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# Bankruptcy and Restructuring Chapter 11 Strategies 2009

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# What Does the Current Financial Crisis Portend for Bankruptcy Reorganizations?

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**Introduction**

The National Bureau of Economic Research announced on December 1, 2008, that the United States is in a recession. It began, the Bureau said, twelve months earlier, in December 2007. At twelve months and counting, this recession has already lasted longer than the downturns in 1990-91 and in 2001 and is a mere six months shy of the 1981-82 recession. Presently, it appears the recession will last well into 2009.

While an analysis of how we got here is beyond the scope of this chapter, a review of some of the economic highlights, for lack of a better word, of the last several months may provide some perspective on what we may anticipate for bankruptcy reorganizations in the future. This chapter will therefore focus on three themes:

1. Where we are economically as of the writing of this chapter
2. How the 2005 changes to the Bankruptcy Code affected the prospects for reorganizations generally
3. Given the current economic crisis, what we can expect for reorganizations in the near term

Underlying this inquiry will be my assumption that just as the 2005 changes to the Bankruptcy Code were precipitated largely by our nation's then economic vitality, so, too, will the changes in the near term be predicated on our nation's current economic malaise. This corresponding cycle of economic vitality and malaise is shown most vividly in the rise and most recent fall of the hedge fund market.

**So Where Are We?**

*The Rise (and Fall) of Hedge Funds*

In recent years, hedge funds have come to dominate investments in large insolvency cases. With huge amounts of money at their disposal, coupled with the need for high returns and limited opportunities for such returns, hedge funds have most recently been drawn as both the savior and sometimes the nemesis of financially distressed companies.

Alfred Winslow Jones coined the term "hedged fund" in 1949. He coined the term to describe an investment vehicle that simultaneously bought and sold short sales, thus leveraging the investment's overall sensitivity to market fluctuations. Such a fund had the singular goal of providing a "hedge" against risk.

Now, however, with the remarkable panoply of such funds available:

> … [a] single definition of 'hedge fund' is extremely difficult, if not impossible to derive. The term appears nowhere in the U.S. securities laws and even people in the investment community cannot agree on a single definition.... They are not mutual funds, private equity funds, venture capital funds, or commodity pools…, [they] are exempt from coverage under the Investment Company Act of 1940 … [and they] have been able to avoid registration with the U.S. Securities and Exchange Commission …. (Rosenberg and Riela, "Hedge Funds: The New Masters of the Bankruptcy Universe," *Norton Journal of Bankruptcy Law and Practice* [Oct. 2008], 702.)

Defining hedge funds, for the most part, by what they are not, Rosenberg and Riela stated, as this chapter was being written, that hedge funds "will continue to have an enormous influence over the restructuring process for financially troubled companies." *Id.* Indeed, hedge funds were recently described by no less than *The Economist* as "the omnipotent vanguard of financial capitalism … uncompromising in their search for returns … dominat[ing] trading activity in most securities." (*The Economist* [Oct. 25-31, 2008], 83-85.)

The influence of hedge funds was depicted pictorially, as well. It was only last year when CME Group Inc. chose Citadel Investment Group founder Ken Griffin for their ads, picturing him as the embodiment of strength, traversing a wide crevasse, symbolizing the close relationship between exchanges and hedge funds, offering a pictorial representation of how hedge fund managers can traverse risk to maximize returns.

But change has come. Griffin is now fending off rumors that his hedge fund is at risk. Most recently, Griffin, along with Phillip Falcone, John

Paulson, James Simons, and George Soros, found himself testifying before the House Committee on Oversight and Government Reform. Chosen because each of them earned more than $1 billion in 2007, the men are discovering the hedge fund industry is primed for greater regulatory oversight.

The congressional concern appears justified. Massive deleveraging and a wave of hedge fund redemptions now threaten one of the most profitable income streams for equity and derivative exchanges and the largely institutional investors who invest in them. Indeed, Donald Fandetti, an analyst with Citi Investment Research, sees a worst-case scenario—where the hedge fund model is fundamentally broken—as the one most likely to prevail. (*Daily Bankruptcy Review* [Oct. 31, 2008], 7.)

Lancelot Investment Management put a group of its hedge funds into Chapter 7 bankruptcy in Chicago, having lost more than a billion dollars from the collapse of the alleged corporate pyramid scheme created by Minnesota businessman Tom Petters. According to Chicago-based Hedge Fund Research, by the end of the third quarter 2008, hedge fund investors overall have pulled out an estimated $31 billion, shrinking the industry's assets by 11 percent to $1.72 trillion. And as an example of how far they've come, Barclay Capital recently attempted a sale of $4.5 billion of debt and derivatives on behalf of a U.S. hedge fund client. The sale reflected barely a ripple in the markets, with portfolio managers in Europe and the U.S. saying there was little evidence that the debt for sale traded. (*Daily Bankruptcy Review* [Oct. 31, 2008], 8.)

