Preface

This is a short introduction to American business bankruptcy, designed for the law student, junior attorney, or even not-so-junior, non-bankruptcy or non-American attorney who wants to understand the law without necessarily becoming an expert in the field. In particular, I have written this book conscious of the fact that the reader’s time is not infinite, and thus I have worked hard to include enough to give the reader a sophisticated view of business bankruptcy, without going too far into fine detail.¹

This book is about business bankruptcy under federal law, not about state debtor-creditor law.² As a general matter, state law provides one or more mechanisms for an unsecured creditor to become a secured creditor, and as such to collect its claim from the debtor’s property.³ Thus, a contractual creditor might obtain a judgment against the debtor for breach of the contract, then give that judgment to a legal official (typically a sheriff or marshal), who goes to the debtor’s place of business to find things that can be sold to satisfy the judgment. Or the creditor might file the judgment with a governmental office and thus create a lien on the debtor’s real estate. That lien entitles the unpaid creditor to be paid when the property is sold, and might even entitle the creditor to conduct a foreclosure sale of the property.

¹ For those looking for more detail on a particular point, all of the major American online legal databases have bankruptcy treatises: Lexis (Collier’s on Bankruptcy); Westlaw (Norton Bankruptcy Law & Practice), and Bloomberg Law (the Bloomberg Law Bankruptcy Treatise). Some are also available as paper books too.
³ Debtor and creditor are terms that law students routinely stumble over: remember, the debtor is the one that owes the money; the creditor is the one that is owed the money. The debtor is in debt. Creditors can include voluntary lenders, like banks or bondholders, or involuntary creditors, like tort victims or governments (who do not get to choose their taxpayers).
State debtor-creditor law favors the diligent, so that the first creditor to get a judgment and enforce it will often recover more than later creditors. In contrast, bankruptcy provides a collective forum for all creditors (and other stakeholders), in which they can assert their claims against the debtor in a single, federal proceeding.\(^4\) For this reason, some view bankruptcy as a deviation from the natural order, as represented by state contract and property law.\(^5\)

The book primarily focuses on two chapters of the United States Bankruptcy Code – chapters 7 (liquidation) and 11 (reorganization).\(^6\) The final Chapter summarizes the Code’s chapter 15, which is of special relevance to international businesses. Many will want to refer to the Bankruptcy Code while reading this book: in the footnote, I provide a link to a free copy online.\(^7\)

Chapter 7 is a simple procedure for business liquidation. A trustee is appointed, who gathers all of the debtor’s assets, sells them for cash, and distributes the proceeds to creditors. It is mostly used by small businesses, and by larger businesses after they either attempt to reorganize or sell their assets under chapter 11. The chapter’s most economically important role may be serving as a baseline for creditor recoveries in chapter 11.

Because management is displaced with a trustee – who often has no connection with the business – chapter 7 is seen as a poor tool

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\(^4\) As explained by one well-known (former) bankruptcy professor:

I see bankruptcy as an attempt to reckon with a debtor’s multiple defaults and to distribute the consequences among a number of different actors. Bankruptcy encompasses a number of competing—and sometimes conflicting—values in this distribution. As I see it, no one value dominates, so that bankruptcy policy becomes a composite of factors that bear on a better answer to the question, “How shall the losses be distributed?”


\(^5\) E.g., Dewsnup v. Timm, 502 U.S. 410, 435 (1992) (Scalia, J. dissenting) (“a bankruptcy law has little to do with natural justice ...”). A wealth of academic scholarship is also based on the notion that bankruptcy should largely mirror state law entitlements. This body of scholarship largely rejects the notion that the Bankruptcy Clause of the Constitution gives Congress substantive powers with regard to bankruptcy.

\(^6\) The Bankruptcy Code appears in title 11 of the United States Code, to be distinguished from chapter 11 of the Bankruptcy Code itself. Thus, a formal cite to part of chapter 7 would appear as 11 U.S.C. § 707, for example. For ease, throughout this book I simply cite to the “Bankruptcy Code.”

\(^7\) https://www.law.cornell.edu/uscode/text/11 accessed 3 April 2019.
for preserving the value of the debtor's assets. But it still might be preferable to state law for winding down a business that has obviously failed. Federal law is more expensive than simply abandoning a corporation under state law, but federal law also is more transparent and might convince creditors that the debtor's shareholders are "doing the right thing."

Chapter 11 is famous as the tool for reorganizing big businesses like Sears, General Motors, Pacific Gas & Electric Co. (twice), Toys "R" Us, Trump Entertainment Resorts (twice), Adelphia Communications, Kodak, Tribune Group, Texaco, and every major American airline (save for Southwest and JetBlue, so far). One storied airline – Trans World Airlines (TWA) – filed chapter 11 three times before giving up the ghost. But chapter 11 is also a powerful tool for selling a distressed business or for liquidating it in an orderly fashion. Lehman Brothers provides a key example of that use of chapter 11, and we might even include GM, Chrysler and TWA's third bankruptcy in this category as well.

One key difference between chapter 7 and 11 is that in chapter 11, no trustee is appointed (at least not initially). Instead, the debtor's management stays in place, with the powers and duties of a trustee. This arrangement is known as the "debtor in possession" or DIP model. It is unique to the United States.

The rationale is that existing management already knows the company and can lead it into and through bankruptcy with the least disruption. In the process, the DIP can preserve the "going concern" value of the company – the extra value, beyond the liquidation value, of the debtor's assets operated as an ongoing, intact enterprise.

Imagine a company called Bogartco, which is a leading manufacturer of trenchcoats and fedoras. Trenchcoats still sell well, but fedoras have gone out of fashion, and the debts from the fedora side of the business threaten to sink the whole company. Filing a chapter 7 case would displace existing management with a court-appointed trustee who would sell the business, either as a whole or in chunks.

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8 Bankruptcy Code § 1101(1).
9 The closest parallel is found in the Canadian Companies’ Creditors Arrangement Act, R.S.C. 1985, c. C-36, or CCAA ("C-C-double A"), where the debtor stays in possession but a monitor is also appointed to provide oversight.
But Bogartco would likely shut down in the meantime, because management and most employees would be let go upon filing.

In a chapter 11 case, on the other hand, Bogartco’s CEO – call him “HB”10 – would stay around and, as the representative of the debtor in possession, attempt to negotiate a reorganization plan that would have support of the company’s creditors, shareholders, and employees. Part of that plan might include replacing HB with another CEO – after all, he presided over the company’s descent into bankruptcy – but that change would not happen on the first day of the bankruptcy case. If the creditors would rather LB take over management, they could seek to include her appointment as part of the deal.

I start the book with key features of the Bankruptcy Code that are common to both chapters 7 and 11, before turning to a more specific look at each chapter in turn. In some instances, I had to make a decision about where to place topics: for example, professionals are employed in chapter 7, but they arguably play a bigger role in chapter 11, so the reader will find a chapter on bankruptcy professionals with the chapter 11 materials.

Again, the goal is to make this easy on the reader, both in terms of time and effort. I welcome your feedback on whether I have succeeded, and what I might improve if and when I update the book.

I owe a special thanks to Thomas Green, Bob Lawless and Will Moon for their comments on early drafts of this book. My former Skadden colleague Peter Clapp is owed special and effusive thanks for not only providing extensive substantive comments, but also providing helpful stylistic and organizational comments throughout the manuscript.

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