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Paul B. Lewis
John Marshall Law School, plewis8@uic.edu

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I. INTRODUCTION

A successful system of corporate reorganization should accomplish two primary things. First, it should determine which firms in bankruptcy are essentially non-viable; these firms should be liquidated. Second, it should provide a mechanism for viable firms to remain functioning entities. In this Article, I contend that the American corporate bankruptcy system is flawed[1] in that it fails to consistently and efficiently achieve these two fundamental goals. By contrast, the Australian corporate reorganization system, known as "Voluntary Administration," largely succeeds on both counts.

There are numerous reasons for the disparity between the American and Australian systems. One core distinction is the treatment afforded creditors of insolvent firms. Insolvent firms are effectively owned by their creditors.[2] In situations of insolvency, creditors, who primarily bear the

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*Associate Professor, Mercer University Law School; J.D., Yale University; B.A., Northwestern University. Funding for this research was provided by a grant from the David C. Lam Institute for East-West Studies. This Article was first presented at a workshop at the University of Western Sydney in Sydney, Australia. I am indebted to many people in Australia for their insights into the Australian insolvency process. In particular, I thank George Caddy and Bob Cruickshanks of the Insolvency and Trustee Service Australia; Diana Kincaid of the University of Western Sydney—Hawkesbury; Rosalind Mason of the University of Southern Queensland; Linda Johnson of Mallesons, Stephen & Jacques in Sydney; Charles Bowdon and Scott Pascoe of Simms Lockwood in Sydney; and Scott Hedge of Kemp Strang in Sydney. I also thank Amber Nickell for excellent research assistance.

[1]The failure of the corporate bankruptcy system, in one form or another, has been a regular theme in the literature for a number of years. *See, e.g.*, Lynn M. LoPucki, *Chapter 11: An Agenda for Basic Reform*, 69 AM. BANKR. L.J. 573 (1995) [hereinafter LoPucki, *Agenda*]; Douglas G. Baird, *Revisiting Auctions in Chapter 11*, 36 J.L. & ECON. 633 (1993); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992); Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WIS. L. REV. 729 (1993) [hereinafter LoPucki, *Trouble*]; Hon. Edith H. Jones, *Chapter 11: A Death Penalty for Debtor and Creditor Interests*, 77 CORNELL L. REV. 1088 (1992); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

[2]Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1360 (7th Cir. 1990) ("Creditors effectively own bankrupt firms."). In fact, the fiduciary duty of a firm's directors shifts upon insolvency from the firm's shareholders to its creditors. *In re* Mortgageamerica Corp., 714 F.2d 1266, 1269 (5th Cir. 1983) ("Becoming insolvent, the equitable interest of the stockholders in the property, together with their conditional liability to the creditors, places the property in a condition of trust, for the creditors, and then for the stockholders."); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) ("If the

burden of further loss, should be given ultimate decision-making discretion. Under the Australian system, creditors—particularly secured creditors—are afforded certain rights which allow them largely to determine the future of a troubled firm. In the United States, the rights of creditors in this regard are more limited.

This Article examines the Australian and American approaches to corporate reorganization. Both American and Australian bankruptcy law were initially grounded in the historical English common law system. However, the two systems have now diverged markedly from their common roots—the American system doing so at its inception, the Australian approach not until comparatively recently.[3] The two systems in their current forms take distinctly different approaches to achieving the identical goals of identifying and saving fundamentally viable companies[4] while providing for the liquidation of those firms that should not survive.

In Part II of this Article, I provide an overview of the Australian approach to corporate insolvency. In Part III, I examine some reorganization history and provide a brief outline of the American approach to Chapter 11 of the Bankruptcy Code ("Chapter 11"). In Part IV, I juxtapose certain salient elements of the Australian approach with their American counterparts and contend that, in light of established economic theory, there are numerous relative advantages to the Australian system.

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corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate-beneficiaries [creditors]." (quoting New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d 397, 398 (N.Y. 1953))); Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12510, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."); FDIC v. Sea Pines Co., 692 F.2d 973, 976–77 (4th Cir. 1982), ("[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.").

[3]In addition, both the Australian and American approaches to corporate reorganization have recently been substantially rewritten. In the American case, the last major overhaul was in 1978 with the enactment of the new Bankruptcy Code. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1994) (enacting Title 11 of United States Code). In Australia, the revisions date from the early 1990s and became applicable as law in 1993. Corporate Law Reform Act, 1992, (Cth), (Austl.)

[4]There is no doubt that reorganization has traditionally been seen as generally preferable to liquidation. United States v. Whiting Pools, Inc., 462 U.S. 198, 203 (1983) (holding that "[b]y permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if 'sold for scrap'" (quoting H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5693, 6179)) (internal citations omitted).

My conclusion is that, in contrast to the Australian model, the American approach to corporate reorganization is slow, expensive, and administratively cumbersome. It also provides inefficient and otherwise inappropriate incentives, and it frequently empowers the wrong party to make vital decisions. As a result, the Australian system more successfully distinguishes those firms with long-term potential viability from those firms without such prospects, and better assures continuance for the former and liquidation of the latter.

II. THE AUSTRALIAN APPROACH TO COMPANY INSOLVENCY

Until relatively recently, Australian corporate insolvency law, like Australian corporations law generally, largely tracked the historical English model. As a practical matter, liquidation was essentially all that was available for businesses.[5] Beginning in the 1960s, however, a series of developments[6] began which ultimately lead to the creation in 1992 of a process designed to maximize the value of the on-going business and preserve the social benefits provided by the business's existence, while also maintaining value for the company's creditors in the event of a liquidation.[7] The process is known as Voluntary Administration,[8] and the relevant

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[5]Two other methods existed to "save" troubled companies though neither was effectively employed. The first was a private administration available through appointment of a receiver, which generally benefited only the secured creditor who imposed the process. The second was a "scheme of arrangement," an expensive and seldomly used process by which a company could, in theory, be saved. Ron W. Harmer, *Comparison of Trends in National Law: The Pacific Rim,* 23 BROOK. J. INT'L L. 139, 148–49 (1997).

[6]Perhaps the most notable development was the success of a process introduced in the 1960s to provide an alternative to straight bankruptcy for individuals engaged in small business. This process allowed the debtor the opportunity to preserve his or her business through mutually agreeable arrangements with his or her creditors. *See* Ron Harmer, *An Overview of Recent Developments and Future Prospects in Australia (With Some Reference to New Zealand and Asia), in* CURRENT DEVELOPMENTS IN INTERNATIONAL AND COMPARATIVE CORPORATE INSOLVENCY LAW 43 (Jacob S. Ziegel & Susan I. Cantile eds., 1994).

[7]By 1993, this goal had already been adopted in both the United States and England.

[8]Corporate Law Reform Act, 1992, § 56 (Austl.) (repealing and being substituted for 5.3A). Outlining its purpose, the newly-enacted part 5.3A states:

> The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:
> (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or
> (b) if it is not possible for the company or its business to continue in existence—results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

Id. § 435.

By contrast, the liquidation of a company in insolvency—the equivalent of Chapter 7 portion of the Australian Corporations Law[9] is contained in Part 5.3A, entitled "Administration of a Company's Affairs with a View to Executing a Deed of Company Arrangement."[10]

Voluntary Administration was expressly designed to be a rapid, inexpensive, straightforward, and flexible means of dealing with troubled companies[11] that are either insolvent or "likely to become insolvent."[12] The system effectively establishes a two-part approach. The first part is the appointment of an administrator; the second is the company operating under a "deed of company arrangement." The deed of company arrangement is a

under the United States Bankruptcy Code—is governed by Part 5.4, entitled "Winding Up in Insolvency." *Id.* § 57. Other options for Australian corporations are also contained in Chapter 5 of the Australian Corporations Laws. These include: "Schemes of Arrangement" (Part 5.1); "Receivers, and other Controllers, of Property of Corporations" (Part 5.2); "Winding Up by the Court on Other Grounds" (Part 5.4A); and "Voluntary Winding Up" (Part 5.5).

[9]Unlike in the United States, where bankruptcy law is exclusively federal and is codified in Title 11 of the United States Code and where corporate law is governed by the states, the corporate insolvency laws in Australia are contained in the Australian Corporations Law. Accordingly, one statute contains all the pertinent regulations for corporations. Like in the United States, insolvency law is federal and governs nationwide. For a critique of the state corporate law/federal bankruptcy law dichotomy in the United States, see David A. Skeel, *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 474–75 (1994) (arguing that Congress should shift authority for corporate reorganization to states).

[10]Corporate Law Reform Act, 1992, §§ 435A–451D (Austl).

[11]THE LAW REFORM COMMISSION, GENERAL INSOLVENCY INQUIRY, Rep. No. 45, vol. 1, ¶ 54 (1988) (noting that "[t]he procedure proposed was designed with the aim that it would be capable of swift implementation, as uncomplicated and inexpensive as possible, flexible, providing alternative forms of dealing with the financial affairs of the company").

[12]Corporate Law Reform Act, 1992, § 436A(1)(a) (Austl.). An insolvent company is one that is unable to pay its debts as they become due. *Id.* § 95A. While the name suggests the voluntary nature of the proceedings, Voluntary Administration can occur involuntarily: "A liquidator or provisional liquidator of a company may by writing appoint an administrator of the company if he or she thinks that the company is insolvent, or is likely to become insolvent at some future time." *Id.* § 436B(1). In addition, pursuant to section 436C, it can also be commenced by a creditor holding a lien over all or substantially all of a company's assets. *Id.* § 436C(1) (stating that "[a] person who is entitled to enforce a charge on the whole, or substantially the whole, of a company's property may by writing appoint an administrator of the company if the charge has become, and is still, enforceable"). Chapter 11, likewise, allows for involuntary proceedings as well, upon a showing that a debtor is generally not paying its debts as they become due. 11 U.S.C. § 303 (1995).

fairly simple document[13] which largely serves the same function as an American plan of reorganization in Chapter 11.

The appointment of an administrator—most often an accountant who must also be a registered Insolvency Practitioner[14]—is typically accomplished by the company's directors signing a form.[15] There is no need for a court filing.[16] In fact, courts are noticeably absent from the general running of the administration. Rather, their role is largely limited to one of supervision.[17] The justification for the absence of court involvement is significant. The resolution of the company's financial difficulties is deemed to be a matter solely between the company and its creditors, with the ultimate resolution reflecting what the creditors believe to be in their best interests.[18] Indeed, one of the express aims of the law is to protect creditor

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[13]A deed of arrangement is by design far more straightforward than other methods available to insolvent companies in Australia. It is a "simplified document of much less size and complexity than the present forms of 'scheme documents' that oppress creditors and others. The deed will incorporate (by simple reference) standard provisions contained in a schedule to the companies legislation. . . ." GENERAL INSOLVENCY INQUIRY, *supra* note 11, at ¶ 56.