Hedge funds, two months ago the so-called masters of the universe, will likely face a failure rate of 25 to 30 percent. See www.telegraph.co.uk/finance (accessed Oct. 27, 2008). (Emmanuel Roman, of GLG Partners, has said 25 percent to 30 percent of the world's 8,000 hedge funds would "disappear 'in a Darwinian process,' either going bust or deciding meager profits are not worth their efforts. This will go down in the history books as one of the greatest fiascos of banking in 100 years.") Those views were reportedly echoed by Professor Nouriel Roubini, a former U.S. treasury and presidential adviser, who estimated that up to 500 hedge funds would fail within months. *Id.* Indeed, *The Economist* has predicted that the failure rate of hedge funds could be as much as 50 percent. *The Economist, supra.*

"The typical [hedge] fund has fallen [in value] by almost a fifth so far this year. 'Convertible arbitrage' funds—which try to exploit price anomalies among corporate bonds—have lost a staggering 46%." (*The Economist*, *supra*.) And the carnage has reportedly been indiscriminate with hedge funds losses in Asia, as well as in London and the United States.

*Additional Fallout from the Financial Crisis*

But, large as it is, the dire market for hedge funds is but one aspect of the financial meltdown. On a global front, currency values are, for the most part, at historic lows. Europe is reportedly on the "brink of a currency crisis meltdown" (www.telegraph.co.uk/finance, accessed Oct. 27, 2008).

"This is the biggest currency crisis the world has ever seen," said Neil Mellor, a strategist at Bank of New York Mellon, and credit worldwide has tightened to unprecedented levels, causing interest rates to rise and convincing countries across the globe to lower their own interbank rates. The federal funds rate in the United States now stands at 1 percent, and Ben S. Bernanke, the Federal Reserve chairman, indicated in a speech that he is inclined to continue cutting interest rates further, though would look for other ways to stimulate the economy, as well.

Unemployment in the United States is currently over 6 percent and expected to rise further still to 8 percent and perhaps even 10 percent by the end of 2009. The impact on the consumer has driven a spike into the heart of industries worldwide, from the travel to the retail industries. Banks are failing, Washington Mutual and IndyMac being among the largest, and U.S. consumers lost more than $2 trillion as the Dow fell 42 percent in value from its October 9, 2007, high to an October 27, 2008, low. (Waggoner, "Is Today's Economic Crisis Another Great Depression?," *USA Today*, Nov. 5, 2008.) The staggering amount of losses realized has caused some to compare the current economic crisis to the genesis of another depression. At that time, the Dow plunged 47 percent from September to November 1929. But while most have said this downturn will likely mirror the 1990-91 recession, even Merrill Lynch's CEO reportedly compared our future to that of 1929.

California is experiencing a staggering $28 billion shortfall. Forty other states are running budget deficits. Two California cities, Rio Vista and Isleton, are weighing the prospects of Chapter 9 bankruptcy amid budget shortfalls and unprecedented debt loads. Reuters has reported, citing Meredith Whitney, an analyst at Oppenheimer & Co., that the U.S. credit card industry may well pull back over $2 trillion of consumer credit lines over the next eighteen months because of risk aversion, inexorably leading, she says, to sharp declines in consumer spending. This pull-back will result, says Whitney, in the closure of millions of credit card accounts, cutting credit lines, and raising interest rates.

The anticipated downturn in the commercial mortgage market, too, affected by the lockdown in the credit markets, will likely be worse than it was in the early 1990s. Mike Kirby of Green Street Advisors, anticipates that within the next few years, commercial property values will have declined 35 percent, perhaps as much as 45 percent, from their 2007 peak. Real estate investment trusts, in the lodging and resorts sector, are currently down by 64.8 percent, according to the National Association of Real Estate Investment Trusts. The industrial and office sector is a close second, falling 63.9 percent, and retail is down 57.9 percent.

And it all began with the subprime housing mortgage market.

Subprime housing market mortgage instruments, chopped up, as they were, into securitized investment vehicles and hedged for default through the use of arcane instruments called credit default swaps, were rolled up and, ultimately and incredibly, valued by the ratings agencies as investment-grade securities. Because the vehicles were sold as soon as they were written, it made little difference to the originating banks as to the financial viability of the mortgagee. The value, at first, lay in the escalating prices of the mortgage collateral. Given the returns, institutional investors took all they could get.

