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Addressing Perceived Abuses of Chapter 11: An 18-Month Legislative Scorecard

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Over the last 18 months, different facets of chapter 11 continue to be the topic of legislative reform, in part driven to eliminate perceived structural inequities and unfairness in a system primarily dominated by large corporate debtors, their private-equity investors and other bankruptcy insiders.[1] Most of the proposed legislation has stalled and, with the exception of some of the subchapter V rules that make it easier for small businesses to reorganize in chapter 11, is unlikely to gain traction in the near future.

"A lot of this [legislation] is not going to pass because one [political] base is going to lock the other for the time being," said **William A. Brandt** of Development Specialists, Inc. (New York) during the "Legislative Update" panel at the 2022 ABI Annual Spring Meeting (available at cle.abi.org). Nevertheless, because a great deal of bankruptcy reform legislation is still pending and commentary on perceived abuses of chapter 11 is now in the mainstream political and cultural zeitgeist, this article provides a brief retrospective on the status of key bankruptcy reform legislation.[2]

Eliminating Pre-Petition Retention Bonuses

Although there is no restriction prohibiting bankruptcy debtors from paying retention bonuses to executives prior to a bankruptcy filing, § 503 of the Bankruptcy Code prohibits such payments during the pendency of the case. Once in bankruptcy, debtors can pay their officers and directors incentive bonuses, but are prohibited from paying them retention bonuses. This has led numerous high-profile chapter 11 debtors to pay certain of their executives large retention bonuses on the eve of their chapter 11 filings.

On Oct. 12, 2021, Rep. Cheri Bustos (D-Ill.) introduced H.R. 5554, the "No Bonuses in Bankruptcy Act of 2021," which would prohibit the payment of retention and incentive bonuses to any employee that is compensated at an annual rate exceeding $250,000. In addition, H.R. 5554 would make any such bonus payment within six months of the relevant company's bankruptcy filing avoidable as a preference. Rep. Greg Steube (R-Fla.) introduced similar legislation in January 2021, which, like H.R. 5554, has stalled.[3] Rep. Bustos has said that H.R. 5554 is "about fairness and it's about looking out for those workers and making sure that those at the very top don't get a bonus for basically working at a company that's filed [for] bankruptcy."[4]

It is possible that H.R. 5554 could promote a more equitable outcome in circumstances in which unsecured creditors receive less than a full recovery or rank-and-file employees lose their jobs while the company is in bankruptcy. However, not every chapter 11 case involves this fact pattern. For example, in a pre-packaged case in which trade creditors are left unimpaired and all voting classes accept the reorganization plan, inequity of the type about which Rep. Bustos is seemingly most concerned may be less of an issue, as it is likely that unsecured creditors and employees will not be adversely affected by the bankruptcy filing to any great extent. Therefore, a modification of H.R. 5554 may be desirable to ensure that its prohibition only applies when warranted by the facts and circumstances.

Addressing "Sham" Independent Directors

Independent directors are often appointed in the restructuring context to ensure that any restructuring proposal is not the product of the board's self-interestedness. Critics argue that many independent directors are not independent, but are actually prioritizing the interests of the private-equity sponsor or law firm that had a significant hand in influencing the decision to appoint the director over the company's best interests. Critics argue that these "sham" independent directors are repeat players in large, corporate restructurings who are, in truth, appointed

1 David Skeel, "The Populist Backlash in Chapter 11," Brookings Inst. (Jan. 12, 2022), *available at* brookings.edu/research/the-populist-backlash-in-chapter-11 (unless otherwise specified, all links in this article were last visited on May 26, 2022).

2 This article is current as of June 17, 2022, and does not reflect legislative developments that may occur thereafter.

3 H.R. 428, the "No Bonuses Ahead of Bankruptcy Filing Act of 2021." *See also* Maurice "Mac" VerStandig, "House Bills Aim to Curtail Executive Bonuses," XLI *ABI Journal* 3, 8-9, 48, March 2022, *available at* abi.org/abi-journal.

4 Maria Chutchian, "Bill Introduced in Congress to End Executive Bonuses in Bankruptcy," Reuters (Oct. 13, 2021), *available at* reuters.com/legal/transactional/bill-introduced-congress-end-executive-bonuses-bankruptcy-2021-10-13.

time and again to implement a preordained outcome to the benefit of certain stakeholders.

On Oct. 20, 2021, a group of Democratic senators including Elizabeth Warren (D-Mass.) and Bernie Sanders (D-Vt.) introduced S. 3022, the "Stop Wall Street Looting Act of 2021," which takes aim at some of the perceived abuses within the current independent director framework.[5] Specifically, the bill gives a committee of unsecured creditors the exclusive right to pursue avoidance actions, causes of action against directors and officers, and fraudulent-transfer claims on behalf of the estate under certain circumstances. Currently, that right sits with the debtor's board and existing management.

