THE UNPROPOSED SOLUTION TO CHAPTER 11 REFORM: ASSESSING MANAGEMENT RESPONSIBILITY FOR BUSINESS FAILURES

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INTRODUCTION

The United States Bankruptcy Code ("Bankruptcy Code") was enacted in 1978.1 In that year alone, approximately 8,000 firms sought to reorganize under Chapter 11 of the Bankruptcy Code.2 By 1992, that number had risen to a high of nearly 24,000.3

The Bankruptcy Code is substantially more “user friendly” than its predecessor, the Bankruptcy Act of 1898.4 Under the Bankruptcy Act of 1898, corporations seeking to reorganize were required to demonstrate they were insolvent or unable to pay their debts as they matured.5 Furthermore, once having filed for reorganization, managers of large publicly held corporations were required to turn their operations over to trustees.6

In drafting Chapter 11 of the Bankruptcy Code, Congress sought to conserve corporate assets by directing managers of financially troubled companies toward reorganization rather than liquidation.7 It accomplished this, in part, by eliminating the threshold requirements for filing for

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3. Id. Bankruptcy filings have decreased since 1992. Nation wide bankruptcy filings have decreased during only four other periods over the last 30 years (1967-1968, 1971-1973, 1976-1978, and 1983-1984). These declines each lasted between six and eleven quarters, with filings bottoming out at between 10% and 20% below peak volume. If history repeats itself, national filing levels may drop to between 800,000 and 900,000 cases per year. This would still be more than double the number of case filings of any year prior to 1985, and higher than the volume of cases filed as recently as 1990. XII AM. BANKR. INST. J. 11 (1993).


7. Peter Passell, Critics of Bankruptcy Law See Inefficiency and Waste, N.Y. TIMES, Apr. 12, 1993, at I. See also H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179 ("The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap"); 123 CONG. REC. H35,444 (daily ed. Oct. 27, 1977) (statement of Rep. Rodino) ("For businesses, the bill facilitates organization, protecting investments and jobs").
reorganization and by allowing corporate managers to retain control of the debtor after filing.8

Unfortunately, Congress' attempt to conserve corporate cash has instead contributed to corporate waste.9 By allowing corporate management to file for bankruptcy when the corporation is otherwise solvent and to remain in control of the corporation indefinitely, Chapter 11 invites abuse by managers seeking to retain their jobs.10 Furthermore, because Chapter 11 limits the downside of any business disaster, it encourages managers to issue excessive debt and take increased risks.11

Three well publicized Chapter 11 proceedings illustrate this strategic abuse of Chapter 11.12 In In re Johns-Manville Corporation, Johns-Manville Corporation filed for relief under Chapter 11 in the midst of an avalanche of lawsuits initiated by persons injured by exposure to asbestos.13 In In re Continental Airlines, Continental Airlines reorganized during wage negotiations with its labor unions.14 In In re Texaco, Texaco declared bankruptcy after Pennzoil won a $10.5 billion jury verdict against it.15

None of these cases involved a failed business. Instead, each case involved a corporation with nonfatal business problems for which bankruptcy provided a convenient solution.16 Johns-Manville filed for bankruptcy to deny punitive damages to asbestos claimants and to stay collection of asbestos damage awards, while it settled with its insurers.17 Continental used

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9. See Passell, supra note 7, at 1; DELANEY, supra note 8 (reviewing the bankruptcies of Johns-Manville Corporation, Continental Airlines Corporation and Texaco Incorporation to support the arguments that large corporations view bankruptcy as a legitimate business strategy and that bankruptcy has become a political system for allocating scarce resources); Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 YALE L. J. 1043 (1992) (presenting empirical data to support the argument that existing bankruptcy law fails to provide managers with appropriate incentives to allocate corporate resources to their highest valued uses).

10. Bradley & Rosenzweig, supra note 9, at 1052.

11. Id.

12. See Passell, supra note 7 and DELANEY, supra note 8, for interesting discussions of "strategic" bankruptcies. These cases, as does this article, primarily involve pre-petition risk taking.


16. DELANEY, supra note 8, at 60-160 (describing at length how Johns-Manville Corporation solved asbestos liability through bankruptcy, Continental Airlines Corporation used bankruptcy to abrogate union contracts, and Texaco Incorporated used bankruptcy to frustrate a business rival).

bankruptcy to gain leverage over labor negotiations. Texaco used Chapter 11 to delay Pennzoil’s attempt to collect its judgment, thereby persuading Pennzoil to settle for a lesser amount.

As a result of these types of strategic bankruptcies, there has been a clamor for reform of Chapter 11. Academics call for the repeal of Chapter 11 and its replacement with market driven forces or perfect market alternatives. Meanwhile, Congress struggles with stop gap measures.

None of the proposed “fixes” are likely to solve the dilemma of Chapter 11 abuse, however. The reason for this is that none of the proposals encourage responsible corporate management.

The failure to address this issue may be traced, in part, to the history of the Bankruptcy Code. Exactly what government policy Congress sought to accomplish when it passed the Bankruptcy Code has been the source of numerous debates. Nevertheless, at its core the Bankruptcy Code is a debt collection and asset distribution system.

Conversely, in other countries, bankruptcy legislation is an instrument for implementing government economic policy. One such country is the People’s Republic of China (“PRC”).

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18. See *In re* Continental Airlines Corp., 60 B.R. at 903. After *Continental*, Congress adopted 11 U.S.C. § 1113, restricting rejection of collective bargaining agreements. 11 U.S.C. § 1113 (1984). In the bankruptcy cases that have occurred since *Continental* involving union contracts, the courts have generally looked at whether rejection was necessary to permit a successful reorganization. *Delaney*, *supra* note 8, at 125.

19. See *In re* Texaco Inc., 81 B.R. at 813.

20. For recent scholarly condemnation of Chapter 11, see Bradley & Rosenzweig, *supra* note 9, at 1058 (concluding that the social costs of bankruptcy have increased under the Bankruptcy Code); Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 Cornell L. Rev. 1088, 1088 (1992) ("[T]here is very little good to be accomplished either from a social standpoint or in the particular case as it appears before our courts, under the rubric of Chapter 11"). For more popular critiques, see Howard Gleckman, *Why Chapter 11 Needs to Be Rewritten*, Bus. Week, May 18, 1992, at 116; Passell, *supra* note 7. A number of factors contributed to the problems surrounding Chapter 11, but the publicity afforded the “strategic bankruptcies” fueled the perception of the need for reform. See Passell, *supra* note 7.


25. The terms “China,” “Chinese” and the abbreviation “PRC” refer to the People’s Republic of China in this article.
The PRC adopted its Enterprise Bankruptcy Law in 1986. Under the Enterprise Bankruptcy Law, bankruptcy cases are administered with an emphasis on social and economic effects rather than the settlement of debtor creditor disputes. The Enterprise Bankruptcy Law, a device for requiring more efficient management of state owned enterprises, features the application of sanctions to those individuals responsible for business failures. It also limits the use of bankruptcy to enterprises which are insolvent and the overall term of bankruptcy to two years.

A comparison of the Enterprise Bankruptcy Law and the Bankruptcy Act of 1898 with Chapter 11 suggests a variety of options available to Congress in reforming Chapter 11 to discourage abuse by publicly held corporations. Section I of this article examines the background, legislative history, purpose, scope, threshold, reorganization and corporate governance provisions of the Enterprise Bankruptcy Law. Section II reviews the comparable provisions of the Bankruptcy Act of 1898 and Chapter 11 of the Bankruptcy Code. Section III discusses the academic and political responses to the crisis of Chapter 11 reform. Section IV discusses proposals for Chapter 11 reform premised on encouraging management responsibility for business performance and


28. Boshkoff & Song, supra note 26, at 361.

29. Enterprise Bankruptcy Law, art. 42, translated in YEARBOOK, supra note 26, at 87.

30. Id. arts. 3, 17, translated in CHINA LAW YEARBOOK, at 83, 84. Article 17 provides that the application must occur within three months of approval of the petition and the reorganization may not last more than two years. However, the Enterprise Bankruptcy Law does not prescribe a time within which the reorganization agreement must be negotiated and approved. Therefore, it is possible that the total delay will exceed two years and three months. See Boshkoff & Song, supra note 26, at 360 n.8.

31. This article concerns only those firms that are publicly traded. Of course, closely held firms are more common in bankruptcy. LoPucki and Whitford note that only seventy-two publicly held corporations claiming assets of $100 million or more filed Chapter 11 petitions between October 1979 and March 1988. Lynn M. LoPucki & William C. Whitford, Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies, 38 CORNELL L. REV. 597, 602 (1993) [hereinafter LoPucki & Whitford, Patterns]. In more recent years, there have been between ten to twenty filings of large publicly held corporations per year. Lynn M. LoPucki & William C. Whitford, Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies, 141 U. PA. L. REV. 669, 675 (1993) [hereinafter LoPucki & Whitford, Corporate Governance]. However, the total dollars involved in these cases may equal or exceed those cases involving closely held corporations. Douglas G. Baird, Revisiting Auctions in Chapter 11, 36 J. L. & ECON. 633, 637 (1993) [hereinafter Baird, Revisiting Auctions]. Furthermore, it is only in publicly held corporations that there is a separation of ownership and control. An individual shareholder may control a large fraction of the stock in a public company. Nevertheless, unlike the closely held corporation, the ownership and operation of the firm are not intertwined. Id. at 637.
assessing management responsibility for business failure.  

I. THE ENTERPRISE BANKRUPTCY LAW OF THE PEOPLE’S REPUBLIC OF CHINA (“PRC”)

A. Background

In the late 1970’s, the People’s Republic of China (“PRC”) launched into economic reform. The theme of this reform was to diminish the role of state planning, to enhance the autonomy of, and the competition among, business enterprises and to provide direct economic incentives for improved performance to enterprises and employees. In short, to break the “big rice bowl.”

For many years, the PRC was plagued by state enterprises which ran at heavy losses. The prevailing practice was to write off the losses through state budget appropriations or to take administrative measures against the enterprises. In the latter situation, the state would merge the enterprise or change its business operations. The employees in the enterprise would remain unaffected, continuing to receive wages and even bonuses. These measures were known as “Guan, Ting, Bing, Zhuan.”

The practice of “Guan, Ting, Bing, Zhuan” hindered economic reform. The state budgetary compensation for losses encouraged poor performance. Administrative measures failed to impose the direct negative impact of the

32. The terms “corporate management”, “management” and “managers” refer to officers, directors and business managers in operational control of the corporation prior to filing for Chapter 11. Chapter 11 gives these “managers” a central role in determining the fate of those parties who hold a financial stake based on a prebankruptcy investment. At least, as compared to creditors and other direct investors, managers may have no direct personal claim to or stake in the estate other than in using its operations to retain their ongoing salary and benefit packages. To the extent that they are biased or interested parties, their interest runs in the direction of maintaining the existing business as an ongoing entity. Raymond T. Nimmer & Richard B. Feinberg, Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity, 6 BANKR. DEV. J. 1, 21, 24-5 (1989). See also FED. R. BANKR. P. 9001(5) (focusing on persons in operating control).

33. In 1978, the Chinese Communist Party Central Committee adopted a new policy of invigorating the domestic economy and opening to the outside world. Qi, supra note 27, at 42 n.11.

34. Zheng, supra note 26, at 685.

35. “Big Rice Bowl” is a Chinese metaphor meaning that the state feeds all enterprises and every enterprise has a share in getting benefits from the state regardless of its contribution. Qi, supra note 27, at 42 n.12 (citing A CHINESE-ENGLISH DICTIONARY 125 (1979)).