The mortgage market was initially driven by the rocketing values in housing. Those values were pushed up by the exponential increase in the demand for housing, driven by U.S. government policies designed to make housing more available and affordable. The housing demand was further fueled by the globally low interest rates and the unprecedented availability of credit.

As the housing bubble continued to grow, the demand for the mortgage investment vehicles, graded on a scale that quickly had no relationship to the value of the homes or the financial viability of the home buyers, soon became fueled, not by the value of the collateral at the root of the underlying mortgages, but by the sheer demand for the mortgage investment vehicles themselves. And in the unlikely event of a default, why, defaults were hedged by the credit default swap market, which, at its zenith, was valued in the trillions of dollars and held by institutional investors worldwide. So when the housing bubble burst, the effect was global.

TransUnion LLC recently reported that the number of consumers with delinquent mortgages will likely double by the end of 2009 over current thresholds, hitting its highest level in at least sixteen years, according to the *Wall Street Journal.* TransUnion predicted that the proportion of consumers with mortgages that are sixty days or more past due will hit 7.17 percent in the fourth quarter of 2009. That would be the highest level reached since TransUnion first started tracking these statistics in 1992. It compares with an expected delinquency rate of 4.67 percent at the end of 2008.

Thus, some lenders, under substantial pressure from lawmakers and prodded by lawsuits from borrowers, have begun programs to modify their mortgage loans. However, that road may be a difficult one for securitized mortgages. Countrywide Financial Corporation, recently acquired by Bank of America, entered into a settlement with various states, agreeing to modify up to 400,000 loans and to provide $8.4 billion in relief to borrowers to settle accusations of predatory lending. *The New York Times* has reported, however, that Greenwich Financial Services has sued the lender, claiming that "under contracts governing 374 Countrywide mortgage trusts, the company must purchase at face value any mortgage that it modifies." *The New York Times* (Dec. 2, 2008). William Frey, president of Greenwich Financial, has reportedly estimated that $150 billion in securitized mortgages could be covered by the requirement. *Id.*

So stock markets around the world are now down to historic lows. Industries that are dependent on commercial paper to fund their daily operations, like the U.S. automotive industry, have experienced plummeting sales as credit becomes priced so high it is virtually unattainable. Other industries, dependant for their financing on the $750 billion junk bond market—a vital source of financing for the country's car makers, airlines, retailers, utilities, restaurant chains, and media companies—were locked out of the market in November 2008 because of yields running 20 percent or more, triple the historic 7 percent threshold, making it too expensive to borrow. As a result, their stocks, too, have been battered, and in the case of the domestic car makers, to lows not seen since the 1950s.

Trillions in pension funds have evaporated like the rolling fog on a fall morning, and prospects for recovery are at best disheartening. Unable to cajole the U.S. government to bail it out, Lehman Brothers Holdings filed Chapter 11, the largest Chapter 11 in U.S. history. AIG, itself a purveyor of the mortgage hedging market, avoided bankruptcy but has borrowed more than $100 billion from the federal government, hog-tied, as it were, to credit default swap vehicles.

> When credit default swaps first appeared in the early 1990s, they were used primarily by banks to hedge the default risks they faced in their own loan portfolios. But by the late 1990s, the use of these swaps had spread to the larger credit market. Two Deutsche Bank researchers could therefore write that 'credit derivatives are no longer an exotic corner of the bond market but must now be considered a market in its [sic] own right.' By the end of 2006, the International Swaps and Derivatives Association (ISDA) estimated that the overall credit derivatives market had grown to $34.4 trillion and was most recently estimated as having a market share of $62 trillion. (Stephen Lubben, "Credit Derivatives and the Future of Chapter 11," 81 *Am. Bankr. L.J.* 405 [2007].)

Alan Greenspan, now criticized for his role in the current "credit crunch," once described credit default swaps as "the most important instrument I've seen in decades." (See Greenspan's address at the Bond Market Association [May 19, 2006], as quoted in Lubben, *supra.*) Currently, their efficacy has come under increasing scrutiny.

The Federal Reserve has cut interest rates nine times since the credit crisis began. And faced with what was then perceived as the very real prospect of a stock market crash, the U.S. Congress reluctantly granted the Treasury Department unbridled discretion to spend upwards of $700 billion under the newly created Troubled Asset Relief Program (TARP). Although TARP was initially designed to buy troubled assets from financial institutions, Treasury Secretary Henry S. Paulson decided to recapitalize the banks instead. While the idea was to provide the banks with greater liquidity, giving them the resources needed to begin loaning money again, no legislative mandate for the use of the bailout funds was included in the legislation. One change that was included that went largely unnoticed, in addition to the bailout funds, was a tax revision giving a $140 billion tax break to the banks.