Assuming, for the sake of argument, that "sham" independent directors are a systemic and pervasive issue that requires legislative action, the Stop Wall Street Looting Act of 2021 seems to trade the potential for one conflict of interest for another. It places the right to bring estate claims on behalf of all stakeholders that have an interest in the estate in the hands of an inherently self-interested group (*i.e.*, those who are tasked with looking out for the interests of only unsecured creditors). A committee could use this exclusive power to further its own purposes at the expense of other stakeholders given that it has no fiduciary duty to maximize value for the estate. Therefore, if a party other than the debtor-in-possession is given the exclusive right to bring estate claims pursuant to this or any future legislation, shouldn't it be a neutral third party charged with maximizing value for the entire bankruptcy estate?

Facilitating Small Business Chapter 11 Cases Under Subchapter V

When the Small Business Reorganization Act took effect on Feb. 19, 2020, qualified small businesses with noncontingent, liquidated debts of less than or equal to $2,725,625 could elect to file a subchapter V chapter 11 case. The subchapter V rules eliminate a significant portion of the administrative cost and burden associated with other chapter 11 cases. On March 27, 2020, the Coronavirus Aid, Relief and Economic Security Act of 2020 became law and increased the debt limitation for subchapter V treatment to $7.5 million until March 27, 2021. This increased debt ceiling was subsequently extended for another year and expired on March 27, 2022.

On March 14, 2022, U.S. Senate Majority Whip Richard Durbin (D-Ill.), Sen. Charles Grassley (R-Iowa) and others introduced S. 3823, the "Bankruptcy Threshold Adjustment and Technical Corrections Act," which would have permanently increased the qualifying debt ceiling to $7.5 million.[6] On April 7, 2022, the bill was amended to include a two-year sunset on the increased debt ceiling. The amended legislation was passed by the Senate on April 7, 2022, and by the House on June 7, 2022. As of June 17, 2022, the legislation is awaiting President Joe Biden's approval.

In addition to effectively reinstating the $7.5 million subchapter V debt ceiling for another two years, Congress should consider amending the subchapter V rules to provide more specificity around what it means for a debtor to have "noncontingent" and "unliquidated" debts of $7.5 million. As presently drafted, the rules provide that would-be debtors with significant litigation liability can effectively opt in to subchapter V by assigning a much lower nominal value to their otherwise-unliquidated debts than is appropriate.

For example, in the recent *Infowars* chapter 11 case, the debtors filed their subchapter V case just days before the damages phase of certain state court litigation commenced.[7] According to the motion to dismiss filed by the office of the U.S. Trustee, this allowed the debtors to avoid a state court ruling that would liquidate the value of the litigation liability so that they could then claim, for purposes of their bankruptcy filing, that the value of their aggregate debt falls below the subchapter V threshold.[8] Whether or not the U.S. Trustee's motion to dismiss provides an accurate description of the *Infowars* debtors' legal strategy, there is a strong argument that the potential for this sort of gamesmanship should be disallowed by legislative mandate.

Reducing Chapter 11 Forum-Shopping

On June 28, 2021, Reps. Zoe Lofgren (D-Calif.) and Ken Buck (R-Colo.) introduced H.R. 4193, the "Bankruptcy Venue Reform Act of 2021," to prevent "forum-shopping" in bankruptcy cases. On Sept. 23, 2021, Sens. Warren and John Cornyn (R-Tex.) introduced a companion bill in the Senate.[9] The legislation defines "forum-shopping" as the practice of "companies filing for bankruptcy outside of their home district — the district in which the principal place of business or principal assets of the company is located." It also suggests that forum-shopping makes it difficult for small stakeholders to meaningfully participate in bankruptcy cases and deprives U.S. district courts and U.S. courts of appeals from contributing to the development of bankruptcy law in those jurisdictions in which few large chapter 11 cases are filed.

The proposed legislation seeks to revise 28 U.S.C. § 1408 to eliminate a non-individual debtor's ability to file for bankruptcy in the district in which it is domiciled, eliminates a non-individual debtor's ability to file for bankruptcy in the jurisdiction in which an affiliate has a pending case unless the affiliate is the would-be debtor's direct or indirect parent, and requires debtors to prove by clear and convincing evidence that venue is proper if a venue dispute arises. The current venue rules permit a debtor to file for chapter 11 in any jurisdiction in which it has its principal assets, principal place of business or domicile, or where any of its affiliates currently has a bankruptcy case pending.[10]

It is difficult to overstate the practical effect that this venue-reform legislation would have on chapter 11 practice for large cases. Eliminating the possibility of filing for bankruptcy in a debtor's domicile or where a nonparent affiliate's case is pending would likely leave many large business debtors unable to file in the jurisdictions in which most large chapter 11 cases are filed these days: the Southern District of

5 A similar version of the bill was introduced in the House on the same day that the Senate bill was introduced. *See* H.R. 5648. *See also* Mahlon Mowrer, "Restarting the Stop Wall Street Looting Act," XLI *ABI Journal* 1, 8-9, 86-87, January 2022, *available at* abi.org/abi-journal.

6 For further details, *see* Patrick Dorsey, "Senate's Proposed Bankruptcy Threshold Adjustment and Technical Corrections Act," XLI *ABI Journal* 5, 10-11, 95, May 2022, *available at* abi.org/abi-journal.

