Boston College Law Review

Volume 47
Issue 1 *The Future Of Chapter 11 A Symposium Cosponsored By The American College Of Bankruptcy*

Article 4

12-1-2005

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Stephen H. Case

SOME CONFIRMED CHAPTER 11 PLANS FAIL. SO WHAT?

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Abstract: Critics of the feasibility requirement set forth in 11 U.S.C. § 1129(a)(11) contend that the current bankruptcy system inadequately prevents repeat Chapter 11, or "Chapter 22," filings. Undoubtedly, there are instances of confirmed Chapter 11 plans that turn out to be unfeasible despite court findings to the contrary. Given the uncertainties of investment projections and capital markets, however, the occasional failure of Chapter 11 plans is not necessarily a greater evil than alternatives such as liquidation or excessively conservative capital structures. Chapter 11 is, by its very definition, a hit-or-miss venture; thus, it misses occasionally. Some confirmed Chapter 11 plans fail. So what?

Introduction

Section 1129(a)(11) of the Bankruptcy Code[1] makes it a condition precedent to confirmation of a Chapter 11 reorganization plan for the court to find that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."[2] The unscholarly folklore suggests that the requirement was created because Congress did not want business debtors to emerge from bankruptcy unless their Chapter 11 plans were soundly contrived, so as to free them from future failure resulting from the vicissitudes of the business

* Managing Director and General Counsel, Cohen & Company, LLC; Adjunct Professor of Law, Georgetown University Law Center; formerly Partner, Davis Polk & Wardwell; A.B., LL.B., Columbia University. Mr. Case is a member of the American Law Institute and the Bankruptcy Judges Education Committee of the Federal Judicial Center, and an emeritus member of the National Bankruptcy Conference.

[1] The current law of bankruptcy is found in Title 11 of the U.S. Code. *See* 11 U.S.C. §§ 101 *et seq.* (2000). Its foundation is the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (effective Oct. 1, 1979) (codified as amended at 11 U.S.C. §§ 101 *et seq.* (2000)). The Bankruptcy Reform Act of 1978 is typically referred to as the "Bankruptcy Code" or the "Code." References in this work to the "Bankruptcy Code" or the "Code" are to Title 11 of the U.S. Code. References to "Chapter 11" are to 11 U.S.C. §§ 1101–1174 (2000).

[2] 11 U.S.C. § 1129(a)(11).

cycle. In other words, Congress intended to prevent debtors from emerging out of Chapter 11 only to file a second Chapter 11 case soon thereafter—a sequence sometimes colloquially referred to as a "Chapter 22" case.

This Article examines the feasibility requirement of 11 U.S.C. § 1129(a)(11) and considers whether it meaningfully and helpfully predicts future business failures. Part I of this Article outlines the current judicial interpretation of the feasibility requirement. Part II then considers whether courts should develop more specific criteria for feasibility determinations. Part III discusses the present dearth of information needed to determine the effectiveness of the feasibility requirement and its implementation. Part IV proceeds to examine the "real world" operation of the feasibility requirement. Part V presents competing views with respect to whether the court system sufficiently prevents repeat Chapter 11 filings. Finally, Part VI discusses—without conceding that a problem necessarily exists—whether the system can be improved and considers factors that likely contribute to overly optimistic expectations for Chapter 11 plans. The Article concludes by arguing that although some Chapter 11 plans inevitably fail under the current regime, this is no greater evil than other—perhaps even less desirable—alternatives.

