instead of experiencing an increase in value, the debtors find a material erosion of asset value during the pendency of the process.

Given the low Chapter 11 success rate[5], more secured creditors appear to prefer to take back their collateral or force a quick sale rather than fund Chapter 11 administrative costs. With the former, a secured creditor can, minimally, calculate its damages and avoid the risk that the value of its collateral will erode unabated post-petition.

I have also noticed a significant change in the types of secured creditors providing funding for businesses, on both the equity and debt sides. Unlike the days when the only big lenders were banks like Manufacturers Hanover, Chase Manhattan, Security Pacific, NatWest, Midlantic, First Fidelity and the like (I have just dated myself!), today's secured creditors are not necessarily banks. Often times, secured creditors are funds managed by individuals with business expertise in the debtor's field who are willing, if not anxious, to take possession of the debtor's assets and attempt to run the business for solely their own benefit.

All of these factors have contributed to a reduced number of Chapter 11 filings and contributed towards the current situation. However, are these the only reasons? No. There is another contributing factor that few bankruptcy professionals wish to acknowledge: ourselves (yes, including me).

When business was good, we all raised our rates. Bankruptcy professional services were in great demand. We did it because we could do it. (Clearly, this is an admission against interest!) However, reducing rates is much more difficult. Why do rates matter? They matter because at a certain price point, secured creditors simply throw up their hands.

High hourly rates, lenders who are more willing to accept a surrender of collateral and fewer lenders who are willing to ''play ball'' in a Chapter 11 in order to give a debtor an opportunity for a ''fresh start'' is an even greater dilemma for small and middle market companies. For companies with annual revenues of at least a billion dollars, hourly rates may not affect their case strategy. However, most companies do not reside in this arena. In fact, in my home state of New Jersey, we rely heavily on middle market cases – which are fewer and further between. It is not a market that I want to see evaporate. I maintain this position not only for my sake (and for the well-being of my colleagues), but also for the interests of the ''the marketplace'' and economy as a whole.

It may be unrealistic to expect professionals to voluntarily roll back their rates. While many of us quietly are discounting our rates, this step alone is inadequate if we are to bring back the concept of ''fresh start'' for most companies. While hourly rates are important, they are only the proverbial tip of the iceberg. There are many other factors that contribute to the high cost of running a Chapter 11 case. As bankruptcy professionals, we should also consider broad questions such as:

- How can we increase the likelihood of long term success of Chapter 11 reorganizations?
- How can we reduce the number of liquidating Chapter 11s?
- How can we reduce the cost of Chapter 11 cases overall so that interested parties do not view the process as too expensive and/or not worth the effort?

In addition to these broad concepts, professionals should also consider ''knottier'' aspects of the practice. For instance, would bankruptcy attorneys be more willing to recommend a Chapter 11 process in lieu of an out of court workout if they were more confident that a bankruptcy court will give a debtor a reasonable, but not excessive, opportunity to demonstrate it can feasibly be reorganized before permitting other constituents to take its assets?

maintained low interest rates to ''support continued progress towards maximum employment and price stability[.]'').

[4] Warren Buffett, Letter to Shareholders of Berkshire Hathaway Inc., February 28, 2002, *http://www.berkshirehathaway.com/2001ar/2001letter.html* (last viewed Apr. 8, 2015).

[5] I base this statement on my personal experience and not upon empirical evidence. However, my experience is considerable.

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As a society, do we value providing all debtors – both individuals and corporations– with the ability to seek a fresh start? If so, should a debtor's desire for a "fresh start" outweigh a lender's desire to, effectively, take its marbles and go home? My vote: we should value a debtor's ability to seek a "fresh start" and provide reasonable assistance to enable the debtor to reach this goal. (The bankruptcy process already provides secured creditors with sufficient tools to protect their interests during a restructuring process, i.e., permitting exorbitant postpetition interest rates.[6] Furthermore, potential risks for lenders are accounted for in the pre-petition interest rate and fees charged to borrowers.)

The Honorable William H. Pauley III, a district court judge sitting in the SDNY, recently "lambasted" firms representing both plaintiff and defendant in a suit.[7] The Court "ordered [counsel] to trim down their pleadings, and pointed to what he said has become an industry-wide problem." Judge Pauley noted that "[v]oluminus pleading is self-defeating. It chokes the docket and obscures otherwise meritorious claims and defenses." (Here, the pleadings included a 175-page complaint with 1,400 pages of exhibits that was followed by a 210-page answer.)

Bankruptcy attorneys are just as guilty of these tactics. In many law firms, the bankruptcy practice is a spinoff from the litigation department. In litigation departments, many firms are feeling the pinch of clients who think that litigation is too expensive a remedy. Too expensive because lawyers will take 12 depositions even if three would have been sufficient.

And, if your adversary does it, you also have to do it. Really? Doesn't anyone want to settle cases anymore over a good bottle of wine?[8]

Perhaps, bankruptcy judges should be encouraged to become activists? To be clear: "Activist" does not mean encouraging the bankruptcy court to second-guess parties with respect to substantive matters. However, it does mean permitting the bankruptcy court to be more interventional in controlling the cost of the Chapter 11 process. After all, why else deem the bankruptcy court "a court of equity" and give its judges Section 105 powers?[9] In other words, can we find a way to ensure that a bankruptcy proceeding is "sized" according to the dollars involved and complexity of a debtor's case without unreasonably sacrificing due process? My answer: Yes. This would mean that pleadings – applications, motions, responses, replies – would all be limited in length. Moreover, all parties involved would be expected to maintain this standard and, use alternative methods, like mediation, to resolve issues.