7 *InfoW LLC, et al.*, No. 22-60020 (Bankr. S.D. Tex. April 17, 2022).

8 Motion of the U.S. Trustee to Dismiss Debtors' Chapter 11 Case [Docket No. 50] at ¶ 48.

9 S. 2827. Similar legislation had been introduced in the Senate in 2018, 2019 and 2020.

10 28 U.S.C. § 1408.

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Texas, District of Delaware, Southern District of New York and Eastern District of Virginia. Critics of the Bankruptcy Venue Reform Act of 2021 argue that diverting cases from these jurisdictions may lead to less certain outcomes for debtors, creditors and other parties-in-interest. On the other hand, there may be some truth to the argument that retirees, employees and other small stakeholders are underrepresented in large chapter 11 cases. One wonders whether there is a legislative solution to address the legislators' concerns without doing violence to the current venue rules.

Limiting Nonconsensual Third-Party Releases

On July 28, 2021, members of the U.S. House and Senate introduced the "Nondebtor Release Prohibition Act of 2021" (NRPA).[11] On Nov. 3, 2021, the House Judiciary Committee voted to allow the bill to go to the full House for consideration. The Senate companion bill is still awaiting consideration by the Senate Judiciary Committee, although Sen. Durbin is a co-sponsor of the legislation. In addition to its blanket prohibition on nonconsensual third-party releases, the NRPA would require a releasing party to provide affirmative written consent before a third-party release could be approved on a consensual basis.

The NRPA dovetails with recent decisions that cast doubt on the propriety of nonconsensual third-party releases[12] and the notion that consent can be demonstrated by a releasing party's inaction.[13] Prior to these decisions, some courts had approved nonconsensual third-party releases in rare circumstances,[14] and bankruptcy courts in at least the Third and Fifth Circuits still routinely approve consensual third-party releases where the releasing party fails to opt out or otherwise object to the chapter 11 plan.[15]

In general, the NRPA would significantly curtail the number of third-party releases provided in most chapter 11 cases. This could potentially make parties that otherwise would have received a third-party release less willing to support a chapter 11 plan. There is some argument that the NRPA will not work to reduce the most meaningful third-party releases. For example, there could be a situation in which a significant economic party-in-interest may have sizable claims and causes of action against a debtor's directors and officers that it is willing to give up in order to reach a global resolution with respect to the debtor's restructuring.

Abolishing the "Texas Two-Step"

The NRPA also takes aim at the "Texas Two-Step": a prebankruptcy series of corporate organizational transactions pursuant to Texas's divisive-merger statute whereby a "goodco" is created to hold valuable assets and a "badco" is created to file for chapter 11 and take with it undesirable liabilities. Critics argue that this practice allows a debtor to impermissibly shield assets from creditors by exploiting the chapter 11 process. If passed, the proposed bill would eliminate the Texas Two-Step by providing statutory grounds for dismissing a bankruptcy case if the debtor was formed within 10 years prior to the case via a divisional merger or equivalent transaction.

As previously discussed, the NRPA has failed to gain significant momentum since its introduction, so it seems unlikely that the "Texas Two-Step" strategy is going to go away by virtue of the NRPA. However, Sen. Durbin has indicated that he would like to develop bipartisan legislation to outlaw the practice, so there may be new developments on the way in the future.[16]

Conclusion

Although most of the legislation discussed herein has not been passed, it has kept chapter 11 reform in the mainstream debate. Indeed, the chapter 11 system is admittedly imperfect. It requires ongoing review and, if necessary, periodic legislative intervention to ensure that it continues to work for the ever-changing American economy. abi

11 H.R. 4777; S. 2497. *See also* Maurice "Mac" VerStandig, "Senate Legislation Looks to Upend Nondebtor Releases, Stays," XL *ABI Journal* 10, 8, 55-56, October 2021, *available at* abi.org/abi-journal.

12 *In re Purdue Pharma LP*, 635 B.R. 26 (S.D.N.Y. 2021).

13 *Patterson, et al. v. Mahwah Bergen Retail Grp.*, 636 B.R. 641 (E.D. Va. 2022).

14 *See, e.g., SE Prop. Holdings LLC v. Seaside Eng'g & Surveying (In re Seaside Eng'g & Surveying Inc.)*, 780 F.3d 1070, 1079 (11th Cir. 2015); *SEC v. Drexel Burnham Lambert Grp. Inc. (In re Drexel Burnham Lambert Grp. Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992).

15 *See, e.g., In re Strike LLC*, No. 21-90054 (DRJ) (Bankr. S.D. Tex. May 17, 2022) [Docket No. 1111] ¶¶ 33-35; *In re Riverbed Tech.*, No. 21-11503 (CTG) (Bankr. D. Del. Dec. 4, 2021) [Docket No. 169] ¶¶ 32-36.

16 "Durbin Highlights Johnson & Johnson's Shameful 'Texas Two-Step' Maneuver on Senate Floor," U.S. Senate Committee on the Judiciary (Feb. 15, 2022), *available at* judiciary.senate.gov/press/dem/releases/durbin-highlights-johnson-and-johnsons-shameful-texas-two-step-maneuver-on-senate-floor.

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