I. Judicial Interpretation of the Feasibility Requirement

Conventional approaches to legal scholarship call for analyzing reported judicial rulings in order to illuminate the meaning of a statute. Thus, in order to understand the feasibility requirement set forth in section 1129(a)(11),[3] one must turn to the courts. A frequently cited legal standard for feasibility is whether the factual showing at the plan confirmation hearing establishes a "reasonable assurance of success," though "[s]uccess need not be guaranteed."[4] In the context of section 1129(a)(11), relatively few reported cases articulate much more than this basic standard, except to state that Chapter 11 issues are fact-intensive and that trial court decisions will be upheld unless "clearly erroneous."[5]

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[3] *See id.*

[4] Kane v. Johns-Manville Corp., 843 F.2d 636, 649 (2d Cir. 1988) (citing Prudential Ins. Co. v. Monnier (*In re* Monnier Bros.), 755 F.2d 1336, 1341 (8th Cir. 1985); *In re* Wolf, 61 B.R. 1010, 1011 (Bankr. N.D. Iowa 1986)).

[5] *See, e.g.*, *In re* T-H New Orleans Ltd. P'ship, 116 F.3d 790, 801 (5th Cir. 1997) (quoting *In re* Briscoe Enters., Ltd., II, 994 F.2d 1160, 1165–66 (5th Cir. 1993)) (explaining that "the [bankruptcy] court need not require a guarantee of success," and instead may require

The "clearly erroneous" rule is important in the context of appellate review of feasibility determinations. The feasibility of Chapter 11 plans is decided exclusively at the trial court level based on the factual record before the court. Thus, if a busy trial court takes the time to write an opinion that is based heavily on the weight that the court gives to various witnesses and other evidence in the record, it is difficult for a reviewing court to find a lawful basis upon which to reverse the trial court. In other words, due to the "clearly erroneous" standard, reversal on appeal of a reasonably well-drafted trial court opinion or order containing carefully detailed factual findings regarding feasibility is virtually impossible. For instance, according to the U.S. Court of Appeals for the Seventh Circuit, "[t]o be clearly erroneous, a decision must strike [the court] as more than just maybe or probably wrong; it must, as one member of this court recently stated during oral argument, strike [the court] as *wrong with the force of a five-week-old, unrefrigerated dead fish*."[6]

II. Should Courts Develop More Specific Feasibility Criteria?

Aside from the frequently cited standard for feasibility referenced in the Second Circuit's *Kane v. Johns-Manville Corporation*—whether there is a "reasonable assurance of success," though "[s]uccess need not be guaranteed"—no other clearly articulated appellate standards

"[o]nly a reasonable assurance of commercial viability"); *see also In re* Danny Thomas Props. II Ltd. P'ship, 241 F.3d 959, 963 (8th Cir. 2001) (holding that a provision in the post-confirmation obligation documentation requiring automatic liquidation in the event of default does not render feasible an otherwise unfeasible plan); *In re* 203 N. LaSalle St. P'ship, 126 F.3d 955, 962 (7th Cir. 1997) (holding that the bankruptcy court's findings on close questions of fact as to feasibility were not clearly erroneous), *rev'd on other grounds sub nom.* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999); Quality Inns Intern., Inc. v. L.B.H. Assocs. Ltd. P'ship, 911 F.2d 724 (4th Cir. 1990) (unpublished table decision) ("In light of the extensive confirmation hearing and the bankruptcy court's opportunity to evaluate the demeanor and credibility of the witnesses, the court does not find its determination of feasibility to be clearly erroneous."), *available at* Nos. 89-2443 to 89-2445, 1990 WL 116761, at *4; Berkeley Fed. Bank & Trust v. Sea Garden Motel & Apts. (*In re* Sea Garden Motel & Apts.), 195 B.R. 294, 305 (Bankr. D.N.J. 1996) (quoting *In re* Eddington Thread Mfg. Co., Inc., 181 B.R. 826, 832–33 (Bankr. E.D. Pa. 1995)) ("[T]he feasibility inquiry is peculiarly fact intensive."); S & P, Inc. v. Pfeifer, 189 B.R. 173, 187 (Bankr. N.D. Ind. 1995) (holding that a debtor failed to prove a sufficient future cash flow and upholding the bankruptcy court's finding that reorganization was impossible), *aff'd*, 78 F.3d 587 (7th Cir. 1996) (unpublished).