36. Qi, supra note 27, at 41.

37. Zheng, supra note 26, at 685-86.

38. Id.

39. Id.

40. Id. “Guan, Ting, Bing, Zhuan” can be roughly translated as close, stop, merge, transfer.

41. Id. at 686.

42. Id.
enterprise's losses on the responsible managerial personnel.\footnote{43}

The practice also affected reform in other areas. First, it negatively impacted the goal of enhancing the independence of enterprises in business management.\footnote{44} Enterprises issued bonuses and increased fringe benefits even when they sustained a substantial loss.\footnote{45} As the system did not impose direct financial obligations proportionate to the increased autonomy of enterprises, there was no economic deterrent to prevent abuse.\footnote{46} Second, it negatively impacted the adoption of fluctuating interest rates to control borrowing and capital investment.\footnote{47} The government was unable to prevent enterprises, not concerned with losses, from borrowing at high interest rates.\footnote{48}

By the early 1980s, it was clear that, unless action was taken to relate the economic success of enterprises and individuals to their business performance, continuing economic reform would be undermined.\footnote{49} In 1983, the Technology and Economics Research Center of the State Council conducted a study on technological progress in the PRC.\footnote{50} The study concluded that the only way to accelerate technological progress in the PRC was to enact a bankruptcy law to weed out inefficient enterprises.\footnote{51}

The possibility of enacting comprehensive bankruptcy legislation was enhanced by the adoption of a revised Constitution\footnote{52} and the General Principles of the Civil Code\footnote{53} in 1982 and 1986, respectively. The General Principles of the Civil Code, in particular, provided the basis for the enactment of the bankruptcy legislation. The civil code states that an enterprise may cease operation when that enterprise is declared bankrupt and that representatives of an enterprise may assume responsibility for civil liabilities of that enterprise.\footnote{54}
B. Legislative History

The PRC does not subscribe to the theories of *stare decisis* or *res judicata*.55 The popular philosophy is that "as the legislature is the representative body of the people, it should decide how the law should be applied to the people."56 As a result, legislative history is the primary source of legal interpretation in the PRC.57

Under the Constitution, "basic laws" of the PRC must be passed by the National People’s Congress ("NPC").58 All laws, other than those passed by the NPC, must be passed by the National People’s Congress Standing Committee ("NPC-SC").59 In practice, NPC representatives propose to the NPC that a law should be enacted. The actual drafting of the law and its introduction to the NPC or the NPC-SC is performed by other government departments, such as the State Council.60

The first formal step in the enactment of the bankruptcy law was a proposal ("Proposal Draft") made by NPC representatives in 1984 to the second session of the sixth NPC.61 The Proposal Draft was sent to the Economic Legislation Research Center ("ELRC") of the State Council.62 In December 1984, the State Council approved the formation of a bankruptcy law drafting task force under the leadership of the ELRC, the State Economic Commission and the State Administration for Industry and Commerce.63

The drafting task force finalized the Law of the PRC on Enterprise Bankruptcy ("Opinion Solicitation Draft") in September, 1985.64 The Opinion Solicitation Draft was circulated for comment to officials in central


59. *Id.* The precise scope of legislative powers of the NPC and NPC-SC has not been clearly defined and practice has not been consistent. *Id.* at 336 n.11.


63. *Id.* at 339-40; Zheng, *supra* note 26, at 694.

64. Chang, *supra* note 50, at 342.
government agencies as well as in the provincial and municipal governments. The drafting task force then compiled the comments on the Opinion Solicitation Draft and formulated a draft law. The Law of the PRC on Enterprise Bankruptcy ("Draft Law") was approved by the Standing Committee of the State Council on January 31, 1986.

The Draft Law was presented by the Vice Chairman of the State Economic Commission on behalf of the State Council to the sixteenth session of the sixth NPC-SC in June 1986 ("June Session"). The Draft Law was presented with the caveat that it would not be put to a vote until the next NPC-SC session in late August.

Meanwhile, in early August, certain staff members of the NPC-SC held meetings with lawyers from the United States and Europe. These staff members requested information on foreign bankruptcy laws related to issues which were the subject of amendments made at later sessions of the NPC-SC. Of particular interest was the subject of encouraging corporate efficiency by punishing unsuccessful managers. Chinese drafters expressed disappointment upon learning that the bankruptcy laws of the United States and many western European nations do not include provisions for punishing bankrupt companies' managers.

Although the Draft Law was scheduled to be adopted in late August 1986 at the seventeenth session of the NPC-SC ("August Session"), it was deferred to a later session. This delay was due to the NPC's inability to agree on the implementation of the system.

The NPC Law Committee and the NPC Committee on Finance and Economics then invited government officials to attend a symposium on the Draft Law. Following further discussion, the NPC Law Committee ultimately proposed a number of revisions to the Draft Law. It was finally concluded that with those revisions, the Draft Law was feasible.

On December 2, 1986, during its eighteenth session, the NPC-SC passed

65. Id.; Zheng, supra note 26, at 694.
66. Chang, supra note 50, at 343; Zheng, supra note 26, at 694.
67. Id. at 345-46.
68. Id. at 346. Presentment of a law in the session before it is to be put to a vote is the general practice of the NPC-SC. Id.
69. Id. at 347.
70. Id.
71. Id. at 366.
72. Id.
73. Id. at 347.
74. Id. at 348; Zheng, supra note 26, at 695.
75. Chang, supra note 50, at 349-50.
76. Id. at 349-50; Zheng, supra note 26, at 695.
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the Enterprise Bankruptcy Law. The Enterprise Bankruptcy Law was proclaimed law on the same day. However, its effective date was delayed pending the adoption of related legislation. The Enterprise Bankruptcy Law finally became effective in November 1988.

C. Purpose

The hortatory language of Chinese laws has greater legal significance than the hortatory language of laws in the United States and other western

77. Chang, supra note 50, at 350-51; Zheng, supra note 26, at 696. As adopted the law is divided into six chapters. Chapter one sets forth the "general principles" of the law, including the law's purpose, its scope of application, the "threshold" of bankruptcy, and circumstances which permit exceptions to the law's general provisions and suspension of the bankruptcy procedure. Chapter two describes the procedure for filing petitions of bankruptcy, the rights of creditors and debtors to file petitions for the debtor's bankruptcy, and the procedure courts are to follow in handling such petitions. Chapter three describes the creditor's conference which follows the filing of a petition for bankruptcy. Chapter four provides for a reconciliation-and-readjustment procedure as an alternative to bankruptcy. Chapter five includes provisions for entering a final declaration of bankruptcy and for liquidation of the bankrupt enterprise's assets. Chapter six sets forth the date on which and the conditions under which the bankruptcy law becomes effective. The final chapter also provides for criminal and administrative penalties.

Xiaohua, supra note 60, at 375 n.7.

78. P.R.C. CONST., art. 80, translated in Constitution, supra note 52, at 20-21. Such immediate effect given to a new law is in accordance with the PRC Constitution. Chang, supra note 50, at 351.

79. Article 43 of the Enterprise Bankruptcy Law, supra note 26, provides that it shall be implemented "three full months after the Law on Industrial Enterprises by the Whole People has come into effect, and the specific plans and steps for the trial implementation stipulated by the State Council." Enterprise Bankruptcy Law, art. 43, translated in YEARBOOK, supra note 26, at 87.

80. Cao Siyuan, Bumpy Road for China's Bankruptcy Law, NEWSL. OF INSOL INT'L, Nov. 1993, at 15. Since the Enterprise Bankruptcy Law of the PRC went into effect in 1988, courts have handled fewer than 1,000 cases. Bankruptcies, limited to small companies, are often shrouded in secrecy. Decisions are not reported and the cases themselves receive scant coverage in the Chinese press. Sheila Tefft, Beijing Tries to Limit Stew of Bankruptcies, THE CHRISTIAN SCI. MONITOR, Aug. 11, 1994 at 9. Implementation has been hindered because of opposition from workers, banks and local governments afraid of the social consequences of thousands of unemployed. The obstacles to implementation include confusion over who owns state assets, how to evaluate these assets and who is liable for the debts owed by bankrupt firms. Mark O'Neill, China Heralds New Waves of State Bankruptcies, THE REUTER EUR. BUS. REP., Aug. 17, 1994.

Journalists report that western and Chinese analysts charge that the momentum of market reforms is stalling under the staggering burden of state companies. Tefft, supra at 9. Historically, officials have agreed that bankruptcy must be the answer but have insisted that the country is not yet ready to deal with the consequences of economic restructuring and an increasingly militant labor force. Tefft, supra at 9. However, in August 1994, Chinese officials unveiled a bankruptcy experiment to take place in 18 industrial cities. The experiment is backed by 7 billion yuan put into a special bankruptcy fund to cover the resulting losses of China's banks. It is believed that the experiments will at last establish proper bankruptcy procedures in China. China Stirs Its Sleeping Giants, ECON. NEWS., Aug. 27, 1994, at 53, Tony Walker, China Plans Reform of State Enterprises, FIN. TIMES, Oct. 5, 1994, at 4.
legal systems. The preamble to the Enterprise Bankruptcy Law describes the goals of the law, in descending order of importance:

This law is formulated in order to suit the development of the socialist planned commodity economy and the needs of the reform of the economic structure, to promote the autonomy of operation of enterprises, owned by the whole people, to strengthen the economic responsibility system and democratic management, to improve the condition of operations, to raise economic efficiency, and to protect the lawful rights and interests of creditors and debtors.

D. Scope

The scope of the Enterprise Bankruptcy Law was heavily debated by Chinese lawmakers. The two primary issues were "whether the law should apply to enterprises with foreign investment, or just to Chinese enterprises and if the latter, whether it should apply only to state enterprises, or . . . also to collective enterprises and other types of Chinese economic organizations." The earliest drafts of the bankruptcy law applied to all enterprises in the PRC. However, as divergent rules often govern Chinese enterprises and foreign investment, difficulties arose in drafting a bankruptcy law capable of addressing both kinds of entities' needs. In addition, for some foreign investors the drafts raised the possibility that their money-losing investments in the PRC might be declared bankrupt with unanticipated results. Of particular concern were the provisions providing for the punishment of management. Thus, during the August Session of the NPC-SC, the Draft Law was revised to apply only to Chinese enterprises.

Similarly, both the Proposal Draft and the Opinion Solicitation Draft applied to collective enterprises and individual enterprises, as well as to

81. Chang, supra note 50, at 365.
82. Enterprise Bankruptcy Law, art. 1, translated in YEARBOOK, supra note 26, at 83.
83. Chang, supra note 50, at 361.
84. Id.; Zheng, supra note 26, at 696-97.
85. Chang, supra note 50, at 362.
86. Id.
87. "Punishment of management . . . would be very difficult to apply to enterprises involving foreign investment." Id.
88. Enterprise Bankruptcy Law, art. 2, translated in YEARBOOK, supra note 26, at 83. As revised, the law applies only to Chinese state owned enterprises. But the Chinese government has established a bankruptcy system for enterprises involving foreign investment. See, e.g., Shenzhen Act, supra note 61.
89. Chang, supra note 50, at 362-63. Collectively owned enterprises are under the leadership of the local government, which provides their capital. However, local governments assume only partial responsibility for the debts of the enterprises which they sponsor and control. In 1987, there were approximately 360,000 collectively owned enterprises. Xiaohua, supra note 60, at 376.
state owned enterprises. However, during the August Session, the Draft Law was restricted to state owned enterprises. The decision to restrict the scope of bankruptcy law to state owned enterprises reflects the differences among the enterprises. Government assumption of responsibility for their losses make state owned enterprises "uniquely unable and unwilling to respond to market signals." Further, efficient state owned enterprises are crucial to the success of economic reform because of the determinative role that these large enterprises play in the economy. Finally, as only state owned enterprises are able to transfer "potentially unlimited debts to the central and provincial governments," state owned enterprises place a far greater burden on the government budget than do other types of enterprises.

