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Bankruptcy And Reorganization
Through The Looking Glass Of 50 Years
(1960 – 2010)

Keynote Address
Harvey R. Miller
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Bankruptcy And Reorganization Through The Looking Glass Of 50 Years

It is a great honor to have been selected as the keynote speaker to commemorate the admission of the Class of 2010 as fellows of the American College of Bankruptcy.

Keynote speeches are difficult to formulate because they often are presented around meals and a need to move on to more liquid refreshments. Robert Burns said that a keynote speech should have a cheery opening, a bright close and not much substance in between! We shall see.

Unlike my prior appearances as a keynote speaker, I actually was given an assignment for tonight. David Heiman assigned as my subject a 50 year perspective on bankruptcy and reorganization law in the United States. In 1936 Professor Charles Warren wrote a book on the history of bankruptcy law. He wrote, "[b]ankruptcy is a gloomy and depressing subject…a dry and discouraging topic." Thank you David!

Now, to add insult to injury, last week I was told that I have 15 minutes within which to cover the 50 years. To complete the task within that timeframe, I will have to move as if propelled by a Toyota accelerator! In the context of 15 minutes, all that I can say is that it has been one hell of a half century!!!

The 1960s And The Expansion Of Bankruptcy as a Debtor's Protective Process

How does one reduce the history and events of 50 years into 15 or perhaps 20 minutes. It is a challenge. As I compute it, I have approximately 18 seconds per year. It is impossible – so I had decided to speak about healthcare, but someone else seems to monopolize the subject. So, back to bankruptcy.

What, after all, is bankruptcy? It is a substantive and procedural process that is intended to resolve the claims to the assets of a debtor that is unable to satisfy its obligations and that may be insufficient to satisfy all legitimate claims. From that basic premise, bankruptcy has expanded in scope and size to include a variety of third parties with different objectives propelled by the hope of financial gains. It is an ever-changing process fueled by economic cycles, tempered by political objectives and, sometimes, the actual intervention of the government to protect national interests. It fluctuates through stages of protection of debtors to the enforcement of creditors' rights, often depending on how one construes the plain meaning rule. In a retroactive overview of 50 years, there are cycles favoring debtors, other times creditors, and sometimes encouraging purchasers and, finally, furthering governmental objectives.

I start with the 1960s as the beginning of modern bankruptcy practice. It was the age of Aquarius and individual and sexual freedom, but bankruptcy was not a part of the public consciousness or considered

part of the legal and strategic options for distressed debtor enterprises. The results of the railroad reorganizations of the last part of the 19th Century that had leached into the 20th Century, and the fallout of the Great Depression of the 1930s, had largely dissipated. Business bankruptcies had not yet captured the attention of the public.

It was a much simpler world. Most businesses were privately owned. They operated on the foundation of long term relationships, customer and vendor loyalty and prudence. In most situations, you could actually determine the value of a business by reviewing its financial statements. Wall Street was laboring under the post-Depression protective statutes such as the Securities Act of 1933 and its related statutes. The SEC and various national securities exchanges actively regulated the financial markets. There were no highly esoteric, incomprehensible securities being created, packaged and sold. There were restrictions on financial engineering intended to hide liabilities as off-balance sheet items. Auditors actually audited companies and economists were contained within their academic precincts. The inventions of the PC, blackberries and iPhones were a long way off.

Bankruptcy was considered a sub-strata of commercial law, a small, arcane, undesirable practice area inhabited, allegedly, by somewhat shady groups accused of feeding off the carcasses of failures. Most elite law schools did not offer a bankruptcy course.

Major law and accounting firms shunned the bankruptcy arena. Individuals and businesses, public and private, strived to avoid the stigma of bankruptcy. Federal courts were considered too formalistic to assist in business cases. Debtor/creditor issues were resolved through the medium of common law compositions or in state courts through receiverships and assignments for the benefit of creditors. Notwithstanding the enactment of the 1938 Chandler Act amending the Bankruptcy Act of 1898, federal bankruptcy proceedings, generally, were limited to liquidations to provide access to the avoidance powers of the Bankruptcy Act.