We should also re-think the bankruptcy code's definition of who is eligible to restructure as a "small business case." *See* 11 U.S.C. § 101(51C). Currently, this process is limited to debtors with non-contingent, liquidated, secured and unsecured debt in an amount not exceeding $2,490,925. *Id.* at § 101(51D). Today, aggregate indebtedness of $2.5 million is more likely for a closely held candy store as opposed to a mid-market business.

Another thought is to examine the Chapter 11 administrative process once a case is commenced. I do not suggest that we sacrifice due process; however, more attention needs to be placed on the "mechanics" of running a case if we are to facilitate the "fresh start" Congress intended. For example, can technology be used more effectively? Video conferencing and telephonic conference calls can save a fortune in attorneys' fees. Can more applications and motions be considered without a hearing? Does every disclosure statement need to be so darn long?! Are there short cuts appropriate for Chapter 11 cases where there is an active creditors committee? Are there short cuts appropriate for smaller Chapter 11 cases? Perhaps, it is time for professionals to make greater use of "short forms" that provide a court with necessary information in boilerplate firm. I admit to looking askance at such pleadings and considering them "inappropriate" for sophisticated modern Chapter 11 practices. However, upon reflection, if such forms will enable my firm to effectively and efficiently restructure companies with debts less than one billion, I will not only use the forms, but create them myself.

I began my legal career working for the United States Trustee's Office. It was an invaluable experience. Although it has been several years since my tenure, I still believe that the United States Trustee's program provides an important service as an overseer of the process. However, since the Program was founded, the practice of bankruptcy has evolved. The role of the official committee of unsecured creditors of a debtor has grown significantly. I find successful debtor restructurings are rare without the support of this critical constituency.

The United States Trustees Office's role in forming a creditors' committee is clear. Moreover, the selection of individual committee members by the United States Trustee is rarely, if ever, challenged. Committee members are often sophisticated business people with a great deal of knowledge about the debtor and its industry. Consequently, the creditors committee represents interests very much in line with the goals of the Bankruptcy Code. Accordingly, once a committee is formed by the United States Trustee's Office, assuming the committee is active, diligent and communicative with its constituency, what should the role of United States Trustee's Office be in the case going forward?

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[6] I realize that I am not making any friends with these statements. However, as noted by the Supreme Court, the goal of the Bankruptcy Code is to provide honest, but unfortunate debtors, with a "fresh start." *See, e.g., Grogan v. Garner*, 498 U.S. 279, 286 (1991) (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) ("This Court has certainly acknowledged that a central purpose of the Code is to provide a procedure by which certain insolvent debtors can reorder their affairs, make peace with their creditors, and enjoy 'a new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt.' "). Accordingly, we must endeavor to fulfill this goal and provide debtors with at least the prospect to seek "new opportunity"; mere lip service is insufficient. This means that the demands of secured creditors must be balanced against a debtor's logistical needs to ensure that an appropriate balance during the Chapter 11 cases infancy is reached. The rights of secured lenders cannot be allowed to diminish the rights of all others.

[7] Aebra Coe, "Judge Reams Out BigLaw Firms For Lengthy Filings." Law360.com, Mar. 26, 2015. (*http://www.law360.com/articles/636192/judge-reams-out-biglaw-firms-for-lengthy-filings*) (last viewed Apr. 8, 2015).

[8] The first bottle is on me for any adversary that takes me up on this offer. Dinner is on me too if our clients actually settle.

[9] Maybe more judges should be encouraged to follow Judge Pauley's example and intervene when practitioners do not file "short and plain" pleadings when appropriate?

In healthcare, the paradigm is one that is moving away from a fee for service model. Today doctors and hospitals are being rewarded for managing patient care in ways that reduce the need for additional medical care and/or extended hospital visits. Is there a lesson to be learned here by the legal profession? Yes. Should we reward professionals for efficiency, economy and good rapid results beyond normal hourly rates? Certainly.

Bottom line: Fresh Starts are important – not only to individuals, but to corporations and, ultimately, all of us who are dependent on them for our livelihood. (Given the important role that corporations hold in today's economy, ''all'' refers to more than just bankruptcy professionals.) As a group, we need to make the Chapter 11 process less expensive, more efficient and ''effective'' than alternatives such as ABCs and Article 9 transactions. Ultimately, we need to find a way to permit companies to at least attempt to effectuate true reorganizations in lieu of quick transactions that rarely provide benefits to anyone beyond secured creditors. This means that bankruptcy courts may need to be more reluctant to approve onerous DIPs and quick 363 sale processes unless, and until, they are convinced that a debtor's reorganization is not realistic. It also means that bankruptcy professionals must work together to avoid long, drawn out Chapter 11s that only erode value and drive up professional fees. It would be a balancing act, but together, we can make this work.

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