E. Threshold Requirements

Another principal problem facing the drafters of the Enterprise Bankruptcy Law was setting workable standards for defining the threshold of bankruptcy. The earlier drafts of the bankruptcy law all contain varying formulations of three general types of bankruptcy standards: ratio of liabilities to assets, ratio of losses to assets, and timely payment of debts.

The standards of ratio of liabilities to assets and ratio of losses to assets were eliminated from the Draft Law during the August Session. The ratio of liabilities or losses to assets standards were criticized because many enterprises in the PRC have large amounts of debt. Hence, the standards made an unacceptably large number of Chinese enterprises definitionally bankrupt.

The standard which remains in the Enterprise Bankruptcy Law for the threshold of bankruptcy is the timely payment of debts. The Enterprise

90. Chang, supra note 50, at 362-363. State owned enterprises are industrial entities established with state capital and accountable to the state. In 1987, state owned industrial enterprises numbered 93,000. Xiaohua, supra note 60, at 375. Other types of enterprises include township cooperative enterprises formed by individuals pooling their private funds, "sino-foreign joint ventures, foreign owned enterprises and privately owned enterprises. There are relatively few enterprises of these types." Id. at 376.

91. Enterprise Bankruptcy Law, art. 2, translated in YEARBOOK, supra note 26, at 83; Chang, supra note 50, at 362-63.

92. Xiaohua, supra note 60, at 376.

93. Id. at 376-77.

94. Id. at 377; Chang, supra note 50, at 363.

95. Chang, supra note 50, at 358. The simplest definition of the liabilities to assets standard is whether the debts of the enterprise exceed the total amount of its assets; the ratio of losses to assets standard is a restriction against negative net worth or accumulated net losses; the timely payment of debts standard is similar to the general standard for involuntary bankruptcies in the United States found at 11 U.S.C. § 303 (1988). Chang, supra note 50, at 358-60.

96. Chang, supra note 50, at 359.

97. Id.

98. Id.
Bankruptcy Law provides that a bankrupt entity is one that has sustained serious losses resulting from poor operations and management and cannot pay debts that are due. The "resulting" language was carefully chosen. The Proposal Draft defined "a bankrupt enterprise as one which, 'because of mismanagement and serious deficit cannot repay debts which are due . . .'." During NPC debates, the concern was raised that "many troubled state owned enterprises' deficits were caused by . . . excessive government interference . . . ." The Enterprise Bankruptcy Law reflects this concern and limits the definition of bankrupt enterprises to those suffering from losses resulting from poor management.

State owned enterprises are eligible for both voluntary and involuntary bankruptcy. However, the law imposes certain restrictions upon involuntary proceedings. State owned public utilities and enterprises of major concern to the national economy, whose debts will be repaid by the government, are not eligible for involuntary proceedings. Similarly, enterprises that obtain a government guaranty and are able to repay their debts within six months after initiation of bankruptcy are not eligible for involuntary proceedings. Finally, bankruptcy proceedings will be suspended if the reconciliation and readjustment procedure is initiated.

F. Reorganization and Exclusivity

During the bankruptcy proceeding, the department in charge of the debtor may petition the court for reorganization or "reconciliation and readjustment." The petition for reorganization must be filed within three months after the filing of the bankruptcy petition.

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99. Enterprise Bankruptcy Law, art. 3, translated in YEARBOOK, supra note 26, at 83.
100. Xiaohua, supra note 60, at 377 (quoting Sona Rufen, Legal Committee Thinks Draft of Bankruptcy Law is Generally Feasible, PEOPLE'S DAILY, Nov. 16, 1986).
101. Id.
102. Id. The concept of poor management is not defined in the Enterprise Bankruptcy Law.
103. Enterprise Bankruptcy Law, arts. 7-8, translated in YEARBOOK, supra note 26, at 83-84. Although the criteria for bankruptcy are inability to pay debts as well as sustaining losses due to poor management, the Enterprise Bankruptcy Law does not require a petitioner in an involuntary bankruptcy proceeding to show that the debtor sustained serious loss due to inappropriate management as a prerequisite to filing a bankruptcy petition. Rather, the Enterprise Bankruptcy Law sets up a trigger mechanism allowing creditors to initiate bankruptcy proceedings as long as the debtor fails to pay debts as they become due. Id. art. 7, translated in YEARBOOK, supra note 26, at 83.
104. Id. art. 3(1), translated in YEARBOOK, supra note 26, at 83.
105. Id. art. 3(2), translated in YEARBOOK, supra note 26, at 83.
106. Id. art. 3, translated in YEARBOOK, supra note 26, at 83. If read literally, suspension of the liquidation process in favor of reorganization is possible only in an involuntary bankruptcy. See Enterprise Bankruptcy Law, art. 17, translated in YEARBOOK, supra note 26, at 84-85. This distinction between voluntary and involuntary proceedings is believed to be a drafting error. Boshkoff & Song, supra note 26, at 363 n.24.
107. Id. art. 17, translated in YEARBOOK, supra note 26, at 84-85. There are no separate bankruptcy courts in the P.R.C. Bankruptcy cases are heard by the People's Court, the court of general jurisdiction. Boshkoff & Song, supra note 26, at 363 n.29.
months after the court has received the case.\textsuperscript{108} The maximum period for
time for reorganization is two years.\textsuperscript{109}

Once the petition for reorganization is accepted by the court, the
enterprise submits a draft agreement to a creditors' committee.\textsuperscript{110} The
agreement includes a plan for rescheduling the repayment of debts.\textsuperscript{111} If
the creditors accept the agreement and the court approves it, bankruptcy
proceedings are suspended.\textsuperscript{112}

The government authority responsible for filing the readjustment is
charged with overseeing the enterprise's reorganization program.\textsuperscript{113} If the
debtor enterprise is able to repay its debts in accordance with the reorganiza-
tion agreement, the court will terminate bankruptcy proceedings.\textsuperscript{114}

However, the court will declare the enterprise bankrupt if it is unable to
repay its debts after two years.\textsuperscript{115} The court may also terminate reorgani-
za-tion and enter a declaration of bankruptcy if it finds that the enterprise has
not implemented the reconciliation agreement or that the enterprise has
violated rules proscribed by bankruptcy law.\textsuperscript{116} Finally, the court may
enter a declaration of bankruptcy upon a showing by the creditors' committee
of deterioration of the financial status of the debtor.\textsuperscript{117}

Upon a declaration of bankruptcy, the case proceeds to liquidation. The
court establishes a liquidation group to take over the bankrupt enterprise.\textsuperscript{118}
The group consists of representatives from the department in charge of the
debtor, government departments in charge of finance, and specialists in the
pertinent line of business, among others.\textsuperscript{119} The liquidation group has full
power to care for, liquidate, dispose, of and distribute the bankrupt es-
tate.\textsuperscript{120}

\textbf{G. Corporate Governance: The Punishment of Management}

The concept of bankruptcy law as a mechanism for punishing bankrupt
enterprises' managers was firmly embodied in the early drafts of the

\begin{itemize}
\item \textsuperscript{108} Enterprise Bankruptcy Law, supra note 26, art. 17, translated in YEARBOOK, supra note
26, at 84-85.
\item \textsuperscript{109} Id.
\item \textsuperscript{110} Id. art. 18, translated in YEARBOOK, supra note 26, at 85.
\item \textsuperscript{111} Id.
\item \textsuperscript{112} Id. art. 19, translated in YEARBOOK, supra note 26, at 85.
\item \textsuperscript{113} Id. art. 20, translated in YEARBOOK, supra note 26, at 85.
\item \textsuperscript{114} Id. art. 22, translated in YEARBOOK, supra note 26, at 85.
\item \textsuperscript{115} Id.
\item \textsuperscript{116} Id. art. 21, translated in YEARBOOK, supra note 26, at 85.
\item \textsuperscript{117} Id.
\item \textsuperscript{118} Id. art. 24, translated in YEARBOOK, supra note 26, at 85.
\item \textsuperscript{119} Id.
\item \textsuperscript{120} Id. The powers of the liquidation group are similar to those of a Chapter 7 trustee
\end{itemize}
Enterprise Bankruptcy Law. Under the Proposal Draft, the managers of a failing enterprise which received a bankruptcy warning were to be instantly removed.

Under the Opinion Solicitation Draft, fraud and misrepresentation were punishable by prison terms of two to five years and the managers were subject to other criminal penalties if the bankruptcy was caused by their relinquishment of duty. Additionally, fines were to be assessed against those primarily responsible for the bankruptcy as well as those who favored one creditor over another. Finally, the Opinion Solicitation Draft prohibited those leaders of the enterprise with responsibility for the bankruptcy from taking another leadership position or operating another enterprise for a period of three years.

An important issue at the August Session, however, concerned the fairness of punishing managers of a bankrupt enterprise who have limited autonomy in their management decisions. At the beginning of the August Session, the NPC Law Committee recommended that the detailed provisions on penalties found in the earlier drafts be replaced by a general provision. Later debates in the NPC-SC on the autonomy of the enterprise recognized the dominant role that the government department in charge of the enterprise plays in the management of the enterprise.

Hence, as adopted, the Enterprise Bankruptcy Law provides that legal representatives of the enterprise whom government supervisory and auditing organs find to be responsible for the enterprise's failure are subject to “administrative” penalties. The imposition of these penalties on manag-
ers reflects their responsibility for the enterprise’s failure, but the nature of the penalties is unspecified.

Additionally, under the Enterprise Bankruptcy Law, administrative penalties apply to officials of the government authority responsible for supervising the bankrupt enterprise. Because such officials are actively involved in the management of the enterprise they are held accountable for the enterprise’s failure. Such penalties are intended to provide an incentive to officials to help the enterprises they supervise avoid bankruptcy.

Lastly, the Enterprise Bankruptcy Law provides that criminal liability may be imposed on the debtor’s legal representative and the leaders of the supervising department if the bankruptcy is caused by their neglect of duty resulting in great loss to state property. Article 187 of the Criminal Law of the PRC provides for a maximum of five years imprisonment.

II. CHAPTER 11 OF THE UNITED STATES’ BANKRUPTCY CODE

A. Background

Congress adopted the first national bankruptcy law in 1800. Throughout the nineteenth century, other bankruptcy acts were adopted by Congress and repealed. The fourth Bankruptcy Act, the Bankruptcy Act of 1898, remained in effect until the enactment of the Bankruptcy Code in 1978.

Although the Bankruptcy Act of 1898 remained in effect until enactment of the Bankruptcy Code, it was extensively revised by the Chandler Act of

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criminal responsibility shall be investigated in accordance with Article 187 of the Criminal Law of the People’s Republic of China.

translated in YEARBOOK, supra note 26, at 87.