As a result, the bailout funds went largely to upgrading the banks' balance sheets or, utilizing the new tax break, providing unfettered funds for the consolidation of the industry. One byproduct of the bailout that could easily have been predicted is an avalanche of industries, from the automotive to home building to the retail industries, holding out their hands for their fair share of additional federal funds.

Although TARP was initially proposed with no oversight, Congress included in the TARP legislation an independent inspector general and an oversight board appointed by both political parties to provide checks on the Treasury's use of the funds. Elizabeth Warren, the chairwoman of the oversight board, said in an interview, reported in the December 2, 2008, *New York Times*, that despite the massive amount of capital pledged and at risk, the federal government still does not seem to have a coherent strategy for the bailout. Instead, it is "lurching from one tactic to the next…."

Most recently, Sheila Bair, chairwoman of the FDIC (Federal Deposit Insurance Corporation), has proposed a plan that would prevent 1.5 million foreclosures, which is modeled after a program implemented by IndyMac after its takeover. In the face of record losses, Ben Bernanke issued a plan that would pledge $100 billion to buy the debt held by Fannie Mae and Freddie Mac and an additional $500 billion to buy mortgage-backed securities guaranteed by those institutions.

The bailout has now resulted in the United States treasury having promised various industries and institutions more than $7 trillion in the aggregate in cash, loan guarantees, and stock purchases.

Notwithstanding the inflationary potential in that astronomical figure—all of it borrowed—David Rosenberg, Merrill Lunch's chief U.S. economist, has reportedly opined that the United States is headed toward a deflationary period in the second quarter of 2009 (www.telegraph.co.uk/news/worldnews/northamerica/usa, accessed Oct. 27, 2008), thereby prolonging the economic malaise. And while unlikely, discussion has even centered on the prospects of a very real depression. See e.g., John J. Xenakis, *Generational Dynamics: Forecasting America's Destiny*, Xenakis Publishing (2003). The author states unsparingly that generational trends and standard trend forecasting techniques lead to an inexorable conclusion that the United States is entering a 1930s-style depression.

Similarly, an article written by N. Gregory Mankiw called "But Have We Learned Enough," published in the October 26, 2008, edition of *The New York Times*, notes parallels between our current economic crisis and the 1930s deflationary spiral. Citing a study written in 1988 by economists Katheryn Dominguez, Ray Fair, and Mathew Shapiro titled *Forecasting the Depression: Harvard Versus Yale,* the researchers conclude that the forecasters at the time were caught completely by surprise by both the severity and the length of the Great Depression. Mr. Mankiw states, "What's worse, despite many advances in the tools of economic analysis, modern economists armed with the data from the time would not have forecast much better. In other words, even if another Depression were around the corner, you shouldn't expect much advance warning from the economics profession."

*Bankruptcy's Role in the Financial Crisis*

Bankruptcy practitioners have long been predicting a bankruptcy tsunami, as it were—if not of unprecedented proportions, at least rivaling that of the late 1980s and early 1990s. But despite an uptick in bankruptcy filings, such prognostications have not come to pass—yet.

To restructure a company in bankruptcy, the company needs ready access to capital at a reasonable cost to affect its purpose. Money is needed to pay the investment banks, the lawyers, the restructuring consultants, the lenders, the vendors, the creditors, both secured and unsecured, and, in extremely rare cases, those who hold the equity. Given the tightening of the credit markets, the substantial rise in the cost of funds, and the sudden refusal of banks worldwide to lend to each other—let alone to third-party businesses, concerned as they are with the value of the collateral upon which the loans rely for repayment—there is a current unavailability of financing at a reasonable price for even the most basic of business needs.

As values continue to fall for the underlying collateral, lending becomes riskier still. And while the credit markets have begun to loosen and will surely recover, the Bankruptcy Code itself, in its present configuration, coupled with the unprecedented liquidity crisis, currently doesn't support the restructuring process.