[14]Corporate Law Reform Act, 1992, § 448B (Austl.). A person must consent to the appointment and can only act as administrator of a company or a deed of trust if he or she is a registered liquidator.

[15]*Id.* §436A. In addition to directors (§ 436A), liquidators (§ 436B) and creditors with liens over substantially all of the company's assets (§ 436C) can appoint an administrator. Empirical studies have shown, however, that 98% of Australian Voluntary Administrations commence by appointment made by the company's directors. ROMAN TOMASIC & KETURAH WHITFORD, AUSTRALIAN INSOLVENCY AND BANKRUPTCY LAW § 65, at 168 (2nd ed. 1997). Neither unsecured nor undersecured creditors may appoint an administrator.

The ease with which a company can enter Voluntary Administration has given rise to some concerns that hopelessly insolvent companies will abuse the process by employing it to delay inevitable liquidation. There are two significant safeguards to this: First, a court has authority to end the administration if it believes the procedure is being abused. Corporate Law Reform Act, 1992, § 447A (Austl.). Second, as is discussed at length *infra*, the fact that certain secured creditors can opt out and foreclose on their collateral assures that it is unlikely that such abuse could be successfully employed for long.

[16]*Id.* § 436A. Instead of a court proceeding, the document of appointment is filed with the Australian Securities Commission and appropriately made public.

[17]The Australian Law Reform Commission contemplated only a supervisory function for courts in the Voluntary Administration process. The Commission recommended that:

> The court have a broad power to make orders for the effective operation of the procedure. Although provision for extensive involvement of the court has been avoided to simplify and reduce the time and expense of the procedure, the court should have a role to ensure that the procedure operates in accordance with the law.

GENERAL INSOLVENCY INQUIRY, *supra* note 11, at ¶ 62.

[18]*See generally* K.J. Bennetts, *Voluntary Administration: Shaping the Process Through the Exercise of Judicial Discretion*, 3 INSOLV. L.J. 135 (1995) (identifying extent of judicial powers in context of voluntary administration).

interests if the company is unsalvageable by providing "a more advantageous realisation of the company's assets than would be effected by an immediate winding up."[19]

Upon the appointment of an administrator, with certain exceptions, an immediate moratorium on all claims is established.[20] The company cannot be wound up (liquidated),[21] liens cannot be enforced[22] (with one major exception discussed *infra*), and owners or lessors of property being used by the company generally cannot reclaim their property.[23] The moratorium facilitates the administrator's investigation of the company's affairs and allows the administrator to prepare a report of recommendations for the creditors, as well as stopping the proverbial race to the courthouse door.

There is, however, one very significant distinction between the Australian moratorium and the American automatic stay. Upon appointment, an administrator must notify the holder of a lien (or a "charge" in Australian parlance) over all or substantially all of the company's property that his or her appointment has been made.[24] That creditor then has the right to "enforce its charge" (foreclose on its lien) within a certain prescribed period of time[25] called the "decision period."[26] Since a bankrupt company cannot stop the lien holder from enforcing its interest,[27] a secured creditor effectively can opt out of an Australian bankruptcy proceeding and foreclose on property following default.[28] While it was initially feared that

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[19]GENERAL INSOLVENCY INQUIRY, *supra* note 11, at ¶ 59.

[20]Corporate Law Reform Act, 1992, § 440B (Austl.). This is of course consistent with the automatic stay provisions of 11 U.S.C. § 362(a) (1995). Justifications for the moratorium are similar to those for the American automatic stay. That is, the moratorium helps provide for an orderly administration of the debtor's affairs (rather than promoting a race to the courthouse door) and it preserves for the estate certain assets that may be necessary for reorganization to successfully occur.

[21]Corporate Law Reform Act, 1992, § 440A(1) (Austl.).

[22]*Id.* § 440B.

[23]*Id.* § 440C.

[24]*Id.* § 450A(3).

[25]*Id.* § 441A. Although the provision governing secured creditors with a lien over substantially all of the company's assets is by far the most significant exception, two others do exist. First, secured creditors who have acted to enforce their rights prior to the appointment of the administrator may also enforce their liens. *Id.* § 441B, F. Second, creditors with a security interest in perishable property may similarly enforce their liens. *Id.* § 441C.

[26]The decision period is typically ten to fourteen days after appointment. If the creditor fails to act within the decision period, it may still give notice pursuant to its security interest that its interest will be enforced when the administration ends. *Id.* § 441E.

[27]*Id.* § 441A(3).

[28]By contrast, Chapter 11 forces a secured creditor to participate in the bankruptcy process unless one of two circumstances has been met which allows the creditor to lift the automatic stay. The first circumstance is "cause," including the lack of adequate protection.

secured creditors would routinely exercise their right to opt out of proceedings, empirical evidence suggests that this has occurred less frequently than had been anticipated.[29]

The appointment of an administrator serves to do something directly opposite to the American debtor-in-possession provision—namely, suspend the powers of the officers of the corporation[30] and replace them with those of the administrator.[31] Any officer of the company who violates this section may be held personally liable.[32] The administrator is charged both with operating and investigating the affairs of the company. Following the appointment of the administrator, proceedings in court or in relation to the company's property can only be initiated or proceed upon written consent

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11 U.S.C. § 362(d)(1) (1995). The second is when the debtor has no equity in the property and the property is not needed for an effective reorganization. *Id.* § 362(d)(2).

[29]Harmer, *supra* note 5, at 155. Perhaps one reason why banks have been reluctant to routinely exercise this right is the fear of negative publicity in that their financial concerns may not correlate with the financial well-being of the business community at large.

[30]While directors do remain in office, their powers are greatly truncated. For example, "[w]hile a company is under administration, a person (other than the administrator) cannot perform or exercise, and must not purport to perform or exercise, a function or power as an officer of the company, except with the administrator's written approval." Corporate Law Reform Act, 1992, § 437C(1) (Austl.). This is the polar opposite of the United States debtor-in-possession provision under Chapter 11, which allows the debtor to act as its own trustee. 11 U.S.C. § 1107(a) (1994). Rather, the director's primary role becomes to assist the administrator. Directors are required to aid the administrator by delivering company books, Corporate Law Reform Act, 1992, § 438B(1) (Austl.), by providing statements about the company's business, property, affairs, and financial circumstances under § 438B(2), as well as providing any other information the administrator reasonably requires. *Id.* § 438B(3).

[31]*Id.* § 437A(1). While a company is under administration, the administrator:

> (a) has control of the company's business, property and affairs; and
> (b) may carry on that business and manage that property and those affairs; and
> (c) may terminate or dispose of all or part of that business, and may dispose of any of that property; and
> (d) may perform any function, and exercise any power, that the company or any of its officers could perform or exercise if the company were not under administration.

Id. Compare this provision with 11 U.S.C. § 1107(a) (1994), which provides that "[s]ubject to any limitations on a trustee serving in a case under this chapter, . . . a debtor-in-possession shall have all the rights . . . and powers, and shall perform all the functions and duties, . . . of a trustee serving in a case under this chapter."

[32]Corporate Law Reform Act, 1992, § 437E (Austl.). If an officer violates this provision and the court determines that damage has been caused to a third party, "the court may (whether or not it imposes a penalty) order the first-mentioned person to pay compensation to the company or other person, as the case may be, of such amount as the order specifies." *Id.*

of the administrator[33] or with leave of the court.[34] In addition, any transfer of shares is void absent court approval.[35]

The administrator acts as company agent.[36] The operations entrusted to the administrator include bringing and defending legal actions and executing documents.[37] There are two noteworthy exceptions to the ability of the administrator to bring legal actions. First, once a company is operating under administration, any guarantee of the company's liabilities which has been given by a director of the firm or a relative of a firm's director is not enforceable except by court order.[38] Second, potentially voidable transactions may not be challenged by an administrator.[39] One additional legal result of the company operating under administration is that the administrator may be personally liable for debts incurred under his or her administration, including debts for goods bought and for property leased, used or occupied.[40] This reflects a clear departure from general

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[33]As a general matter, any action on behalf of the company neither taken nor approved by the administrator is void. *Id.* § 437D. There are, however, some exceptions relating to certain payments by banks. *Id.* § 437D(3).

[34]*Id.* § 440D(1). Circumstances where a court will give leave are rare:

> It may be that where the company is insured against the liability the subject of the proceedings, the administrator will ordinarily consent or the court will give conditional leave, but outside this field it is hard to see situations where it would be proper to grant leave, though doubtless there are such situations.

Foxcraft v. Ink Group Pty. Ltd., 15 A.C.S.R. 203, 205 (1994).

In addition, like the automatic stay under Title 11, this stay is not universally applicable. *Compare* 11 U.S.C. § 362(b)(2) (1995) (providing for no stays against alimony, child support, etc.), *with* Corporate Law Reform Act, 1992, § 440D(2) (Austl.) (providing for no stays against criminal proceedings or prescribed proceedings).

[35]Corporate Law Reform Act, 1992, § 437F (Austl.) ("A transfer of shares in a company, or an alteration in the status of members of a company, that is made during the administration of the company is void except so far as the Court otherwise orders.").

[36]*Id.* § 437B.

[37]*Id.* § 442A(c).

[38]*Id.* § 440J(1).

[39]However, a liquidator may challenge such transactions. Thus, the presence of such transactions may encourage creditors to vote for a liquidation rather than for a deed of arrangement so that such transactions may be legally challenged.

[40]*Id.* § 443A(1):

> The administrator of a company under administration is liable for debts he or she incurs, in the performance or exercise, or purported performance or exercise, of any of his or her functions and powers as administrator, for:
> (a) services rendered; or
> (b) goods bought; or
> (c) property hired, leased, used or occupied.

Id.

agency law. As a general matter, however, the administrator is entitled to be indemnified for these costs out of the company's property.[41]

In terms of investigation, an administrator must call two meetings of creditors shortly following appointment. The first meeting, which must be called within five business days of the commencement of the administration,[42] is to confirm the administrator's appointment[43] and, like in the United States, to determine whether a committee of creditors should be appointed to consult with the administrator and review his or her reports.[44] A second meeting of creditors must be held within five days of the convening period.[45] The convening period is generally the period within twenty-one days of the commencement of the administration.[46]

By the time of the second meeting—typically within a month of the onset of the administration—the administrator, who has been running the business since appointment, will have examined the financial status of the corporation. The administrator will then report to the firm's creditors on both the financial condition of the company[47] and on the company's potential long-term viability.[48] If he or she deems the company viable, the

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[41]*Id.* § 443D.