Bankruptcy professionals represented a small and parochial group of attorneys and accountants. Active trade creditor associations functioned as forums to facilitate expeditious and efficient solutions for private business failures. There were no turnaround experts, distressed debt traders, hedge funds, restructuring officers, specialized bankruptcy financial advisors or the like. Defaulting debtors were considered outcasts. Contractual rights of secured creditors reigned supreme.

The bankruptcy court was a strange place. There were no judges. Rather, bankruptcy cases were filed in the United States District Court and referred to and administered by referees in bankruptcy, who were appointed by the district court for five year terms and served as support personnel. They exercised such authority as was referred to them by the district court. Referees did not have law clerks and very

little in the way of facilities. There were no national bankruptcy law reports. The courts relied on two treatises: Remington on Bankruptcy and Collier on Bankruptcy. Eventually, Remington faded and Collier became the leading treatise under the editorial leadership of Professor Lawrence P. King of the NYU Law School. Larry was very clever; he edited Collier so that it could be cited for any proposition. Collier became the Pepper v. Litton of legal publications. There was no centralized bankruptcy court filing system or a general docket in a district in which there was more than one referee in bankruptcy. In some districts there were part-time Referees who presided over bankruptcy cases two or three days a week and otherwise privately practiced law.

In addition, bankruptcy, despite its stigma, was considered something akin to public service. Imbedded in bankruptcy proceedings was the spirit of economy that mandated that bankruptcy professionals be compensated at rates less than those prevailing in the private sector. Consequently, it was not considered to be a very desirable practice area. It was very localized. New York bankruptcy professionals were not welcomed in New Jersey or Connecticut and Manhattan bankruptcy professionals crossed the East River to Brooklyn with great trepidation and fear, as Brooklyn bankruptcy professionals likewise did when crossing to Manhattan.

However, as the 1960s progressed, something was happening in the United States. Economic change was in the air. Wall Street was shaking off the shackles of the Depression and World War II restraints. The go-go years were beginning. "Going public" as presented by Wall Street dealers caught the imagination of businessmen. It provided capital for growing businesses to expand. To accommodate the expanding economy, financial markets began to grow. Volume on the NYSE at last exceeded five million shares a day. Access to credit became more liberal and the use of leverage became seductive. Businesses and the economy became more credit-intensive and, naturally, because financial discipline did not grow at the same pace, led to overleveraging and failures. This is an integral element of capitalism, otherwise known as creative destruction. That danger and its reality spurred the thinking that there had to be ways to constructively deal with failure.

Some professionals began to investigate the options and possibilities of alleviating the consequences of failure and that debtors might have some rights and protections. The Chandler Act had codified debtor relief provisions as Chapter X and XI. Chapter X provided a very detailed, comprehensive scheme for corporate reorganization primarily directed at public corporations. It mandated appointment of one or more trustees and strict imposition of the Absolute Priority Rule. Chapter X proceedings were to be presided over by a United States district judge

with a heavy involvement of the SEC as a party. It wasn't attractive to distressed debtors and its use was discouraged.

In contrast, Chapter XI, as enacted, was limited to voluntary cases and initially to small businesses that needed to make arrangements with their unsecured creditors to relieve oppressive debts. However, by the 1960s, Chapter XI no longer required application of the Absolute Priority Rule and did not mandate appointment of a trustee. Rather, it provided that a debtor could continue to operate and manage its business and assets as a debtor in possession. Although the recognition of the debtor in possession concept was not uniform throughout the United States, it became the norm for Chapter XI cases filed in the Southern District of New York. In addition, and very importantly, a Chapter XI debtor had the exclusive right to file a plan of arrangement for so long as the Chapter XI case was pending. This represented a tactical weapon of significant potential, as the alternative to a plan of arrangement would be liquidation and the loss of the going concern value of the business and its assets to the detriment of the creditors. These features, plus a growing appreciation by professionals that bankruptcy courts in Chapter XI cases might liberally construe the bankruptcy law beyond its original intent to (a) enjoin secured creditors from exercising remedial rights for extended periods of time; (b) enjoin all unsecured creditors and others from taking any actions against the debtor and its property (both of which led to the automatic stay); (c)