130. Xiaohua, supra note 60, at 379.


132. Enterprise Bankruptcy Law, supra note 26, art. 42, translated in YEARBOOK, supra note 26, at 87.

133. Xiaohua, supra note 60, at 380.

134. Id.

135. Enterprise Bankruptcy Law, art. 42, translated in YEARBOOK, supra note 26, at 87; Minor, supra note 131, at 1224.


In the 1930's, Congress established the Securities and Exchange Commission ("SEC"). One of the major initiatives the SEC undertook was an investigation into abuses, particularly fraud against public bondholders and stockholders, during court supervised reorganizations. This investigation culminated in the company reorganization provisions of the Chandler Act of 1938.

The Chandler Act reforms provided for greater court involvement in the reorganization process. In addition, SEC intervention was mandatory in those cases involving large publicly held companies. The Chandler Act specifically provided for Chapter X corporate reorganizations and Chapter XI corporate arrangements. Chapter XI was designed for the arrangement of small companies with few shareholders or bondholders. Under Chapter XI, the existing management of the debtor continued to run the business and control the reorganization. Only the rights of unsecured creditors were modified.

Conversely, a complete reorganization could be carried out under Chapter X. Chapter X, designed for the reorganization of large publicly held companies, required the appointment of a trustee to operate the business. Furthermore, the SEC was required to scrutinize the qualifications and disinterestedness of the trustee and to make an independent study of the fairness of the reorganization plan.

The overwhelming majority of corporate managers faced with the unsavory task of filing for bankruptcy under the Bankruptcy Act of 1898, 

143. Id.
144. Id. at 431.
145. Id. at 431 (citing 11 U.S.C. §§ 501-676 (repealed 1978)).
retained control by filing for relief under Chapter XI. 153 Thus, many cases that Congress intended to be filed under Chapter X were filed under Chapter XI and valuable time was lost litigating over the proper chapter for a particular reorganization. 154 To avoid such disputes and out of a belief that third party intervention by a trustee and/or the SEC was more costly than it was valuable, Congress eliminated all mandatory supervision of reorganizations by the SEC and produced only one business reorganization chapter in the Bankruptcy Code, Chapter 11. 155

B. Purpose

The provisions of the bankruptcy laws of the United States reflect a variety of separate and discrete policies. 156 A primary purpose of the Bankruptcy Code is to provide a collective forum for sorting out the rights of the creditors against the assets of a debtor. 157 As one commentator has written:

In bankruptcy, with an inadequate pie to divide and the looming discharge of unpaid debts, the disputes center on who is entitled to shares of the debtor’s assets and how these shares are to be divided. Distribution among creditors is not incidental to other concerns; it is the center of the bankruptcy scheme. 158

A primary purpose of Chapter 11 is to rehabilitate a business as a going concern. Underlying the adoption of Chapter 11 is Congress’ belief that it is more economically efficient to reorganize than to liquidate. 159 Hence, in drafting Chapter 11, Congress sought to direct managers of financially troubled companies toward reorganization. 160

153. DAVID G. EPSTEIN ET AL., BANKRUPTCY 3 (1992). See also Michael E. Hooton, The Role of The Securities and Exchange Commission Under Chapter X, Chapter XI and Proposed Amendments to the Bankruptcy Act, 18 B.C. IND. & COMP. L. REV. 427 (1977) (analyzing pre-Code SEC involvement). See also Securities and Exchange Commission v. Canandaigua Enterprises Corp., 339 F.2d 14 (2d Cir. 1964) (holding that the proceeding be transferred from Chapter XI to Chapter X where publicly held debt was to be subjected to an arrangement which, without sacrifice by stockholders, postponed interest on debentures for six years, cancelled other interests, eliminated all sinking fund obligations, put all interest after a certain date on an income basis and made it noncumulative, and defined income so that principal payments to existing trade and other unsecured creditors would be an expense of future years.)

154. EPSTEIN ET AL., supra note 153, at 3.

155. Id.

156. Id.


158. Warren, Policy, supra note 23, at 785.


C. Scope and Threshold Requirements

Under the Bankruptcy Act of 1898, a corporate debtor seeking to voluntarily reorganize was required to be insolvent or unable to pay its debts as they matured. Creditors seeking to force a debtor into bankruptcy were required to prove that the debtor had committed one of six acts of bankruptcy within four months of the time of the filing of the petition. These acts included disposing of assets or attempting to flee a jurisdiction. In addition, all petitioners for reorganization under Chapter X were required to establish their good faith.

Conversely, the Bankruptcy Code does not require a debtor seeking to voluntarily reorganize to be insolvent nor does it condition a debtor's use of bankruptcy on owing any minimum amount of debt. Rather, the Bankruptcy Code provides that a bankruptcy petition may be filed by any entity that may be a debtor, as that term is defined in the Bankruptcy Code. The Bankruptcy Code requires only that the "debtor" be a person with a residence, domicile, place of business or property in the United States.

163. Id.
164. 11 U.S.C. § 141 (1976) (repealed 1978). See, e.g., In re Lela & Co., 551 F.2d 399, 408 (D.C. Cir. 1977) (to find good faith, court looks to the facts to determine whether the financial, economic and legal situation of the debtor is one within the contemplation of Chapter X); In re Diversey Hotel Corp., 165 F.2d 655, 658 (7th Cir. 1948) (sincere debtor could have petition dismissed for bad faith if facts as presented demonstrated petition was not filed for reasons consistent with the intended purposes of the Bankruptcy Code); In re The Bible Speaks, 65 B.R. 415, 420-22 (Bankr. D. Mass. 1986) (discussing pre-Code good faith filing decisions).
166. 11 U.S.C. § 109 provides:

(a) Notwithstanding any other provision of this section, only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under this title.
(b) A person may be a debtor under chapter 7 of this title only if such person is not--

(1) a railroad;
(2) a domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, credit union, or industrial bank or similar institution which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h)); or
(3) a foreign insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, or credit union, engaged in such business in the United States.
(d) Only a person that may be a debtor under chapter 7 of this title, except a stockbroker or a commodity broker, and a railroad may be a debtor under chapter 11 of this title.


Similarly, the Bankruptcy Code does not require proof of any acts of bankruptcy to commence an involuntary proceeding. Under the Bankruptcy Code, the first basis for involuntary relief is that the debtor is generally not paying debts as they come due. This is not an insolvency test. The focus is on whether the debtor is actually paying its debts rather than on the debtor's ability to pay as shown on the balance sheet. The alternative basis for involuntary relief is that within 120 days before the petition was filed, a receiver, assignee or custodian took possession of substantially all of the debtor's property. An involuntary proceeding can be commenced against any debtor who is eligible for voluntary bankruptcy, with the exception of corporations that are not monied, business or commercial.

Lastly, the Bankruptcy Code does not require that a petition for reorganization be filed in good faith. Good faith is only a confirmation

167. 11 U.S.C. § 303 (1988). The notes of the Committee on the Judiciary, Senate Report No. 95-989, explain that the test that the debtor is generally not paying his debts as they become due is a variation of the equity insolvency test which has been in equity jurisprudence for hundreds of years. S. Rep. No. 989, 95th Cong., 2d Sess. 115 (1978) reprinted in 1978 U.S.C.C.A.N. 5787, 5901. Although the Bankruptcy Code does not provide specific standards as to the number or the size of the claims that the debtor is not paying, case law provides some guidance. See, e.g., In re West Side Community Hosp., Inc., 112 B.R. 243 (Bankr. N.D. Ill. 1990) (describing a two step inquiry utilized by courts in applying the generally not paying test).

168. Id.
169. Id.

170. The Bankruptcy Code does not contain an express good faith filing requirement. Carolin Corp. v. Miller, 886 F.2d 693, 698 (4th Cir. 1989) (The "good faith filing" requirement applicable to Chapter 11 cases is not to be found in the Bankruptcy Code itself). In re Albany Partners Ltd., 749 F.2d 670 (11th Cir. 1984) (Chapter 11 does not expressly condition the right to file or maintain a proceeding on the "good faith" of the debtor at the time the petition is initiated.) Some courts have held that, as a good faith determination at the inception of the case is not mandated by statute, it should not "even be considered except under the most egregious circumstances." In re Garsal Realty, Inc. 98 B.R. 140, 152 (Bankr. N.D.N.Y. 1989).

However, other courts have invoked an implied good faith requirement in dismissing reorganization cases. See, e.g., In re Clause Enterprises of Ft. Meyers, Ltd., 150 B.R. 476 (Bankr. M.D. Fla. 1993); In re American Property Corp., 44 B.R. 180 (Bankr. M.D. Fla. 1984); In re Nancant, Inc., 8 B.R. 1005 (Bankr. D. Mass. 1981). Filings dismissed for lack of good faith generally fall into one of several categories: (1) cases filed to obtain the benefits of the automatic stay when an injunction or stay pending appeal is unavailable in litigation, see, e.g., In re Walter, 108 B.R. 244 (Bankr. C.D. Cal. 1989); In re Port Richey Service Co., 44 B.R. 634 (Bankr. M.D. Fla. 1984); (2) single asset cases filed to prevent foreclosure by a secured creditor, see, e.g., In re Tampa Medical Tower Ltd. Partnership, 145 B.R. 99 (Bankr. M.D. Fla. 1992); Carolin Corp., 886 F.2d 693; and (3) where property is transferred to a newly formed or revitalized entity on the eve of filing for bankruptcy, see, e.g., In re Albany Partners, Ltd., 749 F.2d 670; In re Franklin Mort. & Inv. Co., 143 B.R. 295 (Bankr. D. D.C. 1992); Michael J. Venditto, The Implied Requirement of "Good Faith" Filing: Where Are the Limits of Bad Faith, 4 DET. C.L. REV. 1591, 1592 (1993).

Conversely, courts have generally rejected challenges to good faith in "strategic" filings. For instance, Johns-Manville and Continental Airlines both involved good faith challenges. In In re Continental Airlines, three of the carrier's labor unions moved to dismiss the case alleging that it had been filed in bad faith solely for the purpose of rejecting collective bargaining agreements. The court, although acknowledging that rejection of the collective bargaining agreements was a planned element of the reorganization, denied the motion, relying on the debtor's financial position and the need to reorganize. In re Continental Airlines, Corp., 38 B.R. 67.