[6] Parts & Elec. Motors, Inc. v. Sterling Elec., Inc., 866 F.2d 228, 233 (7th Cir. 1988) (emphasis added).

for what constitutes a feasible plan currently exist.[7] As noted above, the issue of feasibility is decided almost exclusively at the trial court level based on the court's characterization of the factual record developed at the confirmation hearing. A trial court determination that a Chapter 11 plan is feasible is a determination that both the future performance of the reorganized business and future conditions in the relevant subsector of the economy are going to have favorable characteristics. This is economic crystal-ball gazing. With respect to this type of forecasting, no one is ever right all of the time.

Where does this leave the courts? It is difficult to speculate as to what a court of appeals might say if compelled to adopt a feasibility standard more specific than that articulated in *Kane*.[8] Would a court require fixed criteria based on balance-sheet ratios; for instance, would there have to be a minimum fixed-charge coverage ratio? Would businesses have to demonstrate enough of an equity-weighted capitalization in order to obtain an investment-grade credit rating? These are conventional concepts to those familiar with financial covenants in corporate loan agreements and debt indentures.

The trouble is, however, that these concepts do not work. Generations of bankers and attorneys, who perpetually devise and revise formulae like these as financial covenants in loan agreements, have not yet come up with a way for contractual language to prevent future default in the real world. Furthermore, excessively conservative capital structures intended to provide multiple "cushions" against future default can sometimes hobble enterprises to the point where they inhibit success. In sum, forward-looking contractual language is often no substitute for good, human business judgment applied at the relevant time.

III. Assessing the Feasibility Requirement's Effectiveness amid a Lack of Data

No centralized federal system currently exists to collect and publish detailed information with respect to how the Chapter 11 system actually works.[9] Thus, many questions abound. Which industries have higher filing rates than others? How long do cases typically last? How

[7] *See* 843 F.2d 636, 649 (2d Cir. 1988) (citing Prudential Ins. Co. v. Monnier (*In re* Monnier Bros.), 755 F.2d 1336, 1341 (8th Cir. 1985); *In re* Wolf, 61 B.R. 1010, 1011 (Bankr. N.D. Iowa 1986)).

[8] *See* 843 F.2d at 649 (citing *Prudential Ins. Co.*, 755 F.2d at 1341; *Wolf*, 61 B.R. at 1011).

[9] Nat'l Bankr. Review Comm'n, Bankruptcy: The Next Twenty Years at 919 (1997).

many cases result in the confirmation of plans? How many jobs are saved or lost as a result of Chapter 11? The lack of data is frustrating to researchers trying to answer these questions.

Recent legislation, however, should address this problem.[10] A new federal statute requires the Attorney General of the United States (who will presumably act through the Office of U.S. Trustee) to promulgate regulations that will require Chapter 11 debtors to file periodic reports.[11] These reports will include, in addition to any other matters proposed at the discretion of the Attorney General, the following:

> (1) information about the industry classification, published by the Department of Commerce, for the businesses conducted by the debtor;
> (2) length of time the case has been pending;
> (3) number of full-time employees as of the date of the order for relief and at the end of each reporting period since the case was filed;
> (4) cash receipts, cash disbursements and profitability of the debtor for the most recent period and cumulatively since the date of the order for relief;
> (5) compliance with title 11, whether or not tax returns and tax payments since the date of the order for relief have been timely filed and made;
> (6) all professional fees approved by the court in the case for the most recent period and cumulatively since the date of the order for relief (separately reported, for the professional fees incurred by or on behalf of the debtor, between those that would have been incurred absent a bankruptcy case and those not); and
> (7) plans of reorganization filed and confirmed and, with respect thereto, by class, the recoveries of the holders, expressed in aggregate dollar values and, in the case of claims, as a percentage of total claims of the class allowed.[12]

The statute also requires that the reports

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[10] *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 602(a), 119 Stat. 23, 120–22 [hereinafter BAPCPA] (to be codified at 28 U.S.C. § 589b).