construe rejection and assumption of executory contracts, including collective bargaining agreements and unexpired leases to favor debtors in possession or trustees, and (d) allow dilution of equity interests as part of a Chapter XI plan, were very attractive.

The threat of SEC action to force conversion of Chapter XI cases to cases under Chapter X became less of a problem as the Supreme Court beat back the SEC in a series of decisions that tipped the scale decidedly in favor of Chapter XI.

In 1960 there were 715 reorganization and arrangement cases filed in the United States. In 1970 there were 1,422 such cases filed. In 1975 the first billion dollar Chapter XI case was commenced by the W.T. Grant Company. W. T. Grant was an NYSE listed corporation and once had been considered the Tiffany of retailing. Its liabilities included $640 million to a syndicate of banks. The big time had arrived for debtors! After the enactment of the 1978 Bankruptcy Reform Act, in 1980 and 1990, respectively, there were 6,348 and 20,783 reorganization cases filed in the United States.

The 1980s Through 2000 – The Age Of The Debtors

The enactment of the Bankruptcy Code essentially fused former Chapters X and XI into the Code's business reorganization chapter. Under that chapter, a plan of reorganization could affect all creditors, secured and unsecured, as well as equity interest holders and it allowed relaxation of the absolute priority rule. The Bankruptcy Code

was intended to provide a level playing field for debtors and creditors by balancing the needs of the economic stakeholders in the interests of rehabilitation and reorganization of a distressed business. Its enactment was actively and unanimously supported by all major constituencies, including the financial community, unsecured creditor associations, stockholders' organizations and the bankruptcy judiciary.

It evidenced the mutually agreed principle that the reorganization paradigm was better than liquidation as it preserved going concern value, protected industries and jobs and, generally, projected greater recoveries for impaired creditors. Chapter 11 reorganizations had entered the mainstream of commercial life in the United States. Overleveraging, excessive real property financings and other investments, the loss of competitor status as the global economy began to take hold, as well as fraud and other causes, resulted in a sharp increase in the volume and the size of the assets and liabilities of the cases filed under chapter 11 and, not to be forgotten, the expanded demand for professionals and the increase in potential fees. [Duberstein comment].

The leveraged buyout mania of the 1980s led to chapter 11 cases filed by Federated Department Stores, R.H. Macy & Co., Trans World Airlines, Southland Corp., Global Marine, National Gypsum Corp. and, in part, Drexel Burnham and Olympia & York, among others. Massive toxic tort litigation precipitated chapter 11 cases by the Johns

Manville enterprise, A.H. Robins, and a host of major American businesses that were tainted by some connection to asbestos, some of which continue to this very day. Pension and labor issues, and, sometimes, environmental issues, caused the demise of LTV, Bethlehem Steel Corporation, Allis-Chalmers and numerous rustbelt entities, as well as a host of airlines including Braniff, Continental, Pan American, Eastern, United, Delta, Northwest and U.S. Air, as well as a large number of smaller airlines. Some of the airline cases went on to become classic chapter 22s and in the case of TWA, a final chapter 33. A massive state court judgment ($11+ billion) caused Texaco Inc. in 1987 to commence the then largest chapter 11 case in history.

It was the zenith of the age of the debtor. The consensus was that chapter 11 actually worked, despite the wailing cries and criticism coming from certain academics. The size and scope of cases filed under chapter 11 continued to increase. As the 20th Century drew to a close, the financial and credit markets continued to expand. The lessons of the past were ignored or, perhaps more appropriately, it became evident that there is no institutional memory.