Similarly, after Johns-Manville filed its Chapter 11 petition, motions to dismiss were filed
requirement of Chapter 11.\textsuperscript{171} Congress eliminated the statutory requirement that petitions for reorganization be filed in good faith. It also neglected to include good faith as a cause for dismissal or conversion of a Chapter 11 proceeding.\textsuperscript{172}

Thus, the Bankruptcy Code, unlike the Bankruptcy Act of 1898,\textsuperscript{173} imposes no explicit financial or good faith requirements on debtors seeking\textsuperscript{174} to use Chapter 11. Debtors, at most, face only indirect obstacles. Furthermore, the Bankruptcy Code reduces the stigma of bankruptcy by allowing solvent companies to file for Chapter 11.\textsuperscript{175} As a result, bankruptcy courts resolve financial disputes and collect debts rather than judge debtors and their management.\textsuperscript{176}

**D. Reorganization and Exclusivity**

The Bankruptcy Code gives the debtor an exclusive right to file a Chapter 11 reorganization plan within 120 days after the filing of the petition.\textsuperscript{177} The debtor then has 180 days from the petition date to have its

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by a committee representing asbestos claimants. The motions asserted that the filing had been improperly motivated by the desire to use the estimation and discharge provisions available in Chapter 11. The court denied the motions, relying on the historic economic viability of the debtor, the financial pressures created by the size of the projected tort liabilities and the benefit to creditors which would result from reorganization. It concluded that using a reorganization to liquidate and manage these liabilities was not an abuse of the court's powers. \textit{Johns-Manville Corp.}, 36 B.R. 737. With respect to an implied good faith filing requirement, the court stated "it follows logically that in the case of a filing by a viable and legitimate company with real creditors not formed as a sham solely for the purpose of filing, the burden to establishing the company's good faith should be tested where Congress placed it: for emergence out of Chapter 11 pursuant to Section 1129." \textit{Id.} (relying on \textit{Banque de Financement v. First Nat'l Bank of Boston}, 568 F.2d 911 (2d Cir. 1977)).
\end{quote}

\textsuperscript{171} Good faith is required as a condition to the confirmation of a plan. 11 U.S.C. § 1129(a)(3) (1988). Under this section, "good faith exists 'when there is a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code.'" \textit{In re Cherry}, 84 B.R. 134, 137 (Bankr. N.D. Ill. 1988) (quoting \textit{In re Nite Lite Inns}, 17 B.R. 367, 370 (Bankr. S.D. Cal. 1982)) or when the plan was proposed with "honesty and good intentions" and with "a basis for expecting that a reorganization can be effected"; \textit{In re Koelbl}, 751 F.2d 137, 139 (2d Cir. 1984) (quoting Manati Sugar Co. v. Mock, 75 F.2d 284, 285 (2d Cir. 1935). The focus is upon the plan; the inquiry is therefore different than the threshold determination of a good faith filing. \textit{In re Madison Hotel Associates}, 749 F.2d 410, 425-26 (7th Cir. 1984); Venditto, \textit{supra} note 170, at 1593. \textit{See also} Lawrence M. Ponoroff & F. Stephen Knippenberg, \textit{Legal Theory: The Implied Good Faith Filing Requirement: Sentinel of an Evolving Bankruptcy Policy}, 85 Northwestern U. L. REV. 919 (1991).

\textsuperscript{172} 11 U.S.C. § 1112 (1988). Indeed, all of the examples of cause for dismissal set forth in the Code are based on the debtor's post-petition activities. \textit{Id.}

\textsuperscript{173} 30 Stat. 544 (1898).

\textsuperscript{174} Bankruptcy Act of 1898, \textit{supra} note 4.

\textsuperscript{175} DELANEY, \textit{supra} note 8, at 13-17. For similar observations see \textsc{Elizabeth Warren & Jay L. Westbrook}, \textit{The Law of Debtors and Creditors} 416-17 (2d ed. 1991) (criticizing the "act of bankruptcy" requirement because it disregards financial condition and results in delays).

\textsuperscript{176} DELANEY, \textit{supra} note 8, at 13-17.

plan accepted.\textsuperscript{178} This time period, known as the exclusivity period, may be increased upon request by any party in interest upon a showing of cause.\textsuperscript{179}

In promulgating the exclusivity period, Congress sought a compromise between Chapters X and XI of the Bankruptcy Act of 1898.\textsuperscript{180} Filing under former Chapter X required the appointment of an independent trustee to run the business and allowed any party to propose a reorganization plan.\textsuperscript{181} Filing under former Chapter XI allowed the debtor to retain control of business operations and the exclusive right to file a reorganization plan.\textsuperscript{182} The issue in exclusivity is how long the managers of the debtor are allowed to hold total control over an agenda that affects the financial interests of other parties.\textsuperscript{183} The debtor's control has a significant impact on bargaining. A debtor with an extended exclusive right to file a plan may delay filing until creditors, faced with the increasing costs of continued delays, acquiesce to an unfavorable plan.\textsuperscript{184}

Congress recognized that unlimited delay in the filing of a Chapter 11 plan makes creditors hostages of the debtor. It, therefore, drafted the exclusivity period to strike a balance between the debtor's interest and those of other parties.\textsuperscript{185} Two policies which coexist throughout Chapter 11 are captured in the exclusivity clause: encouraging debtor's management to utilize Chapter 11 while still promoting the probability of reorganization.\textsuperscript{186}

By limiting the period to 120 days, Congress hoped to put a certain amount of pressure on the reorganization process.\textsuperscript{187} However, the establishment of the 120-day exclusivity period has been accepted by judges as a determination by Congress that Chapter 11 debtors should be granted a longer reorganization period.\textsuperscript{188} Most Chapter 11 debtors are routinely

\textsuperscript{178} Id.
\textsuperscript{179} Id.
\textsuperscript{181} Nimmer & Feinberg, supra note 32, at 67.
\textsuperscript{182} Id.
\textsuperscript{183} Id. at 72.
\textsuperscript{185} Nimmer & Feinberg, supra note 32, at 67.
granted extensions of the exclusivity period. Moreover, debtors who fail to meet the deadline or to obtain an extension usually suffer no consequences.

Where managers have total control over a corporation they are likely to be risk takers with its assets. Shareholders or creditors believing corporate management has acted improperly and engaged in unnecessary risks with corporate assets have as their primary remedy under the Bankruptcy Code the right to seek appointment of a trustee.

**E. Corporate Governance: Protection of Management**

1. Appointment of a Trustee

Under Chapter X of the Bankruptcy Act of 1898, trustees were

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In a study by LoPucki and Whitford, in thirty-four out of forty-three cases exclusivity was continued throughout the case. Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 1991 Wis. L. Rev. 11, 31 n.67 (hereinafter LoPucki & Whitford, *Venue Choice*). LoPucki and Whitford explain:

> The debtors in many of these cases were suffering from delay, but the key to understanding the bargaining leverages was to realize that their creditors were suffering much more. For many debtors, the difference was great enough that they could trade movement of the case for substantive concessions from other parties.

LoPucki, *Trouble, supra* note 188, at 753-54.

Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), provides that a bankruptcy court order extending or shortening the period in which the debtor has the exclusive right to file a plan may be appealed as of right to the district court. The right to an appeal from a bankruptcy court order extending the debtor's exclusive right to file a plan is intended to assist creditors in avoiding unduly long extensions of exclusivity. See discussion infra Part III(D).

190. The failure to meet the deadline or obtain an extension violates no rule. Legally, the only consequence of expirations of exclusivity is that other parties in interest may file a plan. In a study by LoPucki and Whitford, out of nine cases where the exclusivity period was allowed to expire, most resulted in the confirmation of plans jointly proposed by the debtor and the unsecured creditors' committee. Only in one case were creditors able to capitalize on the expiration of exclusivity and, even in that case, months elapsed before they decided to do so. LoPucki & Whitford, *Venue Choice, supra* note 188, at 36 n.85; LoPucki, *Trouble, supra* note 187, at 747-48.


192. Bienenstock, *supra* note 185, at 550. Shareholder derivative and similar suits are not effective control devices because they become property of the estate once a bankruptcy case is filed. Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129 (2d Cir 1984). A creditors' committee or another party in interest may request leave to prosecute such actions, but requests are not always granted. *Id.* at 549, n.29; 11 U.S.C. § 1104(a) (1988).
mandatory in any case involving at least $250,000 of noncontingent debt. The Senate's version of the Bankruptcy Code [also] required a trustee in any case involving at least $5 million of non-trade debt and 1000 security holders. Ultimately, however, Congress refused to require the appointment of trustees based on a debt and security holders formula due to concern that such automatic appointment would discourage managers from seeking Chapter 11 protection. "By limiting the circumstances requiring a trustee, Congress increased the probability that management would resort to Chapter 11 while the debtor still had sufficient assets and vitality to maximize its chances for a successful reorganization as a going concern."

As enacted, the Bankruptcy Code authorizes a court to enter an order appointing a trustee at any time after commencement of the case and before confirmation of the plan. However, Chapter 11 presumes that existing management will continue to operate the debtor. Therefore, appointment of a trustee is extraordinary and the requesting party must establish the grounds for appointment by clear and convincing evidence.

Two separate bases exist for appointment of a trustee. The first is "for cause," including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case.

Courts have not clearly defined the "cause" sufficient to warrant appointment of a trustee. Misconduct of the debtor which diminishes the

194. Bienenstock, supra note 185, at 549.
195. "[A] standard that led to too frequent appointment would prevent debtors from seeking relief under the reorganization chapter, and would leave the chapter largely unused except in extreme cases. One of the problems that the Bankruptcy Commission recognized in current bankruptcy and reorganization practice is that debtors too often wait too long to seek bankruptcy relief." H.R. REP. NO. 595, supra note 7, at 233-34, reprinted in 1978 U.S.C.C.A.N. at 6193 quoted in Bienenstock, supra note 185, at 549-50, n.29.
196. Bienenstock, supra note 185, at 550.
199. See, e.g., In re Microwave Products of America, 102 B.R. 666 (Bankr. W.D. Tenn. 1989) (trustee appointed where failure of debtor to investigate avoidable transfers or to collect receivables from parent company resulted in erosion of confidence in debtor); In re Stein & Day, Inc., 87 B.R. 290 (Bankr. S.D.N.Y. 1988) (appointment of trustee not justified where creditor had not shown fraud, dishonesty or gross mismanagement, although debtor corporation had breached agreement with secured creditor by failing to establish escrow account); In re William A. Smith Constr. Co., 77 B.R. 124 (Bankr. N.D. Ohio 1987) (appointment of trustee justified where debtor lacked adequate managerial control and had depleted corporate assets, pre and post petition, resulting in impairment of secured creditor's interest). See also Nimmer & Feinberg, supra note 32, at 55.
sale of secured claims or depletes assets of the estate, combined with records that fail adequately to reflect such transactions, may be enough. However, creditors' allegations of mismanagement of the debtor's business alone will not normally warrant appointment of a trustee. Appointment of a trustee based on mere mismanagement is seen as defeating the Chapter 11 philosophy of giving the debtor a second chance.

A second standard allows the court to appoint a trustee if it is in the interest of creditors, equity security holders and the estate. Again the presumption is with retaining current management, the Bankruptcy Code does not contemplate that a trustee will be appointed because a court believes someone else will operate the business more effectively or even because the managers are tactically disadvantaging creditors. Thus, while theoretically this is an alternate standard for appointment, practically courts rarely order the appointment of a trustee absent indicia of fraud, dishonesty or gross mismanagement.

Not surprisingly, however, managers more interested in their own future than that of creditors or shareholders will not leave a paper trail of fraud or gross mismanagement. Rather, such managers will operate by the book yet make key decisions based on considerations of their own welfare. In this case, the debtor's president or CEO remains in control of the company with broad discretion to operate the business. The court will not scrutinize or grounds for appointment of a trustee).


204. Epstein et al., supra note 154, at 17-8. As one commentator has noted, the mere fact of filing for relief in bankruptcy does not necessarily demonstrate that the managers are incapable or unsuited. "Indeed, slight evidence of mismanagement in the form of imprudent or poor business decisions or use of resources are to be expected . . . ." Nimmer & Feinberg, supra note 32, at 56 (citing In re La Sherene, Inc., 3 B.R. 169, 174 (Bankr. N.D. La. 1980)).