[42]*Id.* § 436E(2).

[43]*Id.* § 436E(4). It is worth noting that creditors cannot vote to end the administration at this point.

[44]*Id.* § 436(E)(1), (F). Compare these provisions with 11 U.S.C. § 1102(a)(1) (1994), providing that "as soon as practicable after the order for relief under chapter 11 of this title, the United States trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States trustee deems appropriate."

[45]Corporate Law Reform Act, 1992, § 439A(2) (Austl.).

[46]*Id.* § 439A(5)(b). This period of time may be extended for cause. *Id.* § 439A(6). In addition, the period is routinely extended to twenty-eight days if Christmas or Easter fall within the period. *Id.* § 439A(5)(a).

[47]*Id.* § 439A(4)(a). This includes investigating any past or present officer who may have committed misconduct or who may be otherwise accountable to the business. *Id.* § 438D.

[48]In giving notice of this meeting, the administrator must accompany the notice with the following:

> (a) a report by the administrator about the company's business, property, affairs and financial circumstances; and
> (b) a statement setting out the administrator's opinion about each of the following matters:
> (i) whether it would be in the creditors' interests for the company to execute a deed of company arrangement;
> (ii) whether it would be in the creditors' interests for the administration to end;
> (iii) whether it would be in the creditors' interests for the company to be wound up; and his or her reasons for these opinions; and
> (c) if a deed of company arrangement is proposed—a statement setting out details of the proposed deed.

administrator will present the creditors with a deed of company arrangement.[49] The creditors then vote on the deed.[50]

The vote as to whether a company should be liquidated or reorganized is determined by a simple majority of creditors based on both the number of creditors and the total dollar amount owed.[51] If the creditors reject the deed of arrangement, the corporation is liquidated immediately. If the creditors approve the terms of the deed, however, the corporation has twenty-one days to sign the deed, at which point the deed becomes effective and binding upon most parties.[52] All unsecured creditors are bound by the deed,[53] as is the company,[54] the company's officers and members,[55] and the deed's administrator.[56] Secured creditors who have voted for the deed are also bound by it.[57] However, a secured creditor who has voted against a deed that is nonetheless confirmed by the majority is generally not so bound. Rather, such a secured creditor may, as a general matter, enforce its rights in the collateral.[58] However, the court will not allow such a creditor to enforce its rights if it believes that doing so will have a "materially adverse" impact on the purpose of the deed and where the secured creditor is adequately protected.[59]

At the meeting, the creditors may choose any of three options for the deed of company arrangement.[60] The first option is that the company execute a deed of company arrangement specified in the resolution.[61] There are relatively few constraints on what the deed may contain, as the deed should be a vehicle for the creditors in determining how best to deal with the company's assets and liabilities.[62] However, deeds of arrangement must

Id. § 439A(4).

[49]*Id.* § 444A(3).

[50]*Id.* § 439C(a).

[51]*See* CORP REG 5.6.21(2) (Austl.), *available at* http://www.austlii.edu.au/au/legis/cth/num_regles/er1993n135388/s26.html.

[52]Corporate Law Reform Act, 1992, § 444B(2) (Austl.).

[53]*Id.* § 444D(1).

[54]*Id.* § 444G(a).

[55]*Id.* § 444G(b).

[56]*Id.* § 444G(c).

[57]*Id.* § 444D(1).

[58]Corporate Law Reform Act, 1992, § 444D(2) (Austl.).

[59]*Id.* § 444F.

[60]*Id.* § 439C.

[61]*Id.* § 439C(a).

[62]As one commentator put it: "It is hoped that the procedure will allow for considerable flexibility in order to enable the contents of the deed to meet the needs and circumstances of the company and its various creditors. The deed may provide for debts to be compromised or repayments to be delayed or paid in instalments." Phillip Lipton, *Voluntary Administration: Is There Life After Insolvency for the Unsecured Creditor?*, 1 INSOLV. L.J. 87, 92

have certain prescribed conditions necessary to assure the ongoing operation of the company.[63] In addition, the deed must be implemented within twenty-one days, unless an extension is obtained from a court.[64] Once enacted, as noted, the deed binds the company,[65] its officers,[66] members,[67] the deed's administrator,[68] and most of the company's creditors.[69]

The second option is that the administration should end.[70] If the administration is ended,[71] the company reverts to its former position, subjecting a company in poor financial standing to a possible receivership or liquidation at the hands of its creditors. The third and final option is that the company be wound up.[72] If the company is wound up, it is deemed to have been done so voluntarily.[73]

(1993).

[63]Corporate Law Reform Act, 1992, § 444A(4) (Austl.).

The deed must specify the following:
(a) the administrator of the deed;
(b) the property of the company (whether or not already owned by the company when it executes the deed) that is to be available to pay creditors' claims;
(c) the nature and duration of any moratorium period for which the deed provides;
(d) to what extent the company is to be released from its debts;
(e) the conditions (if any) for the deed to come into operation;
(f) the conditions (if any) for the deed to continue in operation;
(g) the circumstances in which the deed terminates;
(h) the order in which proceeds of realising the property referred to in paragraph (b) are to be distributed among creditors bound by the deed;
(i) the day (not later than the day when the administration began) on or before which claims must have arisen if they are to be admissible under the deed.

Id.

[64]*Id.* § 444B(2).

[65]*Id.* § 444G(a).

[66]*Id.* § 444G(b)

[67]*Id.*

[68]*Id.* § 444G(c).

[69]*Id.* § 444D(1). It is, however, possible to terminate the deed. An administrator may do so when it is no longer practicable to carry on the business. To do so, a creditors' meeting may be called to decide whether the company should be voluntarily wound up. *Id.* § 445C, D–F.

[70]*Id.* § 439(b).

[71]The administration typically ends for one of these reasons; however, procedural matters, such as failure to hold the meeting, may bring about an end to the administration as well. *See generally* § 435C(3)(a)–(g) (setting forth seven criteria by which administration may end).

[72]*Id.* § 439C(c).

[73]*Id.* § 491.

III. SOME REORGANIZATION HISTORY AND A CHAPTER 11 PRIMER

Both Australian and American bankruptcy law have their roots in English law, though each has markedly departed from the early English model. To place this in context, I provide a brief overview of the development of bankruptcy law generally in England and of business bankruptcy law in the United States.

A. The Earliest Bankruptcy Laws

The earliest bankruptcy laws stem from Roman law. They were distinctly pro-creditor in nature. Either an insolvent debtor or defrauded creditors could demand transfer of the debtor's estate to the debtor's creditors.[74] Creditors had to elect one of their own to manage the estate.[75] The manager's primary duty was to convey good title to the property to a vendee.[76] The manager advertized the property for sale, sold the estate as a whole to the highest bidder, and that bidder then succeeded to all of the rights and obligations of the estate.[77] Thus, while there were provisions to aid creditors under Roman law, there was no attempt to provide for any "rehabilitation" of the honest but unfortunate debtor.[78]

During the middle ages, the commercial cities in Italy began to develop a form of collectivized debt collection to avoid fraud and facilitate equality among creditors.[79] These laws were an adaptation of the Roman law's bankruptcy procedure where the entire property of the debtor was divided equally among creditors.[80]

B. Early English Bankruptcy

The earliest statute on the subject of bankruptcy in England was passed in 1542.[81] This statute provided certain rights to a merchant's creditors as

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[74] MAX RADIN, HANDBOOK OF ROMAN LAW 315 (1927).

[75] *Id.*

[76] *Id.*

[77] *Id.*

[78] *Id.* at 315–16.

[79] 8 SIR W.S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 229 (1925); *see also* JAN H. DALHUISEN, *The Development of Bankruptcy in Western Europe in the Middle Ages, Renaissance, and Thereafter, Up to the Codification, in* EUROPEAN BANKRUPTCY LAWS 11, 13 (I. Arnold Ross ed., 1974) (describing how Italian system established equality among creditors).

[80] *Id.*

[81] 34 & 35 Hen. 8, c. 4 (1542-1543) (Eng.); HOLDSWORTH, *supra* note 79, at 236.

a group which they did not possess individually.[82] These rights became operable when a debtor committed certain acts—called acts of bankruptcy—which were thought to raise concerns over the creditors' ability to use conventional debt collection mechanisms to compel repayment.[83] The law was not designed to aid the debtor in any meaningful way; rather, it was largely geared toward the prevention of debtor fraud.[84] When a debtor committed a designated action which suggested the possible thwarting of a creditor's ability to collect, the creditors could petition the Lord Chancellor and request that the debtor's assets be gathered and distributed.[85] If the creditors were still not fully repaid as a result of this action, creditors retained the ability to resort to their other rights to attempt to compel payment.[86]

The first true act of bankruptcy—rather than for the prevention of fraud—came in 1570 during the period of Elizabeth's reign.[87] The law applied only to traders,[88] and it defined what should be regarded as acts of bankruptcy.[89] The Chancellor was given authority to appoint an individual with rights to exercise the powers of the Chancellor over the bankrupt's person and property.[90] These "commissioners" oversaw what amounted to the liquidation of the debtor's assets and the distribution of the proceeds from these assets to creditors.[91] This included a power analogous to pursuing fraudulent conveyances.[92] The law was distinctly pro-creditor in orientation: it provided no opportunity for discharge,[93] and a debtor who committed fraudulent acts of bankruptcy faced possible imprisonment.[94]

The focus of most bankruptcy legislation in England in the 16th and 17th centuries was to increase penalties on non-compliant debtors.[95]

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[82] 34 & 35 Hen. 8, c. 4 (1542-1543) (Eng.).

[83] HOLDSWORTH, *supra* note 79, at 236.

[84] *Id.*

[85] *Id.*

[86] *Id.*

[87] 13 Eliz., c. 7 (1570). The first English statute employing the term "bankrupt" was several years earlier. 34 & 35 Hen. 8, c. 4 (1542-1543) (Eng.).

[88] Others were treated merely as insolvents under common law.

[89] Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 9 (1995).

[90] *Id.* at 8.

[91] *Id.*

[92] 13 Eliz., c. 7, § 8 (1570).

[93] The Act stated: "[i]f the creditors were not fully satisfied, they could gain remedy for the residue of their debts, as if the act had not been made." *Id.* § 10. Further, "all future effects of the bankrupt, whether lands or goods, are to be appointed and sold by the commissioners for the satisfaction of his creditors." *Id.* § 11.