The 21st Century began with a series of major cases precipitated by claims of fraud and other misdeeds, including Enron, Global Crossing and WorldCom and the dot com fiasco. The first decade of the 21st Century ended with even larger, more complex, difficult and novel cases initiated under chapter 11, including Lehman

Brothers ($600 billion), LyondellBasell (chemical companies) and General Growth Properties (shopping center REIT), among others, as the world slipped into a deep economic morass. A morass that caused the federal government to become a major player in the bankruptcy arena, as it endorsed and financed the use of chapter 11 to resolve the distress of General Motors, Chrysler and Delphi Corporation, and injected billions of dollars into various entities to stave off bankruptcy.

But something was occurring during the 1980s and 90s and into the 21st Century that would dramatically change bankruptcy reorganization. Prior to the mid 1990s, the bankruptcy law was amended, perhaps, once or twice in a decade. It took over five years to pass the Bankruptcy Reform Act of 1978. However, for the past 15 or more years, there has rarely been a session of Congress in which there hasn't been some attempt, in some way, shape or form, to amend the bankruptcy law. Each amendment made to the Bankruptcy Code starting in 1984 and through 2005 has tilted the proverbial level playing field against the debtor, as special interest legislation was enacted. Each clawback amendment, and particularly the 2005 amendments under the absurd title the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA"), have clawed back debtor protections both for individuals and businesses, and reduced the efficacy of the Bankruptcy Code as a vehicle to rehabilitate businesses, preserve jobs, serve the public good and provide a fresh start to debtors.

In that context, what are the major defining events of the past 50 years? There are at least six occurrences other than the work of the National Bankruptcy Commission of 1970 and the enactment of the Bankruptcy Reform Act of 1978 that have been seminal in the evolution of bankruptcy laws and practice:

1. The enhancement and elevation of the bankruptcy court as a part of the '78 Reform Act, and the appointment of the best and the brightest to the bankruptcy bench. Judges of high intellectual powers, discretion, independence, dedication and objectivity. Judges willing to be bold in the discharge of their duties, despite being woefully under-compensated.

2. The trading of claims. Debt became a salable commodity long before the enactment of the Bankruptcy Reform Act. But, it became the crucible for a radical change in business bankruptcies. In the 1980s, distressed debt traders began to emerge from the caves of Wall Street. They began to disrupt the basic fabric of bankruptcy reorganizations that were premised upon longstanding relationships between the debtor and its creditors.

1991 was a watershed year for business bankruptcies. The amendment of Bankruptcy Rule 3001 to facilitate the free trading of claims marked the end of the debtor/creditor relationships that facilitated reorganization cases. Distressed debt traders and funds, sometimes referred to as "vulture funds," were motivated by different objectives. They sought to buy low, sell high and, in may cases, did not have any real concern as to whether the debtor would be reorganized or rehabilitated. Claims trading made a casino out of bankruptcy. A trader's market. It has become a freestanding industry.

Hordes of business school graduates are employed by firms dealing in distressed debt trading to analyze value and create programs to buy and sell claims against debtors. The traders took over and have continued to dominate reorganization cases, reducing the debtor in many instances to a conduit. It has given rise to ad hoc committees, associations of similarly situated creditors (mostly traders)(anything to avoid the impact of BR 2019) and domination of statutory creditors' committees.

3. The worlds of finance and business have changed. During the age of the debtor, the predominant creditor groups were unsecured. They were contained within the four corners of the Bankruptcy Code. The Code was enacted in the context that reorganizations principally would deal with unsecured creditor claimants. Over the last 10 years, the importance of the unsecured creditor constituency has diminished significantly. Business is conducted in a completely different fashion than it was in 1978 and in the 80s. At long last, institutional creditors found the UCC! Essentially, all major financing is done on a secured basis. Generally, all of a debtor's assets are subjected to liens and encumbrances. The result has been that debtors do not have unencumbered assets with which to support a chapter 11 administration. It is the odd case today in which the major outstanding debt is unsecured. As a consequence, a debtor in possession may only look to the existing secured creditor group for debtor in possession financing. The ability to prime existing secured creditors is almost nonexistent. This has enabled secured creditors to impose onerous and

oppressive provisions on debtors in possession that include roll ups, excessive interest and often precipitate dismemberment and sale of the debtor's business and assets. It has also substantially increased the cost of administration.