**How Does the Bankruptcy Code Affect the Prospects for Reorganization?**

In its more than one-hundred-year history, the power of the Bankruptcy Code to control the formal restructuring process in the United States has shifted from creditor-managed railroad reorganizations of the nineteenth century to the Chandler Act of the New Deal, to the debtor-controlled Chapter 11 cases of the 1980s and, most recently, back once more to creditor control of the process. See e.g., Douglas G. Baird and Robert K. Rasmussen, "The End of Bankruptcy," 55 *Stanford Law Review*, 751 (2002). That creditor control of the restructuring process and the loss of liquidity caused by the current crisis have resulted in more companies that file for bankruptcy shutting down simply because they cannot obtain the financing necessary to operate during their reorganization. (Jonathan D. Glater, "Advantage of Corporate Bankruptcy Is Dwindling," *The New York Times* [Nov. 19, 2008].)

Examples abound: Linens 'n Things, which has been in bankruptcy since May 2008, is now liquidating its inventory, having suffered a loss of credit. Steve and Barry's, the East Coast-based retailer, was bought out of bankruptcy, but three months later it is now back in, this time in a liquidation. Mervyn's announced it would liquidate. The Bennigan's chain of restaurants, which also held the Steak and Ale brand, simply closed its doors on a Sunday night, leaving employees, landlords, vendors, and a host of other creditors, in the dark on Monday morning.

While the pace of bankruptcy filings is on the rise, propelled certainly by the credit crisis, the numbers are lower than one would expect. "The number of corporate filings rose last year to 28,322, but that is the second lowest number of corporate filings since 1980, according to the American Bankruptcy Institute." *Id.* Indeed, "true reorganizations, in the spirit of the bankruptcy code are becoming extremely rare," says Sandra Mayerson, a lawyer at Holland & Knight in New York.

As a result, prior to the most recent credit crisis, bankruptcy reorganizations were down more than 50 percent in 2006, and restructuring outside of the federal courts, through the use of state law or agreements among debtors and creditors alike, had increased. Nevertheless, the credit problems are substantially affecting the markets in 2008 and will likely continue to do so into 2009 and 2010. It is thus difficult to perceive in the present atmosphere how the bankruptcy courts will not see a substantial increase in case loads.

As an example, *Bankruptcy Law360* recently reported that the Bain Corporate Renewal Group has predicted an increasing number of defaults on speculative grade debt. This default rate could result in more than one hundred companies with a market capitalization more than $100 million filing for bankruptcy in each of the next two years. Bain CRG also reportedly said it expects to see the number of bankruptcies of $100 million companies to be between ninety-five and 120 in 2009 and marginally fewer in 2010, as the current recession takes hold.

The current liquidity shortfalls, which hedge funds, private equity investors, other institutions, and consumers alike have been experiencing over the last twelve months, have exacerbated the problem. But it is likely, given the extraordinary lack of liquidity and the fundamental changes wrought by the most recent amendments to the Bankruptcy Code, that the increase will be not in business reorganizations, but in liquidations—a perhaps unintended consequence of the 2005 amendments, a development that will likely create a substantial drain on the economy's recovery. The changes to the Bankruptcy Code, wrought by Congress in 2005, have made the current situation worse.

*The Most Recent Changes Wrought*

Ostensibly intended to curb perceived abuses by both debtors and their professionals, in 2005 Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Those amendments to the Bankruptcy Code have, perhaps unintentionally, made it more costly to reorganize and more difficult—and more expensive—for existing management to control the debtor company's destiny.

A Shorter Exclusivity Period

Under Section 1121 of the Bankruptcy Code, a debtor had the exclusive right to file a plan of reorganization during the first 120 days following the filing of a bankruptcy petition and a concurrent 180 days to solicit acceptances of that plan. Courts, under the former statute, had great discretion to extend the time further beyond the respective four- and six-month periods. Indeed, large corporate debtors routinely asked the courts for several extensions to complete the groundwork necessary for filing and soliciting a confirmable plan.

However, under new Section 1121(d)(2), the debtor's 120-day period to file a plan may not be extended beyond eighteen months, and acceptance must be undertaken before the expiration of twenty months.

For smaller business cases, those involving debts of $2 million or less, the new exclusivity period is even shorter. Those debtors have 180 days to file their plans of reorganization unless extended by the court for cause. Even if extended, the plan must be filed within 300 days. Some courts have interpreted the shorter exclusivity period with even harsher results.

In *In re Florida Coastal Airlines Inc.*, 361 B.R. 286 (Bankr.S.D. Fla. 2007), the debtor filed its plan of reorganization within the 300-day exclusivity period but filed its amended plan after the exclusivity period expired. Contemporaneously, a creditor that had unsuccessfully tried to acquire the company before the company's bankruptcy filed a competing plan. Although the court found that the debtor's plan "related back" to the date of the filing of its original plan, thus presumably preserving the debtor's exclusivity, the court nevertheless denied the debtor its exclusivity, allowing the competing plan to compete for creditor votes. Thus, the debtor, although filing within the allotted time, was nevertheless effectively divested of its control of the reorganization process.