207. Id. at 55; Epstein et al., supra note 154, at 17-8. See, e.g., In re Hotel Associates, Inc., 3 B.R. 343, 345 (Bankr. E.D. Pa. 1980) (holding that a determination must be made that a trustee will accomplish the goals of a Chapter 11 plan more efficiently and effectively than the management of the debtor with whom the members of the business community have had and will continue to have business transactions). Compare, In re Gaslight Club, 782 F.2d 767 (7th Cir. 1986); In re Lifeguard Industries, Inc., 37 B.R. 3, 17 (Bankr. S.D. Ohio 1983) (court denied order confirming appointment of newly elected directors on ground that proposed management lacked experience and ability): In re United Press International, Inc., 60 B.R. 265 (Bankr. D.C. 1986) (bankruptcy court upheld a consent order abolishing the debtor's board of directors, appointing a new chief executive officer and authorizing the new CEO to file a plan).

entertain objections to ordinary course transactions, nor will the court substitute its judgment of business risk for that of the debtor.\textsuperscript{209} Hence, Congress' "attempt to entice management to use [Chapter 11] also serves to entrench management and shield it from breaches of its own fiduciary duties."\textsuperscript{210}

209. While in control of the Chapter 11 debtor, the CEO or president acting as the Debtor in Possession ("DIP") does have statutory duties involving ministerial and reporting functions. These duties include the obligations to file reports, hire personnel and conduct the reporting and accounting activities generally associated with operating a business. 11 U.S.C. § 1106 (1988).

However, other statutory sources provide the DIP with the right to operate the business and exercise business discretion. 11 U.S.C. §§ 1107-08. Finally, still other statutory sources expressly empower the DIP to make decisions that benefit some claimants but harm others. These include the power to propose reorganization plans differentiating among classes of creditors, 11 U.S.C. § 1121(a), to reject or assume executory contracts, 11 U.S.C. § 365, to object to claims, 11 U.S.C. § 1106(a), and to decide whether to seek avoidance of some preexisting transfers and obligations, 11 U.S.C. §§ 344-554. These powers establish "a simple proposition: the DIP is a separate, independent force with the opportunity to influence and control how losses are distributed." Nimmer & Feinberg, supra note 32, at 27.

The power of the DIP is further accentuated by the fact that the court will not scrutinize ordinary course of business transactions, 11 U.S.C. § 563, nor will it substitute its judgment of business risk for that of the debtor. See, e.g., Committee of Asbestos-Related Litigants v. Johns-Manville, Corp. (\textit{In re Johns-Manville Corp.}), 60 B.R. 612 (Bankr. S.D.N.Y. 1986) (multinational corporate debtor's hiring of lobbyist is a transaction in the ordinary course of business, where corporation hired lobbyists before filing petition and such employment is common in industry practice); \textit{In re Simasko Production Company}, 47 B.R. 444 (D. Colo. 1985) (court would not entertain objections to debtor's financing order on the basis that financing would be used to fund a business program which posed a serious economic risk).

210. Bienenstock, supra note 185, at 550. In addition to the appointment of a trustee, other theoretical "controls" on management include the creditors' committee and the United States Trustee. However, these controls are often ineffective.

The Bankruptcy Code requires the appointment of a committee of creditors holding unsecured claims as soon as practicable after filing of the petition. Additional committees of creditors or equity security holders may also be appointed. 11 U.S.C. § 1102. Official committees consult with the debtor, investigate the debtor's business and financial condition, participate in formulating a plan of reorganization, make recommendations regarding the plan and may request appointments of trustees and perform other services. 11 U.S.C. § 1103.

"In theory, committees should have significant influence over the outcome of the reorganization proceeding, thus curbing debtor indiscretions. In practice, however, they rarely exert such influence." Edward S. Adams, \textit{Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results}, 73 B.U. L. REV. 581, 614-15 (1993). Even where committees are appointed and active, several elements contribute to their ineffectiveness. First, the lack of compensation beyond expenses creates a disincentive for spending considerable time on committee matters. Second, the committee members often do not have the requisite expertise. Lastly, their effectiveness is constrained by their inability to directly control the debtor. "They can only influence debtor in possession actions, not compel them." \textit{Id.} at 614-15; John T. Roache, \textit{The Fiduciary Obligations of a Debtor in Possession}, U. ILL. L. REV. 133, 161 (1993) (citing \textit{In re B & W Tractor Co.}, 38 B.R. 613 (Bankr. E.D.N.C. 1984) for the finding that creditors' committees in general are inactive and ineffective).

The office of United States Trustee was established to aid in the administration of bankruptcy cases. 28 U.S.C. §§ 581-89 (1988). The United States Trustee is charged with monitoring the progress of cases under Title 11 and taking such actions as it deems to be appropriate to prevent undue delay. 28 U.S.C. § 586(a)(3)(G). The United States Trustee has complete discretion in determining whether and how to advance goals of case management. It is the current policy of the United States Trustee program to encourage creditor involvement and to act directly in a Chapter 11 case only when such involvement is minimal. Hon. Steven W. Rhodes, \textit{Eight Statutory Causes of Delay and Expense in Chapter 11 Bankruptcy Cases}, 67 AM. BANKR. L. J. 287, 309 (1993). Some commentators charge that the United States Trustee program has failed to carry out congressional intent in supervising Chapter 11 cases. \textit{See}, e.g.,
Managers of corporations in Chapter 11, whether solvent or insolvent, do owe fiduciary obligations to both creditors and shareholders.211 However, to say that a man is a fiduciary only begins the analysis. It gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?212

Managers of a debtor under the protection of Chapter 11 assume the fiduciary responsibility of protecting the financial interests of shareholders and creditors.213 Such interests are often conflicting, not only with each other,214 but also with the interests of the managers themselves.215 Managers are concerned with preserving or improving their position with the corporation. They will be adverse to liquidating substantial assets, during the Chapter 11 case or as part of the reorganization plan, if the liquidation will materially decrease the business to be managed.216 Similarly, managers will prefer creditors willing to hire them to operate the business of the reorganized debtor, irrespective of whether those creditors are acting in the best interest of the estate.217 "In both situations, management has a fiduciary duty to do what is best for the estate and creditors, and has a potentially conflicting interest in doing what is best for management."218

Moreover, where debtors are insolvent, shareholders have little incentive to be vigilant.219 "Directors who are major shareholders may acknowledge


214. Id.
215. Id.
216. Bienenstock, supra note 185, at 545-46.
217. Id. at 545-46. See also LoPucki & Whitford, Bargaining, supra note 206, at 150-51.
218. Bienenstock, supra note 185, at 546.
219. Id. at 545.
the loss of their pecuniary interests and may resign." Independent directors may also resign, particularly if liability insurance becomes unavailable. The consequence of this is a board of directors consisting solely of management. Absent court intervention, the managers report to themselves and the potential for abuse is increased.

3. Protection of Management

The Bankruptcy Act of 1898 limited abuse through the threshold requirements of insolvency and good faith and the mandatory appointment of trustees for large, publicly held corporations. The Bankruptcy Code

220. Id.

221. Id.

222. Id. A number of federal laws restrict the actions of managers. See, e.g. 26 U.S.C. §§ 1-9601 (1988) (Internal Revenue Code); 15 U.S.C. § 77a-77b (1988) (Securities Act of 1933). However, there is no federal law formulating the fiduciary duties of an insolvent company's officers and directors. Rather, corporate law is a matter of state law. Bienenstock, supra note 185, at 551.


However, even in these states the courts utilize a business judgment test in enforcing fiduciary standards. This test requires that unless a plaintiff shows "fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors." Nimmer, supra note 32, at 35 (citing Treadway Co. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980)).

Of course, the filing of the bankruptcy suspends the enforcement of most laws outside of bankruptcy. 11 U.S.C. § 362 (1988). However, most bankruptcy courts follow the business judgment test in reviewing compliance of the debtor with its fiduciary duties. Nimmer & Feinberg, supra note 32, at 36. This is true even though the fiduciary role of the DIP’s management differs from that of fiduciaries in non-bankruptcy settings and even though states have insufficient reason or opportunity to focus on corporate governance issues as they relate to insolvent corporations because insolvent corporations usually wind up in bankruptcy where they are subject to federal bankruptcy laws. Nimmer & Feinberg, supra note 32, at 36; David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEX. L. REV. 471, 490 (1994) (arguing that the states should regulate corporate bankruptcy).

223. See discussion supra Part II(C).
requires neither insolvency nor good faith. Moreover, creditors may normally obtain a Chapter 11 trustee only upon a showing of fraud, dishonesty or gross mismanagement.

Just as the Bankruptcy Code provides few consequences for management's deviation from duty, there is "no statutory federal law formulating the fiduciary duties of an insolvent company's management and directors." Rather, state laws and jurisprudence remain in effect, except to the extent preempted by federal law.

Common law sanctions are also limited. Case law establishes that although difficult to prove, willful and deliberate violations of fiduciary duties will result in personal liability. Case law also provides that negligence by a fiduciary results in liability of the estate. However, this is little solace to a creditor already facing inadequate estate assets for recovery of his claim.

III. THE CRISIS OF CHAPTER 11 REFORM

A. Background

Reform of Chapter 11 has been a topic of debate among academics since the 1980's. Thomas Jackson and Douglas Baird first analyzed Chapter 11's alteration of the individual contracts entered into by a debtor and its creditors. Their creditors' bargain model posits that, if creditors were able to bargain among themselves, they would agree to refrain from enforcing their individual collection rights in order to preserve the debtor as a going concern. However, because creditors are too widely dispersed to bargain effectively among themselves, bankruptcy is necessary to

224. See discussion supra Part II(C).
225. See discussion supra Part II(E)(1).
227. Id. See discussion supra Part II(E)(2), n.222.
228. See Ford Motor Credit Co. v. Weaver, 680 F.2d 451 (6th Cir. 1982) (individual debtor partner may be personally liable for willful violations of fiduciary duties); United States ex rel. George Schumann Tire & Battery Co. v. Grant, 145 B.R. 104 (Bankr. M.D. Fla. 1992) (Chapter 7 trustee could be held personally liable for breaching fiduciary duty by failing to turn over funds).
229. Ford Motor Credit Co., 680 F.2d at 462.
232. Jackson, Creditors Bargain, supra note 231, at 862.
implement the creditors’ bargain. Nevertheless, Jackson and Baird assert that bankruptcy should not alter a creditor’s state law entitlements. To encourage creditors to participate in the reorganization process, the substantive rules in bankruptcy should reflect state law.

Initial criticism of the creditors’ bargain model focused on the reality that bankruptcy does not preserve creditors’ state law entitlements. Rather, bankruptcy favors lower priority creditors and the debtor at the expense of creditors entitled to a higher priority under state law.

Other commentators argue that bankruptcy’s alteration of the creditors’ state law priorities undermines the validity of the creditors’ bargain model. In their view, bankruptcy should implement social concerns beyond the creditors’ bargain with the debtor.

A third group of commentators question Baird’s and Jackson’s assumption that bankruptcy is necessary to solve the creditors’ “common pool” problem. One commentator argues that the creditors’ bargain model focuses only on creditors, ignoring the role of debtors. Another commentator argues that creditors could prevent the dismemberment of a viable debtor through the use of secured credit arrangements, without the necessity of bankruptcy.

As early as 1986, there were suggestions that Chapter 11 could be eliminated without adverse results. This precipitated a heated debate among academics, but did not create a stir in the popular media. However, in 1992, Michael Bradley and Michael Rosenzweig drew national attention by concluding that Chapter 11 should be abolished.