In addition, the world has gotten much smaller and much more integrated. Global competition and pressures impact mightily on the ability to reorganize. Supply chains have contracted, limiting competition among suppliers and raising the costs of operations. Control of financial assets has consolidated in fewer institutions. The creation of SPEs as vehicles to avoid bankruptcy expanded, albeit probably in vain.

4. Debtor in possession financing. Under the prior Bankruptcy Act, there was virtually no post petition financing in reorganization or arrangement cases. Section 364 of the Bankruptcy Code served as the catalyst for banks to finally realize that debtor in possession financing was a good, profitable and essentially a low risk business. It did not really take hold until the mid 1980s, but it spread like wildfire and was a major factor in the increased use of bankruptcy

by distressed businesses. Initially debtor in possession financing was unsecured but entitled to the highest administrative expense status. Debtor in possession loans got so large that the lenders began to syndicate them. This added another facet to the reorganization process, as the marketing of the debtor in possession loan slowly but surely required that the borrower be subjected to more rigorous obligations and, ultimately, to the collateralization of debtor in possession loans to enhance the syndication process.

5. The prepackaged or prearranged chapter 11 reorganizations. The recognition that the Bankruptcy Code would accommodate a prepackaged or prearranged chapter 11 plan that would short circuit the time and oversight of the bankruptcy court was feverishly adopted by creditors and debtors. Chapter 11 plans were presented to bankruptcy courts on an expedited basis with the requisite acceptances and the agreement of all parties that the confirmation standards of section 1129 of the Bankruptcy Code had been satisfied. In the face of no opposition, bankruptcy courts freely confirmed these plans. Unfortunately, they resulted in a high level of recidivism which, in

turn, gave ammunition to the academic critics of chapter 11 to accuse the court and debtors of failing to discharge their responsibilities.

6. The Section 363 Option Emerged. In the casino-like atmosphere that began to dominate the business bankruptcy arena, the desires and objectives of the debt traders to realize their objectives of big recoveries or faster ownership, and the criticisms of academics, led to the use of section 363 for debtors to sell all or substantially all of the assets of a debtor's business shortly after the commencement of a business bankruptcy case. As the economy began to sputter in 2007, section 363 became more and more attractive. It (a) accelerated recoveries by secured creditors; (b) provided the purchaser with the assets and properties free and clear of claims and liens of any kind; (c) injunctive protection; and (d) virtual finality if the sale was quickly consummated. To effectuate such sales which might provide for an ongoing business and provide employment, an almost formalized process has developed known as the "stalking horse" process. Section 363 sales predominated business bankruptcy

cases through the final years of the first decade of the 21st Century.

The chapter 11 scenario that evolved during the 50 years ending in 2010 is materially different from that which was contemplated in the mid 1960s and by the Bankruptcy Reform Act of 1978. In today's world, a debtor essentially is a captive of its secured creditors, the designated CRO, and the trading market. Secured creditors have become de facto creditors in possession. The creditor constituencies often change on a daily basis as claims freely trade. If collateral security is reasonably liquid, a quick sale may be the result. The role of the debtor has retreated to something akin to that of the 1960s.

Esoteric, virtually incomprehensible securities represent the backbone of much of the credit markets. Derivatives, the time bomb that exploded in 2007 and 2008, has continued to command the attention of the world, as the plight of Greece and others illustrate. Through the expert, efficient and effective efforts of a well financed lobby, the financial community has caused the Bankruptcy Code to be riddled with provisions that protect derivatives and more. These safe harbor provisions place derivatives beyond the jurisdiction of the bankruptcy court and the discretion of the bankruptcy judge. They are representative of a growing wave that seeks more and more to contract the power of the bankruptcy court and the discretion of bankruptcy judges. The objective of rehabilitation, once tempered by the need for

protecting creditor recoveries, is now more than offset by the demand for expeditious maximization of creditor recoveries. These two objectives may be in eternal conflict and negatively affect the probability of rehabilitation.