[94] HOLDSWORTH, *supra* note 79, at 237.

[95] Tabb, *supra* note 89, at 10.

Debtors' homes could be invaded to assist in repayment, and non-compliant debtors could be maimed.[96]

The notion of discharge first appeared in English law in the early 18th century, when Parliament passed an act containing a provision allowing for discharge.[97] Bankrupt traders who surrendered to the commissioner and conformed to his dictates or who were apprehended and then conformed were discharged from all debts due at the "time as he, she, or they did become bankrupt."[98] In addition, provisions allowed conforming bankrupts not only to receive a discharge, but also to receive an allowance to provide them an opportunity to again become productive members of society.[99]

The statute in effect at the time of the American Constitutional Convention was the 1732 statute of George II.[100] This law largely followed the lead of the Act of 1705 in attempting to create incentives for compliance from debtors. Discharge and retention of some property remained an option for the compliant debtor; extremely harsh treatment remained the norm for the non-compliant debtor.[101] Most English bankruptcy practices, including the prospect of imprisonment for debt, were imported to America and were generally being used in the Colonies prior to the framing of the Constitution.[102]

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[96] *Id.* (citing 21 Jam., c. 19, § 8 (1623); 1 Jam., c. 15, § 9 (1604)).

[97] 4 Ann., c. 17, § 7 (1705). Discharge was available, though, only to traders, and could only be invoked involuntarily by creditors. *See generally* John C. McCoid II, *Discharge: The Most Important Development in Bankruptcy History*, 70 AM. BANKR. L.J. 163, 163 n.2 (1996) (noting that bill was introduced in 1705, and this is date commonly cited, though it was not enacted until 1706).

[98] 4 Ann., c. 17, § 7 (1705).

[99] *Id.* § 8. Debtors could receive an allowance, not to exceed 200 pounds, of 5 pounds per hundred of the net estate recovered, so long as creditors received at least 8 shillings per pound owed. McCoid, *supra* note 97, at 167.

[100] 1 Geo. 2, c. 30 (1732).

[101] Tabb, *supra* note 89, at 12. Though the laws remained pro-creditor throughout the 17th century in England, a different attitude regarding bankrupts began appearing. For example, according to Blackstone,

> a bankrupt was formerly considered merely in the light of a criminal .... But at present the laws of bankruptcy are considered as laws calculated for the benefit of trade, and founded on the principles of humanity as well as justice; and to that end they confer some privileges, not only on the creditors, but also on the bankrupt or debtor himself.

1 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 1355–57 (William Carey Jones ed., Bancroft-Whitney Co. 1916) (1765); Tabb, *supra* note 89, at 11–12.

[102] Vern Countryman, *Bankruptcy and the Individual Debtor—And a Modest Proposal to Return to the Seventeenth Century*, 32 CATH. U. L. REV. 809, 812 (1983).

C. *The Constitutional Era and Bankruptcy*

The Constitution gives Congress the right to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[103] However, it almost did not do that. This power was not included in the original draft of the Constitution.[104] The subject was not even discussed until very late in the Convention when the Bankruptcy power was proposed as an addition to the Full Faith and Credit Clause.[105] The discussion of the subject of bankruptcy at the Constitutional Convention does not provide much guidance as to what was intended by the inclusion of the bankruptcy provision in the Constitution. The only objection set forth at the Convention to the bankruptcy power was based on a desire to insure that in this country—unlike in England—debtors could not be put to death.[106]

The Bankruptcy Clause, Article I, Section 8 of the United States Constitution, is extremely brief. There are two primary arguments that have been advanced for its brevity. The first is that the drafters intended to create an entirely new federal system, and a congressional statute, not the Constitution, was the most appropriate forum for the details to be fleshed out.[107] The second argument is that the American system of bankruptcy was

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[103]U.S. CONST. art. I, § 8.

[104]3 JOSEPH STORY, COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES 4 (Fred B. Rothman & Co. 1991) (1833).

[105]CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 4–5 (1935).

[106]2 MAX FARRAND, THE RECORDS OF FEDERAL CONVENTION OF 1787, at 489 (1911).

[107]This argument is based on the fact that under the Confederation, the states possessed the sole authority to create bankruptcy laws. *The Articles of the Confederation*, art. II (reserving to states all rights not expressly delegated to United States). The dissimilarity of the bankruptcy laws between the states caused a multitude of problems. 3 STORY, *supra* note 104, at § 1101. Many of these state laws were passed in part to relieve debtors from imprisonment, a problem which had grown due to the consequences of the war and other monetary disorders. Kurt Nadelmann, *On the Origin of the Bankruptcy Clause*, 1 AM. J. LEGAL HIST. 215, 223–24 (1957). Records of the Prison Discipline Society reflect that in 1830, thousands of people had been imprisoned for debt, including 3,000 in Massachusetts, 10,000 in New York, 7,000 in Pennsylvania and 3,000 in Maryland, with an estimated 50,000 additional people in the northern and middle states. Richard Ford, *Imprisonment for Debt*, 25 MICH. L. REV. 24, 29 (1926).

The issue naturally arose as to whether a statute in one state could protect a debtor if he or she ventured into another state. This question was often litigated in the years leading up to the Constitutional Convention. *See, e.g.*, James v. Allen, 1 U.S. 198, 200–01 (1786) (holding that order protecting debtor in New Jersey has no effect outside New Jersey); Miller v. Hall, 1 U.S. 240, 242–43 (1788) (considering effectiveness of Maryland statute granting discharge to debtor).

In THE FEDERALIST NO. 42, James Madison discussed the importance of a national bankruptcy code to prevent debtors from fleeing to other states with impunity:

> The power of establishing uniform laws of bankruptcy is so intimately connected

adopted with the English system in mind; therefore, the drafters just assumed that the United States system would mirror that of England.[108]

For most of the nineteenth century, there was no federal bankruptcy law. The Bankruptcy Act of 1800 was repealed in 1803;[109] the Bankruptcy Act of 1841[110] lasted even a shorter time. Both laws were intended to be temporary. In 1867, Congress passed a bankruptcy statute which lasted until 1878.[111] Each of these laws was passed in response to a particular economic crisis.[112] Finally, in 1898, Congress passed a lasting (though frequently amended), bankruptcy statute, the Bankruptcy Act of 1898.[113] This

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> with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States, that the expediency of it seems not likely to be drawn into question.
>
> The power of prescribing by general laws, the manner in which the public acts, records and judicial proceedings of each state shall be proved, and the effect they shall have in other States, is and evident and valuable improvement . . . . The power here established may be rendered a very convenient instrument of justice, and be particularly beneficial on the borders of contiguous States, where the effects liable to justice may be suddenly and secretly translated, in any stage of the process, within a foreign jurisdiction.

THE FEDERALIST NO. 42 (James Madison).

An additional argument that a completely new law was intended stems from the fact that the bankruptcy clause speaks of "uniform laws" rather than one "uniform law." This leads to the inference that Congress was free to create different laws for different types of debtors.

[108]This argument is based on the fact that the principal sponsors of the clause were both trained in the English system. James Monroe Olmstead, *Bankruptcy: A Commercial Regulation*, 15 HARV L. REV. 829, 831 (1902). Therefore, the argument goes, the framer's intent was to limit congressional power over bankruptcy legislation to law "analogous to the English bankruptcy laws in force at the end of the eighteenth century." Samuel Williston, *The Effect of a National Bankruptcy Law Upon State Laws*, 22 HARV. L. REV. 547, 551 (1909). The English system at that time was confined to traders and provided only for involuntary bankruptcies. *Id.*

[109]Act of April 4, 1800, ch. 19, 2 Stat. 19, *repealed by* Act of Dec. 19, 1803, ch. 6, 2 Stat. 248.

[110]Act of August 19, 1841, ch. 9, 5 Stat. 440, *repealed by* Act of March 3, 1843, ch. 82, 5 Stat. 614.

[111]Act of March 2, 1867, ch. 176, 14 Stat. 517, *repealed by* Act of June 7, 1878, ch. 160, 20 Stat. 99.

[112]The Depression of 1793 brought about the Bankruptcy Act of 1800. The panics of 1837 and 1857 brought about the Acts of 1841 and 1867, respectively. David A. Skeel Jr., *The Genius of the 1898 Bankruptcy Act*, 15 BANKR. DEV. J. 321, 322 (1999). For a full discussion, *See generally* WARREN, *supra* note 105 (discussing comprehensively history of bankruptcy in United States and analyzing such history with reference to three separate time periods between 1789 and 1935).

[113]Act of July 1, 1898, ch. 541, 30 Stat. 544, *repealed by* Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549.

enactment was supplanted by the current Bankruptcy Code, enacted in 1978.[114]

No concept of business bankruptcy was seriously considered under the Bankruptcy Clause until 1820.[115] At that time, a debate began which centered around whether Congress should have the power to legislate regarding the bankruptcy of corporations.[116] This was an issue since corporations were, in all other respects, regulated by state rather than federal law.[117] Proponents of federal regulation argued that a federal law was necessary due to inconsistent state regulations, and that corporations were sufficiently important to interstate commerce that Congress could regulate their bankruptcies.[118] However, no bankruptcy law actually included provisions intended to regulate business bankruptcy until the passage of the Bankruptcy Act of 1867. This Act, repealed in 1878, provided for limited discharge of corporate debts on consent of the majority of the businesses' creditors.[119]

D. The Bankruptcy Act of 1898

The Bankruptcy Act of 1898 was the first "permanent" bankruptcy law in the United States.[120] The dominant forces behind the Act were business organizations that lobbied on behalf of unsecured creditors.[121] However, pro-debtor forces also played a role.[122] The battle between the two groups resulted in three important developments: First, the creation of an administrative structure providing only for paid referees and trustees;[123] second, state exemption laws were incorporated into bankruptcy law;[124] and third, while involuntary discharge was retained, a vote by creditors ceased to be necessary to obtain a discharge.[125]

Prior to the 1934 amendments to the Bankruptcy Act of 1898, there were essentially three methods for a business to restructure without

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[114]Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified as enacting 11 U.S.C. §§ 101 to 1330).

[115]Skeel, *supra* note 9, at 479.

[116]*Id.*

[117]*Id.* at 479–80 n.30.

[118]*Id.* at 480–81.

[119]This provision was little used during the period that the Act was in force. KEVIN J. DELANEY, STRATEGIC BANKRUPTCY 21 (1992).

[120]Skeel, *supra* note 9, at 325.

[121]*Id.* at 328.