[11] *Id.* § 602(a), 119 Stat. at 120 (to be codified at 28 U.S.C. § 589b(a)(2)).

[12] *Id.* § 602(a), 119 Stat. at 121–22 (to be codified at 28 U.S.C. § 589b(e)).

> shall be designed (and the requirements as to place and manner of filing shall be established) so as to facilitate compilation of data and maximum possible access of the public, both by physical inspection at one or more central filing locations, and by electronic access through the Internet or other appropriate media.[13]

Nothing in the statutorily mandated contents of the reports requires disclosure of prior Chapter 11 filings by the same or related debtors.[14] Perhaps, however, commentators will persuade the Attorney General's office to use its discretion to add to the yet-to-be-promulgated regulations a requirement for the disclosure of such information.[15]

Notwithstanding any answers this new legislation may eventually yield—both in terms of the statutorily mandated information and any additional information that the Attorney General may require—the fact remains that little data is currently available with respect to whether too many Chapter 11 cases result in the confirmation of unfeasible plans. This raises a compelling question: Is the statutory requirement for feasibility in fact a meaningless phrase frequently honored only in breach?

IV. Feasibility Determinations in the "Real World"

Based on the author's experience, the scope of feasibility evidence presented to a court in a Chapter 11 plan confirmation hearing is principally a function of whether the plan's confirmation is contested. Thus, a dichotomy exists in the empirical reality of plan confirmation hearings. On the one hand, if a plan is contested, then the section 1129(a)(11) feasibility issue is likely to be a lightning rod for litigation during the confirmation hearing. Thus, the trial judge in such a case must simply consider the competing evidence and make a decision. The more factually grounded the trial court's decision, the less likely it is to be reversed on appeal.

On the other hand, uncontested confirmation hearings unfold quite differently and, in the author's opinion, present the highest danger of excessively optimistic forecasts that could look foolish in hindsight if the debtor files again. For example, if a plan is supported by the "leading players" in most of the significant creditor groups with

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[13] *Id.* § 602(a), 119 Stat. at 120 (to be codified at 28 U.S.C. § 589b(b)).

[14] *See id.* § 602(a), 119 Stat. at 121–22 (to be codified at 28 U.S.C. § 589b(e)).

[15] *See* BAPCPA § 602(a), 119 Stat. at 121 (to be codified at 28 U.S.C. § 589b(d)).

no or only token opposition, then the proponent of the plan—often the debtor—files sets of spreadsheets with the court along with supporting affidavits. These filings represent to the court that the projected cash flows of the debtor will be sufficient to cover its liabilities. The filings opine further that, barring unexpectedly severe downturns in the business cycle, the plan confirmation is not likely to be followed by liquidation or the need for further financial reorganization.

With no contrary evidence in the record, and no cross-examination of any feasibility witnesses—whose testimony may even have been filed by affidavit—the court typically will accept this evidence as conclusive proof that the plan is feasible. Thus, in such a situation, a plan could be confirmed without any significant focus on the evidence presented in support of feasibility. It is the author's opinion, without the benefit of an empirical study, that most repeat Chapter 11 cases, at least in the large-case environment, can probably be traced back to uncontested plan confirmation hearings featuring consensual Chapter 11 plans similar to that described above.

V. Competing Views on the Need for Reform of the Present System

Recently, some commentators have criticized the effectiveness of the feasibility requirement, publishing detailed studies that purport to establish that some jurisdictions have higher rates of repeat-filing Chapter 11 debtors than others and that consider possible explanations for this phenomenon.[16] For instance, one recent study concluded that:

> Delaware-reorganized firms were significantly more likely to refile, significantly more likely to go out of business . . . and significantly less likely to perform successfully . . . . These findings warrant the conclusion that Delaware-reorganized firms [for the period studied] failed more often than firms emerging from reorganization [elsewhere].[17]

A recent example of the repeat filing phenomenon is US Airways, which has filed for Chapter 11 protection twice in recent years.[18] This is

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[16] *See, e.g.*, Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 Vand. L. Rev. 1933, 1945 (2002).