The Bankruptcy Code has been, and continues to be, subject to criticism as being too debtor protective and invasive of contractual rights. Some believe that the reorganization paradigm is dead and that bankruptcy reorganizations no longer preserve going concern values. They argue that going concern values have been achieved through bankruptcy sales such as those under section 363. However, those contentions were all made in the context of the robust economy and easy credit of 2003-2007, an economy which was built on shifting sands.

Bankruptcy is a pervasive part of our economy. Its growth has attracted all manner of entities, businesses, governments and others. It has moved to the front page of our newspapers, the internet and is covered by many, many blogs. It is a constant subject in the halls of Congress. Managers and management teams spend an inordinate amount of time studying bankruptcy in high priced seminars and in the halls of the most prestigious business schools. Hedge funds, private equity funds and other financial institutions are aggressively recruiting self-styled bankruptcy experts.

While bankruptcy may be here to stay, it is not the same bankruptcy reorganization process that flourished in the 1980s, '90s and

early 2000s. The question is whether that is all bad. Is it wrong to have a secured creditor oriented process and defer to contractual rights? Is chapter 11 serving a useful purpose? Have the volume and efficacy of section 363 sales demonstrated that the objective of bankruptcy should be a prompt disposition of viable assets and businesses that might be continued by a purchaser with the balance of the bankruptcy simply to pursue winding up and liquidating the affairs of the debtor? Is there a need for chapter 11? Has the debtor in possession concept outlived its need? There is an abundance of workout specialists, turnaround managers, valuation experts, compensation experts, other business specialists and professionals that have been rooted in the fertility of the bankruptcy law. It has made many of us more than comfortable. For better or worse, bankruptcy is a part of the public consciousness, the commercial lexicon and legal and strategic plans. It has graduated from being an aberrational possibility. It is a reality.

But, we need to determine what is the proper use of bankruptcy in connection with the failure or distress of business entities and, indeed, for individuals, including sensitive interconnected financial institutions. Is there an alternative to chapter 11 that would be more efficacious and protective of the interests to be served? How should bankruptcy laws integrate with global systems? Is bankruptcy a means to deal with "too big to fail?"

Chairman Bernanke of the Federal Reserve System wrote to Congress that on the basis of the Lehman case, bankruptcy proceedings are inadequate to deal with the failure of large financial institutions. The Treasury and the FDIC have submitted proposed "resolution authority" proposals that would relegate failed financial institutions to, in effect, administrative provisions within the star chamber of the FDIC. The underlying premise is that you can trust the government to do the right thing. An interesting concept!!!

I suggest interested parties read the Examiner's report that was filed yesterday in the Lehman case and its conclusions as to the responsibility or lack thereof by the regulators and the government that aggravated the financial crisis of 2008 and the demise of Lehman.

The world that existed in 1978 is long gone. We face a global economy with a different dynamic and vastly different financing techniques and pressures, economic policies, as well as the ever-present political issues.

What is the bankruptcy law that will properly balance the needs of the stakeholders as well as global interests? The challenge is monumental. I encourage you, tonight's inductees, to participate with your co-fellows as members of this college to work in the best interests of a feasible and effective bankruptcy law that will serve the objectives of fairly dealing with economic distress and failure, and assist in the

appropriate deployment of the assets of a failed business. It is a heavy burden but I know that you will discharge it.

To my captive audience, I thank you for your patience and attention. To many of you, I thank you for assisting me in pursuing passion.

To the Class of 2010 – Congratulations upon your admission to the College and the best to each of you in the future.

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