[122]*Id.* at 330.

[123]*Id.* at 334–34.

[124]*Id.* at 334–35.

[125]*Id.* at 335.

liquidating. The first method was through a voluntary contract between the creditors and the debtor.[126] The second was by making use of existing bankruptcy laws, such as employing a bankruptcy sale. Assets at a bankruptcy sale were typically purchased by creditors, but occasionally the debtor would also "buy" the assets.[127] The third type of reorganization was equity receivership. Equity receivership was a method in which a court appointed a receiver to take control of a debtor's assets and sell them for the benefit of creditors. By invoking diversity jurisdiction, the parties were able to make use of the federal courts.[128] This third method was by far the most frequently employed approach to business reorganization prior to 1934.

Perhaps the most notable use of the federal equity receivership was to save the railroads from liquidation. With railroads, not only was a clear public interest evident, but it was also the case that the railroads' assets had little value if sold for scrap. Typically, a creditor would petition for appointment of a receiver[129]—often the existing management of the firm—who would then continue to run the railroad. This arrangement would typically be consolidated with foreclosure proceedings, and would conclude with a judicial sale at which the creditors—and sometimes the debtor—would become the purchasers under a new arrangement. While in receivership, committees of various groups of creditors would be formed to negotiate a new plan of reorganization with the new corporation. When the assets were purchased at foreclosure, they were then placed with the new corporation. The effect was that creditors' claims against the old firm would be replaced by a stake in the new firm, effectively restructuring the debt while the business remained operative.[130]

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[126]The problem with this arrangement was that dissenting creditors could not generally be bound by a voluntary agreement.

[127]There were two primary problems with this approach: First, it carried the stigma of a bankruptcy proceeding. Second, the bankruptcy proceeding could not continue if a workout was in progress and the debtor's business continued to operate.

[128]Edward H. Levi & James Wm. Moore, *Bankruptcy and Reorganization: A Survey of Changes*, 5 U. CHI. L. REV. 1, 4 (1937).

[129]While equity receivership was generally obtained on a creditor's bill, as a practical matter, the debtor was often the impetus for commencing such an arrangement, arranging for a friendly creditor to file the bill. *Id.*

[130]*See, e.g.*, 7 COLLIER ON BANKRUPTCY ¶ 1100.11[1] (Lawrence P. King ed., 15th ed. rev. 1996); DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 64–72 (rev. ed. 1993); Edward S. Adams, *Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results*, 73 B.U. L. REV. 581, 584–86 (1993).

E. The 1934 Enactment of § 77B

The Depression was the impetus for the introduction of corporate reorganization into existing American bankruptcy law.[131] In his February 29, 1932 address to Congress, President Hoover stated: "[t]he present Bankruptcy Act is defective in that it holds out every inducement for waste of assets long after business failure has become inevitable. It permits exploitation of its own process and wasteful administration by those who are neither truly representative of the creditor nor the bankrupt."[132] President Hoover subsequently urged Congress to implement a system of corporate reorganization.[133] The result was the proposal of H.R. 5884 in the first session of the 73rd Congress. In 1934, this enactment became section 77B of the Bankruptcy Act of 1898.[134]

Section 77B allowed a debtor to propose a plan of reorganization to be approved by its creditors.[135] Confirmation required a creditor vote and court approval. The required majority for creditor vote was two-thirds in dollar amount of each claim affected by the plan.[136] Court approval would be acquired if the court found the plan to be fair, equitable, and feasible.[137]

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[131]The introduction of a precursor of business reorganization laws in England appears to have occurred with the 1870 amendment to the Companies Act of 1862. As the Chancery Division stated in *In re Savoy Hotel Ltd.*:

> [S]ection 2 of the Joint Stock Companies Arrangement Act 1870 introduced for the first time a rudimentary ancestor of section 206, limited to compromises or arrangements proposed between a company which was in the course of being wound up, either voluntarily or compulsorily or under supervision, and its creditors or any class of them. The compromise of arrangement had to be approved by a three-fourths majority in value, but not in number, of the creditors, and the section provided that if that happened the arrangement or compromise should " . . . if sanctioned by an order of the court, be binding on all such creditors or class of creditors, as the case may be, and also on the liquidator and contributories of the said company." The power was expressed to be in addition to any other power of the court.

3 W.L.R. 441, 447 (1981) (quoting The Joint Stock Companies Arrangement Act, 1870, 33 & 34 Vict., c. 104, § 2 (Eng.)).

[132]S. DOC. NO. 72-65, pt. 1 at XI (1932).

[133]H.R. DOC. NO. 72-522 (1933).

[134]Act of June 7, 1934, ch. 424, 48 Stat. 911 (transferred to scattered chapters by Chandler Act of 1938, which was subsequently revised by the Bankrupcy Act of 1978).

[135]*Id.* § 778(a).

[136]*Id.* § 77B(e)(1). There are two distinct methods by which creditor vote can be measured. The first is by dollar amount, where a creditor with a one hundred dollar claim would have one hundred votes, and where a person with a one dollar claim has one vote. The second method is to afford each creditor one vote irrespective of the size of its claim.

[137]*Id.* § 77B(F)(1).

F. The Chandler Act and the Arrival of Chapter X and Chapter XI in 1938

Changes to the business reorganization statute occurred with the passage of the Chandler Act of 1938.[138] Under the new law, section 77B was replaced by Chapters X and XI. Chapter X, unlike section 77B, required the appointment of an independent trustee in all cases where the debt exceeded \$250,000.[139] The trustee was given broad powers.[140] Under Chapter X, a plan could not be confirmed unless it was "fair and equitable."[141] In other words, in the absence of agreement to the contrary, junior interests could not receive anything until all senior classes were paid in full.

Chapter XI was designed primarily to allow small businesses to deal with their unsecured debt. A Chapter XI debtor remained in possession,[142] and the debtor was the only entity that could propose a plan.[143] Any plan that received a majority vote in number and in dollar amount of claims in each class could be confirmed by the court,[144] as long as dissenting creditors would receive at least as much in the reorganization as they would in a liquidation.[145]

By the 1970's, neither Chapter X nor Chapter XI were being used exclusively in the manner in which Congress had intended. Chapter XI had generally replaced Chapter X, which was effectively dead.[146] This and other circumstances led to the drafting of an entirely new bankruptcy law, and the modern Chapter 11, codified at Chapter 11 of Title 11 of the United States Code, emerged in 1978.[147]

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[138]Chandler Act of 1938, ch. 575, 52 Stat. 840 (revised by Bankruptcy Act of 1978).

[139]*Id.* § 156.

[140]*Id.* § 167.

[141]*Id.* § 221.

[142]*Id.* §§ 342, 343.

[143]*See id.* § 306.

[144]*Id.* §§ 361, 362.

[145]This is commonly referred to as the "best interests" test.

[146]By the mid-1970s, less than ten percent of business reorganization cases were being filed under Chapter X. BANKRUPTCY REFORM ACT OF 1978, REPORT OF THE COMM. ON THE JUDICIARY, H.R. REP. NO. 95-595, at 222 (1977); *see also* Lawrence P. King, *The Business Reorganization Chapter of the Proposed Bankruptcy Code—Or Whatever Happened to Chapters X, XI and XII*, 78 COM. L. J. 429 (1973).

[147]The basic law remains from the 1978 Act, though the Code has been subsequently amended. *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333; Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106.

G. Chapter 11—A Primer

Chapter 11 encompasses numerous important substantive changes. Perhaps the most significant of these changes is that the "debtor-in-possession" provision was substantially broadened. Prior to 1978, firms with public debt or equity had a trustee appointed, and only privately held companies could operate as debtors in possession. Under Chapter 11, it is the norm for all companies to operate as debtors in possession.[148] This single change provided incentives for publicly held companies to attempt reorganization. With the debtor-in-possession in control, managers are far more likely to keep their jobs during reorganization, and companies can operate without the constraints of a trustee, and to a large degree, as long as they are operating within the ordinary course of their business, without constraints imposed by their creditors.[149]

There were a number of other significant changes. Under Chapter 11, the insolvency requirement for a business to enter bankruptcy was abolished. A debtor need no longer be insolvent—either on a balance sheet or an equity basis—to file for Chapter 11. As a result, there are now no meaningful constraints on who can seek bankruptcy protection. In addition, the Chapter 11 debtor is now given the exclusive right to propose a plan[150] for the first 120 days following the filing of a petition.[151] This period is frequently extended further.[152] By initially having the exclusive right to propose a plan, the debtor has significant leverage in the negotiating process

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[148]It is, however, possible in unusual cases in Chapter 11 to have a trustee or examiner appointed. 11 U.S.C. § 1104(a), (c) (1994).

[149]As long as the debtor is operating within the ordinary course of its business, the debtor-in-possession fully operates the business during the time the company is in Chapter 11. It has the right, subject to certain restrictions, to use, sell, or lease the property of the estate. 11 U.S.C. § 363 (1995). It can borrow on behalf of the debtor. *Id.* § 364. It can generally assume, assume and assign, or reject executory contracts. *Id.* § 365. For a critique of the changes brought by the advent of Chapter 11, see Bradley & Rosenzweig, *supra* note 1.

[150]A plan proponent must also provide, in addition to the plan, a court-approved disclosure statement containing adequate information for a creditor to evaluate the plan. 11 U.S.C. § 1125 (1994).

[151]*Id.* § 1121(b). This is called the exclusivity period. If the debtor has not filed a plan within 120 days, or if the plan has not been confirmed within 180 days, any party may file its own plan. *Id.* § 1121(c). This was not the case under Chapter X of the Bankruptcy Act, under which the debtor retained the exclusive right to propose a plan throughout the pendency of the bankruptcy proceeding. After the expiration of this period, a creditor could propose its own plan and move to have it confirmed by the bankruptcy court.