[17] *Id.*

[18] *See* Elwin Green, *US Airways Out*, Pittsburgh Post-Gazette, Sept. 18, 2005, at E2.

but one of several examples available in the large company context.[19] The repeat-filing phenomenon is particularly acute within the airline industry. For instance, Trans World Airlines has filed three times, and Continental Airlines and Midway Airlines have each filed twice.[20] Situations such as these lead commentators to conclude that the present system needs more backbone—that is, more independent judicial scrutiny of feasibility evidence is necessary to prevent repeat filings.[21]

Certain cases, however, contradict such criticism of the system. Some Chapter 11 reorganizations have been spectacularly successful.[22] For instance, the stock of Kmart Holding Corporation performed amazingly well soon after its emergence from Chapter 11 in early 2003.[23] In a period of approximately two years thereafter, a $10,000 investment in Kmart Holding Corporation stock would have grown in value to more than $53,000.[24]

Bankruptcies such as that of Kmart Holding Corporation represent a clearly correct finding of feasibility at the confirmation hearing and thus lead to a line of thinking alternative to the views of skeptical commentators who criticize the feasibility requirement's effectiveness in preventing future Chapter 11 filings. This line of thinking says, in effect: So what? Chapter 11 is difficult. The purpose of the process is to save jobs and protect going-concern value. If it doesn't work in some situations, then try again. Keep fixing the business until it works.

The debate as to whether reforms are needed has yet to be resolved. The Judicial Conference Committee on the Administration of the Bankruptcy System and the Federal Judicial Center recently held a conference in which judges and attorneys with expertise in large Chapter 11 cases briefly addressed some of the criticisms referenced above.[25] The participants also briefly debated whether courts should be required to appoint special feasibility experts.[26] No consensus,

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[19] *See* Blakeley & Blakeley LLP, *The Serial Chapter 11 Debtor: From Chapter 22 to 33 to (Even) 44*, Trade Vendor Monthly News Flash, Feb. 2002, http://www.bandblaw.com/tvmnf/February2002/February-2002.htm.

[20] Mark Korda & Mark Mentha, *Chapter 11 Doesn't Fit Australian Story*, Austl. Fin. Rev., June 3, 2003, *available at* http://www.kordamentha.com/national/display.aspx?ID=39.

[21] *See* LoPucki & Doherty, *supra* note 16, at 1984.

[22] *See, e.g.*, *In re* Kmart Corp., 286 B.R. 345 (Bankr. N.D. Ill. 2002).

[23] *See* Kmart Holding Stock Report (KMRT), Charts & Returns, http://quicktake.morningstar.com/Stock/Stockperformance.asp?Country=USA&Symbol=KMRT.

[24] *Id.*

[25] Judicial Conference Comm. on the Admin. of the Bankr. Sys. & Fed. Judicial Ctr., Conference on Large Chapter 11 Cases 1, 36 (2004), *available at* http://www.fjc.gov/public/pdf.nsf/lookup/LargCh11.pdf/$File/LargCh11.pdf.

[26] *Id.* at 36.

however, was reached with respect to either issue.[27] Additionally, a 1997 federal review of the state of national bankruptcy policy reported no significant problems with respect to the drafting or administration of section 1129(a)(11), although it did not address the feasibility issue directly.[28]

VI. Is There a Solution (Assuming There Is Even a Problem)?

Undoubtedly, some Chapter 11 plans approved as feasible in confirmation hearings turn out not to be feasible. Observers differ as to whether they believe such outcomes result primarily from insufficient vigilance in the confirmation process.[29] Blaming bankruptcy judges and creditor constituencies for post-confirmation business failure, however, is not appropriate. No one possesses the proverbial crystal ball. Thus, the only conceivable "fix" of the process may be to conduct a public policy assessment as to whether additional safeguards are necessary in uncontested Chapter 11 confirmation hearings.