New Requirements for Creditors' Committees

Section 1102(b)(3) has imposed new duties on creditors' and other committees. The new section requires committees to offer access to information to those creditors whom the committee represents who are not on the committee, to solicit their comments, and subjects the committees to court orders that may compel additional reporting or disclosure requirements.

In *In re Refco Inc.*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006), the unsecured creditors committee, concerned rightly that the new law might be interpreted as imposing an obligation on the committee that would be contrary to the committee's fiduciary duties and existing law, sought an order from the court limiting the information it had to provide. The court held that the duty to provide information is not unlimited and that the committee would not be required to disclose confidential, nonpublic, or proprietary information, the disclosure of which could reasonably result in a general waiver of the attorney-client or other privilege or whose disclosure could violate an agreement, order, or applicable law. Procuring a *Refco*-type order has since become one of the first obligations of a committee in a bankruptcy case. The procurement of such orders has nevertheless made the reorganization process needlessly more expensive.

New Claims for Suppliers

A new administrative expense was created by BAPCPA for those who sold goods to the debtor within twenty days of the bankruptcy filing date. New Section 503(b)(9) provides for the allowance of an administrative expense claim for the value of goods sold and received by the debtor in the ordinary course of its business within twenty days before the commencement of the case.

BAPCPA also increased the reclamation rights of a seller of goods under Section 546(c). Now the seller may make a written reclamation demand to the debtor for goods received from ten to forty-five days after receipt, or twenty days after the case was filed if the forty-five-day period expires after the bankruptcy is initiated. The new section provides that even if the seller does not make the written demand, it may still assert a right to a claim under new Section 503(b)(9).

Unlike Section 503(b)(9) claims, however, Section 546 reclamation claims are subject to prior security interests in the goods. Courts have therefore held that "if the value of a reclaiming supplier's goods does not exceed the amount of the debt secured by the prior lien, the reclamation claim is valueless." *In re Dana Corp.*, 2007 WL 1199221 (Bankr. S.D.N.Y. 2007). In both *Dana* and *In re Advanced Marketing*, 360 B.R. 421 (Bankr. D. Del. 2007), reclamation claims were denied when the goods were subject to prior liens, and post-petition financing agreements did not extinguish, but rather reaffirmed, the lenders' first-lien positions.

In addition to increasing the priority of suppliers' claims, the *Dana* court noted as an aside that the statutory expansion of the reclamation period will be more costly to the debtors and may increase the likelihood of early administrative insolvency. The result will be that debtors will invariably need greater financial resources to achieve their reorganization.

And there are others. Swap agreements are not subject to the automatic stay. Thus, notwithstanding the "breathing period" originally envisioned by the framers of the Code, swaps can be sold, traded, or declared to be in default, notwithstanding the imposition of bankruptcy. As a result, any right to terminate, liquidate, or accelerate a swap agreement "or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration" of swap agreements is not stayed. Provisions increasing the burdens on a debtor associated with the assumption or rejection of executory contracts or leases have also made reorganization more costly and have marginalized the debtor's control of the process.

Many of the changes, such as those mentioned above, have needlessly resulted in the reduction in the debtor's control of the reorganization process, have divested the debtor of the benefits of the automatic stay in some cases, have increased the costs associated with such reorganizations, and have added priority claims that did not exist previously.

## What Can We Expect from Here?

Some trends in bankruptcy law or practice can be predicted with relative certainty; others less so. Among those that can be predicted with some degree of certainty are changes that have been proposed but not yet implemented. Most of those arise from the difficulties that consumers are currently facing and that do not normally arise in Chapter 11 reorganizations. Among those are the modification of mortgages affecting principal residences and the definition of the so-called means test. Notwithstanding their tenuous relationship to Chapter 11, I will discuss them briefly below.

Among trends or changes that are less certain are those resulting from the profound systemic changes in the country's economic future, the reaction to these changes that may resonate in Congress, and the impact those changes may have on the balance of power in the restructuring arena.

*Changes to Section 1322(b)(2)*

Among changes that are more or less certain on the consumer side of the bankruptcy equation is the change that will likely occur in Section 1322(b)(2). Currently Section 1322(b)(2) prohibits Chapter 13 debtors from modifying first mortgages on their principal residences. While debtors may propose plans that modify mortgages on second homes, personal property, automobiles, vacation homes, rental property, and investment or commercial property, the rational for prohibiting the modification of first mortgages on principal residences is that it would make lending more uncertain, thereby driving up interest and mortgage costs. The argument fundamentally is that the changes sought would ultimately hurt the people the law was ostensibly intended to protect. Given the substantial increase in defaults and foreclosures, however, such arguments sound hollow. Indeed, with mortgage foreclosures at an all-time high, such arguments seem vacuous.