[152]*See id.* § 1121(d).

within Chapter 11.[153] If neither the debtor's plan nor any other plan can successfully be confirmed, it is likely that the firm's assets will be liquidated.[154]

The Code imposes thirteen requirements for a plan to meet in order to be confirmed.[155] All are mandatory, except one—that the plan be consensual.[156] Creditors vote on a plan by class.[157] A favorable vote can be obtained in either of two ways. First, any class of claimants whose interests are unimpaired[158] under the plan is automatically deemed to accept the plan.[159] Alternatively, an impaired class may vote in favor of a plan. To do so, the majority of creditors in the class must vote in favor of the plan, and the claims of those voting for the plan must have a dollar value equal to at least two-thirds of the dollar value of all of the claims in the class.[160]

As long as the plan is consensual, the debtor's ability to retain ownership is contractually determined based upon the agreement of the parties rather than upon the rule of law. If the plan is not consensual, however, and an impaired class rejects the plan, the plan can still be confirmed in what is known as a "cram down"[161] if certain requirements are met.[162] These requirements include that at least one class of impaired creditors who are not insiders has accepted the plan,[163] that the plan does not unfairly discriminate, that the "best interests" test is satisfied,[164] and that the plan is deemed "fair and equitable."[165]

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[153]The desire to give the debtor leverage to negotiate is made clear in the legislative history of the Code. *See* S. REP. NO. 95-989, at 1188 (1978). The fact that the debtor retained the exclusive right to propose a plan under the old Chapter X, however, was deemed to give it too much leverage. Thus a compromise was reached by Congress whereby the debtor would be given initial exclusivity to propose a plan, but after a reasonable time without a plan being first proposed and then confirmed, the right to propose a plan would be opened to all parties in interest. *See, e.g.*, H. R. REP. NO. 95-595, at 174 (1977).

[154]*See generally* 11 U.S.C. § 1112 (1994) (allowing for conversion of case from one under Chapter 11 to one under Chapter 7 of Code).

[155]*Id.* § 1129(a)(1)–(13).

[156]*Id.* § 1129(a)(8).

[157]*See generally id.* § 1122 (classification of claims or interests). All holders of claims and interests may vote on the plan. *Id.* § 1126(a) (stating that "holder of a claim or interest allowed under section 502 of this title may accept or reject a plan").

[158]A class is said to be impaired unless certain specified requirements are met that essentially leave unaltered the rights of the party in question. *Id.* § 1124.

[159]*Id.* § 1126(f).

[160]*Id.* § 1126(c).

[161]*Infra* note 193.

[162]*See* 11 U.S.C. § 1129(b) (1994).

[163]*Id.* § 1129(a)(10).

[164]The best interests test requires the dissenting impaired class of creditors to receive at least as much as it would in a Chapter 7 liquidation. *Id.* § 1129(a)(7)(A)(ii).

[165]*Id.* § 1129(b)(1).

There are two methods of satisfying the fair and equitable requirement, depending on the status of the creditor's claim. For dissenting secured creditors, a plan is fair and equitable and can be crammed down if the secured creditor effectively receives the full economic equivalent of its secured claim. The Code provides three methods of accomplishing this. First, a dissenting secured creditor may keep its lien and receive payments on the plan's effective date equal to the amount of the secured claim; second, the creditor may receive the indubitable equivalent of its claim; or third, the property can be sold free and clear of the lien, with the creditor's security interest attaching to the proceeds of the sale. This lien on proceeds may then be treated under either of the other two options.[166]

For impaired, dissenting unsecured creditors, a plan is deemed to be fair and equitable if it satisfies the terms of the absolute priority rule. The absolute priority rule resulted both from an interpretation of the phrase "fair and equitable," and as a rule of contract law. Because creditors have priority over equity in contracts under state law, it makes sense that for a plan to be fair and equitable, this order of priority must be retained in a reorganization.[167] Hence the derivation of the absolute priority rule, which holds that with respect to dissenting unsecured creditors, no junior class of claimants can receive a penny in a cram down unless all senior classes are paid in full.[168] Thus, a plan is fair and equitable with respect to an impaired class if that class will receive full compensation for its allowed claims before any junior class receives any distribution.[169]

Taken in conjunction with the rest of the Bankruptcy Code, the absolute priority rule provides for a distribution in a cram down that mirrors the priority scheme established under state law.[170] Also, when a company's assets truly cannot meet its liabilities, the absolute priority rule, taken at face value, appears to seriously call into doubt the chance of old equity ever

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[166] *Id.* § 1129(b)(2)(A).

[167] This idea stems from an old United States Supreme Court case called *Northern Pacific Ry. Co. v. Boyd*, 228 U.S. 482, 502–05 (1913), discussed *infra*.

[168] "[T]he holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B)(ii) (1994).

[169] Prior to the adoption of the 1978 Bankruptcy Code, the absolute priority rule went even further in this regard. Under former Chapter X of the Bankruptcy Act, absolute priority had to be maintained for all classes of creditors, irrespective of whether each class consented to the plan. Under Chapter 11, absolute priority may be waived by a class that consents to do so.

[170] *See, e.g.*, U.C.C. § 9-504 (1998) (providing order of applying proceeds from disposition of collateral after default).

participating in the reorganized debtor—presumably the very purpose for the debtor entering bankruptcy protection in the first place.

IV. SOME SALIENT DIFFERENCES BETWEEN AUSTRALIAN AND AMERICAN BUSINESS BANKRUPTCY LAWS

A. Bankruptcy Theory and the Australian and American Models of Company Reorganization

Historically, there have been two primary views of the central purpose of business bankruptcy. The first considers bankruptcy's core role as dealing with an array of social problems that attend a company's mass financial distress. This view may be called the "Social Benefit" approach. Chapter 11 in many respects reflects this view. The other approach—the Creditors' Bargain[171]—focuses on the contractual relations of the parties and views bankruptcy largely as a means to deal with common pool problems. The Australian model more closely parallels this model.

1. The Social Benefit Approach and the American Model

The Social Benefit approach to corporate reorganization law takes as its fundamental premise that bankruptcy plays a unique role in addressing a vast array of complex issues that attend situations of financial distress.[172] These issues include such things as the ramifications of taxes, employees and suppliers remaining unpaid, the existence of outstanding executory contracts, and the presence of creditors threatening to levy and foreclose. The breadth of these concerns necessitates looking beyond state foreclosure laws, which are designed primarily to protect the interest of creditors.

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[171]The name and substance of the "Creditors' Bargain" argument come from writings by Thomas H. Jackson, beginning with his seminal article, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain,* 91 YALE L.J. 857 (1982).

[172]According to this view, state laws designed to deal with isolated defaults are fundamentally different in character from bankruptcy laws and cannot be used as a grounding point for evaluating how bankruptcy law should function. The Social Benefit approach has perhaps most frequently been espoused by Elizabeth Warren in recent years. A number of Warren's writings touch on this theme. *See, e.g.*, Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 781–82 (1987) (arguing that bankruptcy pertains to distribution of losses, not enhancement of creditors' collections) [hereinafter Warren, *Bankruptcy Policy*]; Elizabeth Warren, *Bankruptcy Policy Making in an Imperfect World*, 92 MICH. L. REV. 336 (1993) (articulating competing goals that underlie bankruptcy system); *see also* Donald R. Korobkin, *Value and Rationality in Bankruptcy Decisionmaking*, 33 WM. & MARY L. REV. 333, 335 (1992) (arguing for "value based account" that considers both economic and non-economic values of those affected by financial distress).

Rather, goals in bankruptcy should include enhancing the value of a going company (or at least preserving its going concern value), protecting certain parties deemed socially worth protecting who are not well situated to protect themselves, establishing a method to collectivize debt collection to make it a more fair and efficient process, and determining how the company's existing value will be distributed.[173]

Consistent with the Social Benefit view of bankruptcy is the concept that affording the debtor maximum opportunity to successfully reorganize is the best way to address such attendant social concerns as loss of jobs and the impact on neighboring businesses and suppliers.[174]

Chapter 11—widely considered to be one of the most debtor-friendly reorganization laws in the industrialized world—contains elements that track the Social Benefit approach. Creditor interests are often perceived as secondary in importance to reorganization and accompanying social concerns. To aid reorganization, aspects of Chapter 11 are redistributional.[175] This is reflected in a number of places. For example,

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[173]Determining distribution includes determining who can best bear the risk of loss and protecting those who are poorly situated to bear these costs, such as employees. For example, Warren writes:

> But the revival of an otherwise failing business also serves the distributional interests of many who are not technically "creditors" but who have an interest in a business's continued existence. Older employees who could not have retrained for other jobs, customers who would have to resort to less attractive, alternative suppliers of goods and services, suppliers who would have lost current customers, nearby property owners who would have suffered declining property values, and states or municipalities that would have faced shrinking tax bases benefit from the reorganization's success. By giving the debtor business an opportunity to reorganize, the bankruptcy scheme acknowledges the losses of those who have depended on the business and redistributes some of the risk of loss from the default. Even if dissolution is inevitable, the bankruptcy process allows for delay, which in turn gives time for all those relying on a business to accommodate the coming change.

Warren, *Bankruptcy Policy, supra* note 172, at 787–88.

[174]The legislative history to the 1978 Bankruptcy Code provides support for this position. The House Report of the original committee working on Chapter 11 noted that "[t]he purpose of a business reorganization case . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors . . . . It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets." H.R. REP. NO. 95-595, at 220 (1977).

[175]It is not clear that Chapter 11—unlike other forms of bankruptcy—was intended to be redistributional. For example, corporate bankruptcy offers no "fresh start" by which debts can be discharged and future income and certain other assets can be protected from pre-petition claimants. *Compare* 11 U.S.C. § 1141(d)(2) (1995) (providing that Chapter 11 "discharge" consists of exchanging old obligations for new obligations), *with* 11 U.S.C. § 727(a) (1995) (granting discharge to individual debtor).

certain favored parties receive treatment in Chapter 11 that they could not get under non-bankruptcy law, such as those who obtain heightened priority on the basis of status, like employees, lessees, and those entitled to alimony or child support benefits.[176] In addition, to ensure that a debtor can obtain financing to continue its business, under certain circumstances, a new lender's lien can prime an existing properly perfected security interest,[177] something that cannot occur under state law. Thus, in Chapter 11, the rights of certain parties can be sacrificed to other parties' interests in order to facilitate the goals of rehabilitation and protection of various favored parties

2. The Creditors' Bargain and the Australian Model

The second major approach to corporate reorganization law is the Creditors' Bargain. Adherents to the Creditors' Bargain approach view bankruptcy as a second, procedurally distinct method of debt collection from state law. Bankruptcy, under this view, should be employed in situations where there are multiple defaults. Bankruptcy law should strictly adhere to state law created substantive rights.[178] If not, the problem of forum shopping will always remain. The focus of the Creditors' Bargain is largely creditor protection, since creditors effectively own firms in bankruptcy.[179]

Under this view, bankruptcy is needed because state law debt collection rules are designed to deal with individual instances of a debtor's default and do not deal effectively with multiple defaults. Thus, absent bankruptcy,

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[176] *See generally* 11 U.S.C. § 507(a) (1995).

[177] *Id.* § 364(d).