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233. Id.
234. Id. at 867-70.
235. id.
236. Skeel, Brave New World, supra note 21, at 471.
237. Skeel, Corporate Voting, supra note 21, at 484.
238. Skeel, Brave New World, supra note 21, at 471.
240. Skeel, Brave New World, supra note 21, at 471.
244. Warren, Policy, supra note 23. See also Baird, Loss Distribution, supra note 23.
245. Bradley & Rosenzweig, supra note 9. Bradley and Rosenzweig compared the pre-bankruptcy and post-bankruptcy stock and bond values of publicly held firms that filed under the Bankruptcy Act to those that filed under the Bankruptcy Code. They concluded that firms filing Chapter 11 petitions were worth significantly more on the filing date but lost a much higher percentage of their value while in bankruptcy. However, Bradley and Rosenzweig’s conclusions have been severely criticized. See, e.g., Elizabeth Warren, The Untenable Case for Repeal of Chapter 11, 102 YALE L.J. 437, 438 (1992) [hereinafter Warren, Untenable Case]; Lynn M. LoPucki, Strange Visions in a Strange World: A Reply to Professors Bradley &
B. The Crisis

The intensity of the controversy over the future of Chapter 11 arises from the increasing perception that Chapter 11 is not merely unnecessary but actually harmful for many corporations. Two central concerns fuel this view.

The first is the cost of Chapter 11. Attorney and accountant fees can be significant. Further, Chapter 11 creates disruption and lost opportunity costs.

Second, Chapter 11 creates negative effects even before a corporation files for bankruptcy. Commentators have long recognized Chapter 11’s affect on management incentives. They reason that, because Chapter 11 limits the downside of any business disaster, it encourages managers to issue excessive debt and take excessive risks. Bradley and Rosenzweig attribute even greater harm to management incentives. They argue that Chapter 11 affirmatively diverts assets away from equity security holders and creditors.

C. Academic Proposals

Commentators who conclude that Chapter 11 has failed encourage the adoption of one or more of four general alternatives: auctions; implementation of a predetermined bankruptcy capital structure; contingent or chameleon equity; and/or the elimination of Chapter 11.

The auction was first suggested by Baird. Under this proposal, a court or a trustee would sell the debtor corporation to the highest bidder.

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246. Skeel, Brave New World, supra note 21, at 472.
247. Id.; LoPucki, Trouble, supra note 188, at 730-31 n.6.
248. Skeel, Brave New World, supra note 21, at 472; LoPucki, Trouble, supra note 188, at 730-31 n.6.
249. Skeel, Brave New World, supra note 21, at 473.
250. Id.
252. Bradley & Rosenzweig, supra note 9, at 1047, 1052, 1057.
253. For an in depth analysis of each of the four proposed Chapter 11 alternatives see Skeel, Brave New World, supra note 21, at 472-76. See also LoPucki & Whitford, Corporate Governance, supra note 31, at 753-67.
254. Baird & Jackson, Corporate Reorganizations, supra note 231, at 139-41; Douglas G. Baird, Revisiting Auctions, supra note 31. See also Adler, Risk Allocation, supra note 251, at 488; Bebchuck, supra note 159, at 785-88.
255. Baird & Jackson, Corporate Reorganizations, supra note 231, at 139-41. A mandatory auction, which is required at the commencement of the case, is significantly different from liquidation in Chapter 7, (where individual assets are sold piecemeal and the company is rendered a shell) or even voluntary liquidation in Chapter 11 (where parts of the company are voluntarily sold to raise money to assist the debtor in reorganizing). Of course, voluntary auctions do occur in Chapter 11. Baird cites the case of Financial News Network (FNN) which entered Chapter
Ideally, this would move the assets to their most valued uses quickly and inexpensively.\textsuperscript{256} A second group of commentators argues for implementation of a predetermined bankruptcy capital structure by permitting firms to opt out of bankruptcy.\textsuperscript{257} According to these commentators, if Chapter 11 were optional, debtors would devise their own alternatives to bankruptcy.\textsuperscript{258} For instance, corporations could provide in their bylaws or contracts for a special capital structure of preplanned adjustments that would be triggered by insolvency.\textsuperscript{259}

A third group of commentators suggests variations on the theory of contingent or chameleon equity.\textsuperscript{260} These commentators argue for automatic cancellation of shareholder interests in the event of a corporate default.\textsuperscript{261} Upon cancellation of shareholder interests, the next highest class of claimants replace them as shareholders.\textsuperscript{262} A benefit of automatic cancellation is its effect on management incentives. Managers who cannot look forward to the protection of Chapter 11 are less likely to gamble with corporate assets.\textsuperscript{263}

Finally, at least one author advocates eliminating bankruptcy and abandoning debtors and their assets to the state law collection system.\textsuperscript{264} James Bowers proposes such action in his article criticizing the creditors bargain model.\textsuperscript{265}

11 in 1991. A joint venture between Dow Jones and Group W offered to pay $90 million for FNN's assets. NBC offered $115 million. The bankruptcy court ordered an auction of FNN's assets. NBC eventually won with a bid of $146 million. Baird, \textit{Revisiting Auctions}, supra note 31, at 634.\textsuperscript{256} \textit{Id.} Skeel, \textit{Brave New World}, supra note 21, at 474.\textsuperscript{257} Alan Schwartz, \textit{Bankruptcy Workouts and Debt Contracts}, 36 J. L. & Econ. 595 (1993); Robert K. Rasmussen, \textit{Debtor's Choice: A Menu Approach to Corporate Bankruptcy}, 71 Tex. L. Rev. 51 (1992).\textsuperscript{258} See supra note 257. Under existing law, firms facing financial distress and wishing to reorganize have Chapter 11 as their only option. Implementation of the predetermined bankruptcy capital structure allows firms to "opt out" of Chapter 11 by providing in their charter and/or contracts for planned events that would be triggered by financial distress. Moreover, under this proposal, even firms that chose to "opt in" to Chapter 11 could specify by charter or contract how specific provisions of Chapter 11 would apply. Skeel, \textit{Brave New World}, supra note 21, at 474-75.\textsuperscript{259} See supra note 257; Skeel, \textit{Brave New World}, supra note 21, at 474-75.\textsuperscript{260} Barry E. Adler, \textit{Financial and Political Theories of American Corporate Bankruptcy}, 45 Stan. L. Rev. 311 (1993) [hereinafter Adler, \textit{Political Theories}]; Bradley & Rosenzweig, supra note 9; Skeel, \textit{Brave New World}, supra note 21.\textsuperscript{261} See supra note 260. It is envisioned that a firm in danger of defaulting on its obligations will raise money by issuing equity. Only when the firm's liabilities exceed its assets, and its stock has therefore become worthless, will the firm be unable to sell equity. The firm's subsequent default will then reflect true insolvency thus justifying the elimination of its current shareholders' interests. Skeel, \textit{Brave New World}, supra note 21, at 475 (citing Bradley and Rosenzweig, supra note 9, at 1081).\textsuperscript{262} See supra note 260.\textsuperscript{263} Skeel, \textit{Brave New World}, supra note 21, at 476.\textsuperscript{264} Bowers, supra note 241; Skeel, \textit{Brave New World}, supra note 21, at 476.\textsuperscript{265} Bowers, supra note 241.
Each of the proposals to replace Chapter 11 is problematic. Manda-
tory auctions would suffer from a lack of bidders and depressed prices. Choosing an insolvency capital structure in advance requires costly negotiation and the ability to predict the future. Chameleon equity assumes the existence of perfect markets for the equity of insolvent corporations as well as the cooperation of managers subject to dismissal. Lastly, eliminating bankruptcy and abandoning debtors and creditors to their state law rights encourages a costly race to the courthouse and the dismemberment of the debtor.

D. Legislative Response

In response to the growing controversy surrounding Chapter 11, the House and Senate Judiciary Committees agreed on a compromise bill that would have amended several dozen sections of the Bankruptcy Code in October 1992. However, the proposal never became law because the House adjourned without voting on it.

On March 10, 1993, the Bankruptcy Improvements Act was introduced by Senators Howell Heflin and Charles Grassley. The Bankruptcy Improvements Act of 1993 limited the time in which a court might increase the debtor’s exclusive right to file a reorganization plan to one year unless the court found the need for additional time was not due to circumstances attributable to the debtor. It also created a nine member bankruptcy review commission to investigate and study issues and problems related to bankruptcy.

On October 7, 1994, Congress unexpectedly passed the Bankruptcy Reform Act of 1994 was "unexpected" in its timing. H.R. 5116 was passed by the House, by voice vote, at 6:00 p.m. on October 4, 1994. It was sent directly to the Senate floor without a conference committee in order to beat the end of the 103rd Congressional session. Just prior to its adjournment on October 7, 1994, the Senate passed H.R. 5116 also by voice vote.

IV. THE UNPROPOSED SOLUTION

A. Background

Although there has been a clamor for reform of Chapter 11, few of the proposals are aimed at increasing management accountability within the confines of Chapter 11. The Bankruptcy Code fails today, not because it was poorly drafted, but because Congress failed to anticipate today's problems: the need to compete in an ever shrinking global economy and the impact of bankruptcy legislation upon the ability to compete.

In contrast to Chapter 11, the Enterprise Bankruptcy Law of the People's Republic of China ("PRC") was drafted in the 1980s by a nation attempting to compete in a global economy for the first time. Its purpose is well defined: to assist the PRC in developing a planned economy with market mechanisms. In the PRC, bankruptcy legislation is viewed as a device for implementing economic policy and encouraging management efficiency. The punishment of management is seen as a method of imposing the pain of losses resulting from bankruptcy on management and as providing the discipline over management that would be exercised by shareholders actively involved in the company.

Arguably, in a capitalist system the market should provide the function of disciplining management without the need for legislation. However, a corporation which files for relief under Chapter 11 is shielded from the effects of the market. Furthermore, under Chapter 11, a corporation can

278. Id. at Title VI.
279. Id. at Title I, § 104.
280. Bradley & Rosenzweig, supra note 9, and other proponents of contingent or chameleon equity, hope to affect management incentives by replacing Chapter 11.
281. 11 U.S.C. § 362 (1988) automatically stays all collection efforts and foreclosure actions upon the filing of a bankruptcy action. It also freezes and maintains the status quo among creditors. Id. The Bankruptcy Reform Act provides for an expedited hearing on the automatic stay. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994). However, there are no plans for substantive revisions of section 362. Indeed, most bankruptcy legislation, including that of the P.R.C., provides for an automatic stay. See, e.g., Enterprise Bankruptcy Law, art. 11, translated in YEARBOOK, supra note 26, at 84.
seek such protection from the market irrespective of its financial status and may extend such protection indefinitely. Thus, corporate management is able to take unnecessary risks with the assets of a corporation. When those risks are successful they inure to the benefit of management, but when the risks are unsuccessful they are spread among the creditor body.

What can be done? Elimination of Chapter 11 leaves management at the mercy of the market. However, the cost—allowing a creditor race to the courthouse—is great.

A comparison of Chapter 11 with the Enterprise Bankruptcy Law and the Bankruptcy Act of 1898 suggests the following methods of encouraging responsible management through reform, rather than elimination, of Chapter 11: (1) strengthening the threshold requirements of Chapter 11; (2) limiting the overall time for corporate reorganizations and the exclusive time for filing a plan of reorganization; (3) exercising controls over corporate management; and/or (4) applying sanctions against those members of management who act irresponsibly.

B. Threshold Requirements

Under the Bankruptcy Code, unlike the Bankruptcy Act of 1898 and the Enterprise Bankruptcy Law of the PRC, a voluntary bankruptcy filing does not require any showing of insolvency or inability to pay debts as they become due. As a result, a corporation may file for relief under Chapter 11 for almost any business reason, short of fraud, including mismanagement. In fact, mismanagement is believed to exist in most Chapter 11 filings.

Several options are available to strengthen the threshold requirements of the Bankruptcy Code. The first is to reinstate the requirement of insolvency or the inability to pay debts for a bankruptcy filing. This is similar to the threshold requirement of the Enterprise Bankruptcy Law. However, such a requirement is difficult to apply and discourages entities from filing for Chapter 11.