Several bills were introduced in the 110$^{th}$ Congress that would allow some modification of mortgages encumbering principal residences. Among the bills introduced were:

- HR 3609, the Emergency Home Ownership and Mortgage Equity Protection Act
- S 2133 and HR 3778, the Home Owners Mortgage and Equity Savings Act
- S 2136, the Helping Families Save Their Homes in Bankruptcy Act
- S 2636, the Foreclosure Prevention Act of 2008

Each of the bills has benefits and detriments. By way of example only, HR 3609, as amended, allows the cram-down of mortgages to the current fair market value of the debtor's principal residence. But there are conditions. The cram-down will be allowed only if the mortgage originated between January 1, 2000, and the effective date of the bill; the lender filed a foreclosure action against the borrower; and the Chapter 13 proceeding, filed to effect the cram-down, was filed within seven years of the bill's enactment.

Another limitation of the bill is that it applies to subprime or nontraditional mortgages only. It would nonetheless mandate a waiver of all prepayment penalties and prohibit, reduce, or delay adjustment of any variable interest rate to the prevailing rate published by the Board of Governors for the Federal Reserve System.

*Potential Modification of "The Means Test"*

Recently, an empirical study was commissioned to answer the question of why the number of bankruptcies has declined. See e.g., Lawless, *et al.*, "Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors," 82 *Am. Bankr. L.J.* 349, 385-86 (2008). The authors conclude that part of the reason can be found in the means test for filing Chapter 7 bankruptcy. The authors state:

> The principal feature of the [2005] amendments [to the Bankruptcy Code] was an income-based screen that was supposed to differentiate can-pay debtors from their can't-pay counterparts. The data suggest that this failed: there is no differentiation based on income, either for the sample [taken by the authors] as a whole or from the division of families into Chapter 7 and Chapter 13. Instead, the data suggest that the incomes of the families filing for

> bankruptcy after the amendments are indistinguishable from the incomes of the families filing for bankruptcy before the amendments.
>
> By its own design, the means test focused on income. It did not take account of the overall financial condition of debtors; net worth and debt-to-income ratios were irrelevant to the new law. While secured debt received some favorable treatment, the size and impact of unsecured debt loads, such as credit card and medical debt, were largely ignored. With only slight exceptions, families that owe a little and families that owe a lot of unsecured debt are equally eligible for Chapter 7 relief once they have survived the income-based means test… After the [2005] amendments, families filing for bankruptcy owe more debt, particularly more unsecured consumer debt, than their counterparts from 2001…. The higher debt-to-income ratios … suggest that Americans are struggling harder than ever before they collapse into bankruptcy… [indicating] that families are not turning to bankruptcy even when they have great need. This is a result Congress neither intended nor promised.

While it is difficult to anticipate what may happen in Congress in response to such a study, it is safe to predict that such studies provide a catalyst for change. Thus, while the timing may be something that is unpredictable, it is likely that at some point the means test for filing Chapter 7 may be revised to make bankruptcy relief a realistic alternative for those families in financial trouble.

**Reorganization as a Construct**

It has become axiomatic that Chapter 11 reorganization is not what it purports to be. As an initial matter, the success ratio of Chapter 11 cases, while not easily quantifiable, is historically low. More cogently, however, as has been noted by some commentators (See Chad P. Pugatch *et al.*, "The Lost Art of Chapter 11 Reorganization," 19 *U. Fla. J. L. & Pub. Pol'y* 39 [2008].), while there are innumerable reasons a Chapter 11 reorganization may be filed, from a strategic way to delay creditors, to achieve negotiating leverage, "the provisions of Chapter 11 have been adapted by creative lawyering and judicial willingness to consider flexibility over time to meet the evolving needs of the marketplace…. The occurrence of a paradigm 'reorganization' in which a confirmed plan of reorganization results in a debtor emerging from the ashes of its prepetition tribulations in phoenix-like fashion has more or less become the exception, rather than the rule." *Id.* at 53.

Thus, Chapter 11 is being used, for the most part, not as a tool to restructure a company's obligations, but as a vehicle to effect a short-term solution to the financial problem: to effect a sale of all or part of the company's assets, to quickly satisfy the demands of the secured lender. Chapter 11 bankruptcy has established the unique concept of a "liquidating plan of reorganization," and in the process has propounded confusing tests of subject matter jurisdiction arising from the implementation of liquidating trusts overseen by bankruptcy courts long after the plan has been confirmed.