[178] The United States Supreme Court has supported adherence to non-bankruptcy created substantive rights in bankruptcy. In *Butner v. United States*, 440 U.S. 48, 56 (1979), the Court criticized the use of "undefined considerations of equity" in bankruptcy to change results dictated by non-bankruptcy law. The Court noted: "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law." *Id.* at 54; *see also* Raleigh v. Illinois Dep't of Revenue, 120 S. Ct. 1951, 1955 (2000) (stating that "[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code. The 'basic federal rule' in bankruptcy is that state law governs the substance of claims") (citations omitted).

[179] Creditors effectively own a firm in bankruptcy because the equity of an insolvent firm is essentially valueless while the going concern value of the firm can still be sold to pay off some of the debt to creditors. *See generally* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 740–44 (1988) (examining absolute priority rule from perspective of renegotiation problem).

classic common pool problems would exist.[180] Accordingly, bankruptcy's fundamental purpose is to provide a solution to the common pool problem by forcing creditors in a bankruptcy proceeding to enter a bargain to determine how ownership rights in the assets should be allocated. This bargain—bankruptcy law—replicates the hypothetical bargain the creditors would have made *ex ante* at the time they negotiated their positions were they able to so contract.[181] The bargain has many advantages for creditors, including the avoidance of strategic costs which would be part of a race to the courthouse and the elimination of potential variances in amount of recovery that would exist under state law.[182] For a variety of reasons, including opt-out problems and the fact that the creditors of a given debtor are likely to change over time, creditors cannot put such an agreement into place individually.[183] The reduction in collection costs achievable through bankruptcy is beneficial to secured and unsecured creditors alike.[184]

Thus, under the Creditor's Bargain view, bankruptcy law benefits the collective in several ways. First, it identifies rights that were entered into under state law. Second, it stays individual recovery actions[185] to prevent dismemberment of the common pool and to maximize the total assets available to be recovered. Finally, it sets up a process by which the assets

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[180] THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 11–12 (1986) (promoting concept that reorganization is form of sale to creditors); Alan E. Friedman, *The Economics of the Common Pool: Property Rights in Exhaustible Resources*, 18 U.C.L.A. L. REV. 855 (1971) (proposing qualified, general, theoretical solution to common pool problem). It is important to note in addressing common pool problems that the behavior of each individual in acting selfishly in regard to the pool's assets is rational; however, this self-interested behavior has the result of leading to sub-optimal results for the group when viewed collectively.

[181] This bargain, of course, must be hypothetical. In addition to the practical impossibilities of having all creditors bargain amongst themselves, the identity of creditors changes over time.

[182] The elimination of the risk of variance has value for risk-averse creditors. Jackson, *supra* note 171, at 862.

[183] *Id.* at 866.

[184] Critics of the Creditors' Bargain have argued that it places economic gain as the highest value, and its use of this collectivist methodology is merely a guise to detract attention from the true values at its core. *See, e.g.*, Warren, *Bankruptcy Policy, supra* note 172, at 802–03. Warren argues that Douglas Baird's Creditors' Bargain approach

> is not one of collectivism so much as one of economic rationality: the aim of bankruptcy policy is to make certain that assets go to their highest-valued use. Baird is at pains to avoid the economic lingo, but he cannot escape the conclusion that the only value he protects is economic wealth maximization for the bankrupt estate.

Id.

[185] 11 U.S.C. § 362 (1995).

of the common pool are distributed or put to use according to the method that the creditors as a group value most.[186]

The Australian Model reflects an ideology analogous to the Creditor's Bargain approach. The primary objective of Voluntary Administration is to maximize the chance that the whole or part of a company may successfully continue in business. However, if this is not possible, the secondary goal is to provide a better return to creditors and members than would have been achieved from the immediate winding up of the company.[187] Although not explicit in the first objective, each concern emphasizes the impact of a reorganization attempt on creditors.[188] If the firm reorganizes, the effect will be that the once again viable firm has addressed the problems that led to its insolvency, thus allowing creditors to either be paid in full over a period of time or to at least enjoy any going concern value associated with the company's business. When the business is not viable as a going concern, the return on the creditors' investment becomes the express purpose of the liquidation. By reducing administrative costs through collective action, creditors will receive more than they would have received in a straight liquidation.[189]

A number of elements in Voluntary Administration reflect a Creditors' Bargain approach. For example, the moratorium preserves the common pool, except where a holder of a lien on substantially all of the assets opts otherwise.[190] If such a creditor is convinced that its rights will not be impaired by an administration, it can always opt not to exercise this right. On the other hand, a single creditor without dominant rights in the collateral

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[186] Jackson later revisited and expanded his Creditors' Bargain model. Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989). In this Article, several new elements were added to the Creditors' Bargain model to address the existence of redistribution in bankruptcy for which the simple model did not properly provide. These elements include the consensual sharing of common risk among creditors, the need to discourage self-interested decisions made on the eve of bankruptcy, a recognition of certain non-monetary values among the ownership and management of certain firms, and the presence of "random or unsystematic distributional effects." *Id.*

[187] Corporate Law Reform Act, 1992, § 435A (Austl.); *see also* James Routledge, *Part 5.3A of the Corporations Law (Voluntary Administration): Creditors' Bargain or Creditors' Dilemma*, 6 INSOLV. L.J. 127 (1998) (discussing interpretation of Voluntary Administration laws).

[188] The centrality of the creditors' role is explicit in the comments of the Australian Law Reform Commission (ALRC). While the ALRC advocated a "constructive" approach to corporate insolvency, providing for preservation of the business where appropriate, its focus remained on creditors making an informed decision in an orderly environment about the future of the company. *See generally* GENERAL INSOLVENCY INQUIRY, *supra* note 11.

[189] *See* Routledge, *supra* note 187, at 132–33.

[190] *See* Corporate Law Reform Act, 1992, § 441A (Austl.).

cannot act on its security, thus preventing a single entity with a minority interest from disrupting a process good for the whole. These Voluntary Administration provisions are consistent with an *ex ante* bargain, where a dominant creditor would have bargained for and had these rights outside bankruptcy and would insist *ex ante* on their inclusion in bankruptcy.[191] In addition, the creditors determine the firm's future by majority vote. Thus, whether a deed of arrangement, a termination of the administration, or a liquidation is the end result of the administration, the outcome reflects the sort of *ex ante* bargain one would expect of creditors were they so able to contract.

B. Nine Critical Differences Between Voluntary Administration and Chapter 11

To illustrate why Voluntary Administration functions more effectively than Chapter 11, I will focus on nine distinct elements which distinguish the two systems. These elements are:

> (1) Australia has something akin to an insolvency requirement for voluntary bankruptcy,[192] while the United States does not;
> (2) An Australian vote on a deed of arrangement is determined by a simple majority by number and dollar amount, while in the United States, claims are classified and voting on a plan of reorganization includes a super-majority component;
> (3) The Australian system is far less administratively costly than the United States approach, in part because it does not require the ongoing involvement of bankruptcy court personnel;
> (4) Unlike the United States, Australian law contains no debtor-in-possession provision;
> (5) The Australian system functions far more rapidly than Chapter 11;
> (6) Directors of an Australian company are better shielded from personal liability during the bankruptcy process than are their American counterparts, providing an incentive for Australian directors to place their firm under bankruptcy protection early when the firm is more likely to still be salvageable;
> (7) The Australian administrator is personally liable for all debts incurred by the company for services rendered, goods bought, or property hired or leased during the administration;
> (8) There is an opt-out procedure for Australian creditors with a security interest in all or substantially all of the debtor's assets; the American

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[191] *See* Routledge, *supra* note 187, at 132.

[192] For purposes of this comparative analysis, I employ the term "bankruptcy" to mean Voluntary Administration in the Australian context and Chapter 11 in the American context.

bankruptcy system is mandatory upon all creditors, though certain secured creditors may succeed in lifting the automatic stay; and
(9) Cram down[193] in Australia is far more limited than in the United States.

C. The First Seven Comparative Features

1. The Presence in Australia of Something Akin to an Insolvency Requirement

Australian law, unlike American law, has something close to an insolvency requirement for company bankruptcy. Voluntary Administration is to be employed by companies that are either insolvent or "likely to become insolvent,"[194] with insolvency defined in the liquidity sense of a firm being unable to pay its debts as they become due.[195] By contrast, in the United States, bankruptcy may be employed by any entity that may be a debtor,[196] irrespective of whether there are common pool problems warranting bankruptcy,[197] since the Bankruptcy Code contains neither a good faith filing requirement[198] nor an express insolvency requirement.[199]

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[193]Cram down is an American term for the confirmation of a plan over the dissent of an impaired class of creditors. While the term is not generally employed in Australian legal parlance, I shall employ the term generally to refer to a plan of reorganization being binding upon dissenting creditors in discussing both Australian and American law.

[194]Corporate Law Reform Act, 1992, § 436A (Austl.).

[195]*Id.* § 95A.

[196]11 U.S.C. § 101(13), (40), (41) (1995).

[197]*See supra*; Part II. F; *see also*, JACKSON, *supra* note 171, at 194–203 ("If bankruptcy's rules have been appropriately designed, most cases can be handled reasonably well by creating a rebuttable presumption of appropriateness upon showing that there are multiple creditors and a reasonable prospect of insolvency.").