A second, preferable alternative is to reinstate the good faith requirement of the Bankruptcy Act of 1898. This is a fluid test, which could be applied

282. See discussion supra Part II(E)(1).
283. See discussion supra Part II(E)(1).
284. See THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 194-203 (1986) (proposing the reinstatement of the insolvency requirement.)
285. Enterprise Bankruptcy Law, art. 3, translated in YEARBOOK, supra note 26, at 83. See discussion supra Part I(F).
286. JACKSON, supra note 284, at 201-04 (arguing for application of the insolvency requirement although recognizing that because so much is uncertain at the commencement of the case the insolvency requirement is incapable of precise application); DELANEY, supra note 8, at 160-68 (describing six key tactics utilized by corporations to make themselves appear insolvent and avoid dismissal under a good faith analysis).
on an ad hoc basis by the bankruptcy court. However, in order to control abuse of Chapter 11, the concept of good faith would have to be extended beyond the confines of current case law to include review of prepetition dealings by managers with creditors and other third parties.

C. Reorganization and Exclusivity

Several options are also available to limit abuses of Chapter 11 by limiting the time during which management has exclusive control of a Chapter 11 debtor. First, a statutory cap could be imposed on the overall time a debtor may remain in Chapter 11. Second, Congress could shorten the exclusivity time or require a stronger showing for the extension of the exclusivity period beyond 120 days.

Third, the first two alternatives could be combined, requiring the debtor to file and confirm a plan within a prescribed period of time. For example, Congress could require a plan of reorganization to be filed within 120 days of the petition and to be confirmed within 610 days thereafter, thereby limiting the overall period of protection under Chapter 11 to two years. The time limits would be subject to extension only upon a showing, by clear and convincing evidence, of extraordinary circumstances beyond the control of the debtor, its managers or its counsel. This third option is similar to the requirement of the Enterprise Bankruptcy Law that an application to reorganize must occur within three months of acceptance of the petition and the reorganization may not last more than two years.

D. Corporate Governance: Controlling Management

Under the Bankruptcy Act of 1898, trustees were automatically appointed for large, publicly held corporations. Similarly, the SEC was responsible for reviewing all plans of reorganization. These practices had the advantage of controlling, if not eliminating, corporate managers. However, such practices also discourage corporate managers from filing for bankruptcy.

Several options, other than the automatic involvement of court appointed

287. See In re Eden Associates, 13 B.R. 578, 584 (Bankr. S.D.N.Y. 1981) (finding that the concept of good faith is an elastic one which can be read into the statute on an ad hoc basis.)

288. See discussion supra Part II(C).

289. See LoPucki, Trouble, supra note 188 (proposing "preemptive cramdown" and limits on the discretion of the judge to extend exclusivity); Nimmer & Feinberg, supra note 32 (proposing "aggressive" limits on extensions of exclusivity).

290. Enterprise Bankruptcy Law, art. 17, translated in YEARBOOK, supra note 26, at 84-85. See discussion supra Part I(F).

291. See discussion supra Part II(E)(1). While trustees may have hired old management to actually run the company after a bankruptcy filing, the trustee provided control. See Warren, Untenable Case, supra note 245, at 454 n.76.

trustees and the SEC, are available to control corporate managers. First, Chapter 11 could be amended to provide for the appointment of a trustee upon a showing, by clear and convincing evidence, of some management act from which the court could infer that maximizing the value of the estate was not management’s goal.

Second, Congress could adopt legislation defining the fiduciary duties of the managers of an insolvent or nearly insolvent corporation and amend Chapter 11 to provide for the appointment of a trustee upon a showing, by clear and convincing evidence, of a violation of those duties. Such legislation could require that fiduciaries exercise the due care, diligence and skill as to affirmative and negative duties required of an ordinarily prudent person in the conduct of his or her private affairs. More specifically, the law could include the fiduciary duty to creditors not to commit corporate waste.

E. Corporate Governance: Sanctioning Management

The most controversial method of encouraging responsible management is to provide sanctions for those managers who prove irresponsible, e.g., those managers who think of their own gains before those of the estate. A

293. The Enterprise Bankruptcy Law does not require the appointment of a trustee. In most proceedings, the government authority which files for readjustment is charged with overseeing the reorganization. Enterprise Bankruptcy Law, art. 20, translated in YEARBOOK, supra note 26, at 85. See discussion supra Part I(F).

294. Some courts have already held that a trustee may be appointed based on “loss of confidence” when management has performed some act from which the court can infer that maximizing value for creditors was not management’s goal. See, e.g., In re Ionosphere Clubs, Inc. 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990) (trustee appointed where creditors lost confidence in management’s stewardship of the business); In re Cardinal Indus., 109 B.R. 755, 765-68 (Bankr. S.D. Ohio 1990) (trustee appointed after creditors gave debtor opportunity to direct reorganization and lost confidence in management). Bienenstock, supra note 186, at 552 n.37 (encouraging creditor vigilance in moving for appointment of trustees and for limits on exclusivity).

295. As Bienenstock notes, the Delaware Chancery Court has ruled that where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the shareholders but owes its duty to the corporate enterprise.

To illustrate its point, the court posed an intriguing situation. Assume a corporation’s sole asset is a $51 million judgment on appeal. There is a twenty-five percent chance of affirmance, a seventy percent chance of a reduction to $4 million, and a five percent chance of reversal. The sum of the probabilities times their respective outcomes is $15.55 million. Finally, the corporation had liabilities of $12.5 million. Should the directors accept a settlement offer of $12.5 million? $17.5 million?

The court concluded the board of directors should accept any offer of $15.55 million or greater, but not lower.


296. See Bienenstock, supra note 186, at 557.
variety of civil sanctions could discourage irresponsible management.\textsuperscript{297}

First, Congress could adopt legislation fining corporate managers found liable of violating their fiduciary duties to the estate and/or committing an act from which the court could infer that maximizing the value of the estate was not their goal.\textsuperscript{298} Such legislation could provide a basis for requiring managers to pay all or part of the corporate debt.\textsuperscript{299}

Second, Congress could adopt legislation which creates a presumption that the insolvency of a corporation is due to a lack of activity and diligence on the part of the managers.\textsuperscript{300} Such legislation could require managers to pay all or part of the corporate debt.

Third, Congress could adopt legislation providing that managers found liable of violating their fiduciary duties to the estate and/or committing an act from which the court could infer that maximizing the value of the estate was not their goal are presumed to be substantially unfit to serve in a similar capacity for a designated period of time.\textsuperscript{301}

\section*{F. Policy Considerations}

As previously discussed, identifying the policies underlying the Bankruptcy Code has been the source of numerous debates. At its core, the Bankruptcy Code is a debt collection and asset distribution system.\textsuperscript{302} There are those who believe that the primary purpose of this system is to enhance the collection efforts of creditors with state-defined property rights. Under this view, all bankruptcy laws are to be tested by whether they

\begin{itemize}
  \item \textsuperscript{297} LoPucki and Whitford believe legislation should require that reorganization management maximize the value of the estate. They propose a scheme of mandatory risk compensation payments that reduce "unfortunate" distributional effects that can create incentives for classes to oppose the maximization efforts. LoPucki and Whitford, \textit{Corporate Governance, supra} note 31, at 789-91.
  \item \textsuperscript{298} Fining managers was included in the Opinion Solicitation Draft of the Enterprise Bankruptcy Law at art. 55. \textit{See} discussion \textit{supra} Part I(G).
  \item \textsuperscript{299} It may become more difficult to find corporate managers under this proposal. Presumably, however, the managers will protect themselves with liability insurance and corporate indemnification agreements. \textit{See} Daniel H. Hogard, \textit{Liability of Directors of Chapter 11 Debtor in Possession: "Don't Look Back Something May be Gaining on You"}, 68 Am. Bank. L.J. 155, 162 (1994) (discussing the four layers of protection a director can rely on against personal liability prior to Chapter 11); and Robert M. Sedgwick, \textit{Outside Directors of Financially Troubled Companies are at Risk Despite Traditional Layers of Protection}, CORP. COUNS. WKLY., Oct. 9, 1991, at 5-8 (discussing problems encountered by directors post-bankruptcy filing).
  \item \textsuperscript{300} This presumption certainly underlies the early drafts of the Enterprise Bankruptcy Law, but is not specifically spelled out. It does exist, however, in the bankruptcy laws of other countries. \textit{See} Mark M. Jaffe, \textit{Chapter 11 Strategies and Techniques}, 59 Tul. L. Rev. 1298 (1985) (citing Article 99 of France's Bankruptcy Act of 1967).
  \item \textsuperscript{301} Preventing managers from serving in a similar capacity was included in the Opinion Solicitation Draft of the Enterprise Bankruptcy Law at art 58. \textit{See} discussion \textit{supra} Part I(G). A similar provision already exists for managers found guilty of securities fraud. Lagne W. Barnard, \textit{When is a Corporate Executive Substantially Unfit to Serve}, 70 N.C. L. Rev. 1489 (1992) (discussing the Securities Enforcement Remedies and Perry Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990)).
\end{itemize}
enhance or diminish the creditors' collective benefits. There are others who argue that the system is an attempt to reckon with a debtor's multiple defaults and to distribute the consequences. Under this view, bankruptcy policy becomes a "composite of factors that bear on a better answer to the question 'How shall the losses be distributed.'" 

One of the first tasks of the bankruptcy review commission should be to define the policies underlying reform of the Bankruptcy Code. Articulation of bankruptcy policy will affect how bankruptcy issues are posed and solved. It will also allow a comprehensive review of the system. As one commentator has written, "a clearer articulation of bankruptcy policy does not tell us if the policy has been effectively implemented, but it does identify the normative goals that are critical in deeming the system a success..." 

In formulating a comprehensive bankruptcy policy, the bankruptcy review commission should review the administration of bankruptcy cases with an emphasis on social and economic effects as well as the resolution of debtor-creditor disputes. As posited by this article, one policy to be considered is that of fostering efficient management of publicly owned companies by increasing management accountability and encouraging responsible management decisionmaking.

If bankruptcy policy is to focus on the question of how to distribute losses, then the policy of encouraging corporate efficiency by promoting management accountability is consistent with that policy. The concepts that: (1) management should not be able to utilize the Bankruptcy Code to shield itself from the financial effects of risky behavior to the detriment of other interested parties; (2) management should not retain control of a corporation under the protection of the Bankruptcy Code where it has evidenced that maximizing the value of the estate is not its primary goal; and (3) the financial effects of risky behavior should be borne by the persons responsible for incurring them, all relate to the prevention and the allocation of loss.

**CONCLUSION**

Chapter 11 was designed to maximize assets by discouraging the dismantling of corporations and encouraging the ongoing involvement of management. However, the very sections of the Bankruptcy Code that were intended to preserve assets through the involvement of management, encourage management to take unnecessary risks. Such risks, when successful, inure to the benefit of management. Unfortunately, when such

risks prove unsuccessful, they are spread among the creditor body and, ultimately, society at large.

It is time to reform Chapter 11 to implement economic policy which encourages the survival of viable corporations by encouraging responsible management. Pending legislation proposes a bankruptcy review commission to consider large-scale reform of Chapter 11. Such a commission could easily consider the alternatives outlined above as well as those suggested by an examination of the bankruptcy legislation of other developing countries seeking to thrive in a global economy. There is little to lose and much to gain.