BAPCPA ushered in a host of changes that increased the costs of reorganization and marginalized the control a debtor needs to restructure its obligations. For a more comprehensive discussion of the significant business provisions of BAPCPA, see Richard Levin, *et al.,* "The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005," 79 *Am. Bankr. L.J.* 603 (2005). But the changes wrought by Congress have made Chapter 11—as it was originally envisioned, where a company can restructure its obligations to arise from its tribulations in phoenix-like fashion—a much more difficult process. As noted by Judge Lynn in *In re General Electrodynamics Corp*:

> Congress enacted provisions favoring special classes of creditors to the exclusion of all other considerations. Thus, in amending, for example, Sections 365, 366, 1121 or the Code, Congress has presumably intentionally, made [C]hapter 11 much less suitable as a remedy than it was before BAPCPA became effective. Companies such as Kmart, Mirant Corp. and United Airlines, all of which have survived through use of [C]hapter 11, very likely could not restructure effectively under the Code since the passage of

> BAPCPA. (*In re General Electrodynamics Corp.*, 368 B.R. 543, 549 (Bankr. N.D. Tex. 2007)).

Congress may revisit some of the 2005 changes to the Bankruptcy Code. With a Congress that facially seems more consumer-oriented, it is likely that the Code will be amended. There will be other changes, as well. Among changes that may be discussed in Congress and elsewhere are those involving more systemic issues. When Lehman Brothers was "allowed" to fail, it created a wave of profound problems that the federal government was loath to repeat. As a result, when AIG was threatening the same, it was propped up, at a cost, but regardless of the price tag. The question is simple; the answer is not: with General Motors, Chrysler, Lehman Brothers, Goldman Sachs, Morgan Stanley, Citigroup, AIG, and many, many others experiencing concurrent, fundamental, and profound financial difficulties, what do you do about it? In other words, what do you do with a company that is "too big to fail?" Stay tuned. An answer may be forthcoming.

Regardless of the answer to the systemic issues affecting the economy, like the mentality at work in the hedge fund model, the extra burdens that have been sewn into the fabric of the current Bankruptcy Code seem designed to encourage a short-term, knee-jerk solution to a long-term financial problem. The current Bankruptcy Code gives the debtor an opportunity to structure a sale of its assets or affect some other form of short-term relief. The Bankruptcy Code in its current configuration does not promote the structure of a long-term solution to a business problem. The current liquidity crisis will almost surely accelerate this trend.

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- Inside the Minds: Bankruptcy and Financial Restructuring Law*, "Bankruptcy in the Airline and Travel Industries," Aspatore Books, Summer/Fall 2008*
- Inside the Minds: Bankruptcy and Financial Restructuring Law Client Strategies*, Aspatore Books, Spring 2008*
- *"A New Standard for Rule 12(b)(6),"* ABI Journal*, Dec./Jan. 2008*

- *"Procedure in Bankruptcy," "Bankruptcy and the Secured and Unsecured Creditor," "Chapter 13 Issues," and "Bankruptcy Ethics," sponsored by the National Business Institute Inc. and presented to seminar participants at Bankruptcy Fundamentals Conference, October 1999*
- *"Bankruptcy and the Secured Creditor," "Chapter 13 Issues," and "Bankruptcy Ethics," sponsored by the National Business Institute Inc. and presented to seminar participants at Bankruptcy Fundamentals Conference, Summer 1998*
- *"Everything You Should Know about Bankruptcy Procedure," sponsored by the National Business Institute Inc. and presented to seminar participants at Bankruptcy Fundamentals Conference, Spring 1997*
- *"The Arts in Education,"* Principal Magazine*, Spring 1997*
- *"Is Foreclosure Your Best and Only Option?" and "Bankruptcy and the Secured Creditor," sponsored by the National Business Institute Inc. and presented to seminar participants at Bankruptcy Fundamentals Conference, Spring 1994*
- *"Acquiring Assets of Insolvent Companies,"* Turnaround, Issues in Survival Management*, Vol. III, No. 2, Fall 1993*
- *"Property Exemptions Available in Texas," presented to seminar participants at Bankruptcy Fundamentals for Lawyers and Legal Assistants Conference sponsored by the South Texas College of Law, Continuing Legal Education, June 27-28, 1991.*

**Dedication:** *Dedicated to my wife, Elaine. I also wish to thank Robert Nachman for his insight into the structure of this chapter.*

ASPATORE