In the author's experience, uncontested Chapter 11 plan confirmation hearings have often been the result of successful consensus-gathering efforts. These efforts frequently result in hearings where the court has no reason to question plan-proponent representations with respect to feasibility. This can result in court acceptance of expectations as to future revenue levels, interest rates, and business activity that might not have been able to withstand an attack from well-prepared creditors opposing the plan. Other times, however, honest, carefully calculated sets of projections in which plan proponents have high levels of confidence are presented at uncontested hearings. Inevitably, even when plan proponents hold a good-faith belief—as most proponents likely do—that the emerged business will generate enough cash to meet the demands imposed by the post-plan capital structure, some projections turn out to be wrong. Plan proponent fatigue and recovery dumping by distress investors are also factors likely contributing to any problem with the feasibility requirement—assuming, of course, that there is one. Both phenomena, in efforts to reach a consensus, can contribute to excessive optimism in plan formulation.

Plan-proponent fatigue occurs when the process of managing a business in Chapter 11 becomes so onerous that pressure to end the

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[27] *Id.*

[28] *See generally* Nat'l Bankr. Review Comm'n, *supra* note 9.

[29] *See* LoPucki & Doherty, *supra* note 16, at 1984.

case can distort judgment with respect to how well a business will perform when freed from the expenses and distractions of the Chapter 11 proceeding. This sometimes produces an "offer them anything; just get this nightmare over with" attitude among plan proponents. This can result in excessively optimistic projections and, eventually, in Chapter 22. In addition to plan-proponent fatigue, recovery dumping by distress investors can also contribute to excessive optimism with respect to plan feasibility. Distress investors sometimes acquire claims against debtors at attractively low prices and plan to dispose of any recoveries in the markets as soon as possible after plan confirmation. This strategy encourages such investors to vote in favor of questionable plans. Desiring no long-term stake in the business, they simply expect to realize a gain and immediately transfer the risk of a second bankruptcy to marketplace purchasers. From the perspective of distress investors, the more aggressive the plan expectations, the greater their potential reward.

In the hypothetical scenarios described above, and in other situations, each participant in the plan negotiation process has an incentive to err on the side of optimism. If all constituents support the scheme, then it is in the interest of no participant to derail the plan by submitting evidence at the hearing that might cast doubt on its feasibility. Perhaps the only limiting principle currently in place to guard against situations like these is fear of post-plan prosecution for perjury or fraud.

Conclusion

All of this produces a conundrum for the courts. Should courts intervene during plan confirmation hearings and ask detailed questions regarding evidence offered to establish feasibility? Should courts do so even if no one at the hearing is contesting the plan? Do courts risk a loss of public confidence if they fail to do so?

Even if a court were to require additional evidence of feasibility at a plan confirmation hearing, such a requirement would likely result only in the presentation of substantially similar evidence that the reorganized debtor could or could not reasonably be expected to "make it." How is the court to decide? Who can predict stock markets, commodity prices, or business cycles? Fortunes are made and lost by sophisticated investors with their own money at risk, with extensive and expensive advisory resources, and with considerable time to weigh various investment strategies. That fortunes are sometimes lost indicates that forecasters sometimes make major mistakes. How can a busy bankruptcy judge with little time to conduct a complex confirmation hearing be expected to be as good as—let alone better than—investment seers who, incidentally, are sometimes right and sometimes wrong?

Undoubtedly, there are instances of confirmed Chapter 11 plans that turn out to be unfeasible despite court findings to the contrary. Yet given the uncertainties of investment projections, the vicissitudes of markets, and other imponderables, is the fact that some Chapter 11 plans end up failing a greater evil than the various alternatives—such as excessively conservative capital structures or liquidation with its rapid, attendant loss of numerous jobs? Opinions differ on this issue. Nevertheless, one fact remains: Chapter 11 is almost by its very definition a hit-or-miss venture. Consequently, it misses occasionally.

Some confirmed Chapter 11 plans fail. So what?