[198]*See, e.g., In re* Johns-Manville Corp., 36 B.R. 727, 732, 737 (Bankr. S.D.N.Y. 1984) (finding no insolvency requirement for voluntary Chapter 11 petition, and no good faith requirement to file). However, certain courts have been willing to impose such a good faith filing rule based on inferences made from other Code sections and kick the debtor out of bankruptcy, subjecting it again to state law creditors' remedies. *In re* C-TC 9th Avenue Partnership, 113 F.3d 1304, 1311 (2d. Cir. 1997) (dismissing filing of debtor who "enjoyed no likelihood of rehabilitation" and whose "main purpose in filing its Chapter 11 petition was to stay the state court proceedings and to relitigate in the bankruptcy forum the matters that had been settled in the state court," and holding that court need not rely on factors for dismissal set out in section 1112(b), as "this list is illustrative, not exhaustive"); *In re* Charfoos, 979 F.2d 390, 392 (6th Cir. 1992) ("It is well-settled that even though Chapter 11 does not expressly so state, bad faith may serve as a ground for dismissal of a petition. It is less firmly established though what actions may rise to the level of bad faith.") (citations omitted); *In re* Humble Place Joint Venture, 936 F.2d 814, 816–17 (5th Cir. 1991) ("The Bankruptcy Code provision that a Chapter 11 case may be dismissed 'for cause' has been

The absence of an insolvency requirement has afforded American debtors the opportunity to employ bankruptcy for offensive, strategic purposes. In Australia, strategic use of Voluntary Administration is more limited.[200] In the United States, a solvent debtor may choose to file bankruptcy as a business planning device—perhaps to attempt to force a debt restructuring on an unwilling creditor by virtue of the automatic stay and accompanying delays, perhaps to have the opportunity to reject executory contracts,[201] perhaps to obtain the benefit of a turnover order,[202] or perhaps for management to retain their jobs longer.[203]

One difficulty, it should be noted, with the Australian approach of requiring an insolvency component to enter bankruptcy is determining when a company is in fact insolvent. Whether one defines insolvency on a liquidity basis or based on whether all liabilities, appropriately valued, exceed all assets appropriately valued, three obvious difficulties follow. First, determining appropriate valuation is costly and time consuming. Second, valuation is a difficult, inaccurate science. Finally, valuations change over time. For example, different uses of assets may result in different valuations. Thus, a "solvent" company today may be an "insolvent" company tomorrow.[204]

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interpreted to include the lack of good faith in its filing."); Matter of Winshall Settlor's Trust, 758 F.2d 1136, 1137 (6th Cir. 1985) ("[G]enerally, an implicit prerequisite to the right to file [a Chapter 11 petition] is 'good faith' on the part of the debtor, the absence of which may constitute cause for dismissal. . . ."); *see also* Lawrence Ponoroff & F. Stephen Knippenberg, *The Implied Good Faith Filing Requirement: Sentinel of an Evolving Policy*, 85 NW. U. L. REV. 919 (1991) (examining good faith doctrine and its operation in bankruptcy process).

[199]By contrast, the prior American bankruptcy act, the Bankruptcy Act of 1898, required a showing "that the corporation is insolvent or unable to meet its debts as they mature and that it desires to effect a plan of reorganization." Act of June 7, 1934, ch. 424, 48 Stat. 911, 912 (repealed 1978).

[200]It is not eliminated completely. For example, directors may opt for Voluntary Administration to control who may ultimately liquidate the business if necessary or to delay and eradicate the prospect of liability for potentially fraudulent transactions. *See* discussion *infra* Parts IV.B.4, IV.B.6.

[201]11 U.S.C. § 365 (1995).

[202]*See id.* § 542(a); *see also* United States v. Whiting Pools, Inc., 462 U.S. 198, 202–03 (1983) (requiring I.R.S. to turn over property seized under tax lien to debtor-in-possession).

[203]*See generally* Daniel Keating, *Offensive Uses of the Bankruptcy Stay*, 45 VAND. L. REV. 71, 80–128 (identifying five offensive reasons for filing bankruptcy and noting associated costs of courts allowing offensive uses of bankruptcy stay).

[204]*But see* Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 548 (1996) (arguing that some of difficulties of insolvency requirement could be ameliorated by statutory creation of rebuttable presumption of insolvency).

2. Classification and Voting

Voting for an Australian deed of arrangement is determined by a simple majority of creditors both by number and by dollar amount at stake. Claims are not classified. By contrast, the American voting system is done by classification of claim,[205] and there is a super-majority component required for a class to consent to a plan. As noted, in the United States, unless a class is unimpaired, for it to vote in favor of a plan, both the majority of creditors in the class must vote in favor of the plan and their claims must have a value equal to at least two-thirds of the value of all of the claims in the class.[206]

Classification has a significant advantage and a significant disadvantage. The advantage is that it allows each group of similar claimants to make decisions about what is in the best interest of its own class, without allowing an individual malcontent to destroy a generally beneficial deal. The disadvantage is that there is a constant risk of gerrymandering the classes for the purpose of influencing the voting.[207] Gerrymandering can occur in either of two ways. First, it can happen when different claims are put in the same class. In this scenario, the vote of the majority may not in fact represent a decision that is in the interest of a particular group.[208] The second possibility is when similar claims are put in different classes. The concern here is that a class would be artificially created to satisfy the requirement that one impaired class of non-insiders has voted for a non-consensual plan.[209] The Bankruptcy Code expressly forbids only the former,

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[205]Note that this is not by classification of creditor. A single creditor may have more than one claim. The classic example is an undersecured creditor, who has a secured claim up to the value of the collateral and an unsecured claim for the remainder. This creditor will vote both its secured and its unsecured claim.

[206]The super-majority voting requirement in Chapter 11 deviates from the simple majority requirement of the old Chapter XI. The 1973 Report of the Commission on the Bankruptcy Laws recommended continuing the simple majority requirement for the law that would ultimately become Chapter 11. H.R. DOC. NO. 93-137, pt. 1, at 29 (1973).

[207]Gerrymandering is defined as "the practice of dividing any geographical or jurisdictional area into political units . . . to give some group a special advantage." BLACK'S LAW DICTIONARY 696 (7th ed. 1999).

[208]For example, if secured and unsecured creditors were lumped together, the secured creditors' vote would not reflect the interests of the unsecured creditors, and vice versa.

[209]*See* 11 U.S.C. § 1129(a)(10) (1994). The concern here is that a creditor who could dominate a voting class and reject the plan may effectively be disenfranchised by separate classification. *See generally* Peter E. Meltzer, *Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment*, 66 AM. BANKR. L.J. 281 (1992) (demonstrating through hypotheticals possibility of disenfranchising dissenting secured creditor).

putting dissimilar claims in the same class. The Code does not directly address the latter.[210]

Professor David Skeel has argued for the benefits of a simple majority voting scheme in Chapter 11.[211] According to Skeel, super-majority voting is appropriate only where there is a fear that corporate decisions will by their nature affect majority and minority shareholders differently.[212] This is not true in Chapter 11, since each class member will receive a proportionate share of the distribution. While the benefits of a super-majority scheme in Chapter 11 are nominal, the costs are not. A creditor who wished to block voting would have to buy more than half of the class at stake, and a party that did this would be unlikely, presumably, to adopt a position disadvantageous to that of the class as a whole.[213]

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[210] 11 U.S.C. § 1122(a) (1994) ("[A] plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class."); *see, e.g.*, Matter of Greystone III Joint Venture, 995 F.2d 1274, 1279 (5th Cir. 1991) ("[O]ne clear rule . . . emerges from otherwise muddled caselaw on § 1122 claims classification: thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."); *In re* Barakat, 99 F.3d 1520, 1526 (9th Cir. 1996) ("[A]bsent legitimate business or economic justification, it is impermissible for Debtor to classify [a] deficiency claim separately from general unsecured claims."); *In re* Boston Post Road Ltd. P'ship, 21 F.3d 477, 482 (2d Cir. 1994) ("Classifications designed to manipulate class voting must be carefully scrutinized. There is potential for abuse when the debtor has the power to classify creditors in a manner to assure that at least one class of impaired creditors will vote for the plan, thereby making it eligible for the cram down provisions." (quoting Hanson v. First Bank of South Dakota, N.A., 828 F.2d 1310, 1313 (8th Cir. 1987))) John Hancock Mut. Life Ins. Co. v. Route 37 Bus. Park Assocs., 987 F.2d 154, 158 (3d Cir. 1993) ("[I]t seems clear that the Code was not meant to allow a debtor complete freedom to place substantially similar claims in separate classes. . . . A debtor could then construct a classification scheme designed to secure approval by an arbitrarily designed class of impaired claims even though the overwhelming sentiment of the impaired creditors was that the proposed reorganization of the debtor would not serve any legitimate purpose. This would lead to abuse of creditors and would foster reorganizations that do not serve any broader public interest."); *In re* U.S. Truck Co., Inc., 800 F.2d 581 (6th Cir. 1986) (allowing classification based on desire to create consenting class of creditors). *But see In re* Pine Lake Village Apartment Co., 19 B.R. 819, 830–31 (Bankr. S.D.N.Y. 1982) (disallowing creation of separate classes of unsecured creditors in order to obtain accepting class); Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1, 3 (1994–95) (arguing that "courts should permit any classification proposed by a [C]hapter 11 plan unless a dissenter can establish that the challenged classification would combine, to the dissenter's detriment, creditors or shareholders with different non-bankruptcy liquidation priorities").

[211] David Arthur Skeel Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 VA. L. REV. 461, 515–18 (1992).

[212] The classic case would be a closely-held corporation.

[213] Skeel, *supra* note 211, at 515–16. Because majority voting would limit but not eliminate strategic behavior, Skeel argues that the fiduciary duty standard contained in 11 U.S.C. § 1126(e) (1994) should be retained and employed when a blocking creditor's vote

The Australian system approximates American corporate voting outside of bankruptcy. As a general matter, American state corporation law provides for a one vote per share approach to corporate voting.[214] This reflects the fact that each vote should correlate with the financial stake in the firm of the voter. Similarly, by employing simple majority voting, Voluntary Administration accomplishes two things. First, by requiring a simple majority in amount, the vote will necessarily correlate with the financial stake of the voter. Second, by requiring a majority in number, it considers the rights of small creditors who may be the most adversely affected by the bankruptcy and whose interests may be contrary to those with the greatest value at stake. Thus, by requiring a simple majority, the Australian approach to voting provides the benefits of a vote without the costs that accompany a super-majority requirement.

3. Voluntary Administration Is Administratively Less Costly Than Chapter 11

Voluntary Administration was expressly designed to be cost-effective and administratively convenient.[215] These goals are achieved in several ways. In Australia, unlike in the United States, there is no regular involvement of court personnel in business reorganization cases. A company entering Voluntary Administration need not file documents with a court, and courts are not routinely involved in the process, though they may exercise a supervisory and facilitory function.[216] Likewise, courts do not need to

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reflects an interest at odds with the rest of the class. *Id.* at 516–18. Section 1126(e) states: "On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." 11 U.S.C. § 1126(e) (1994).

[214] *See, e.g.*, DEL. CODE ANN. tit. 8, § 212(a) (1991) (providing one vote to each stockholder for each share of capital stock held by shareholder). However, corporations can generally alter this one vote per share model should they so choose. For an overview of corporate voting rules, see Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 399–400 (1983).

[215] This is a distinct juxtaposition to the state of Australian affairs prior to the enactment of Voluntary Administration. In his second reading speech to the Act on November 3, 1992, then Attorney-General Duffy stated about existing Australian insolvency: "It is often said of our insolvency laws that they are so inflexible and expensive to use that it is impossible for a company to seek to recover through an insolvency administration without facing the likelihood of liquidation." TOMASIC & WHITFORD, *supra* note 15, at 161.

[216] The Court has general supervisory powers to make such orders as it deems appropriate under Part 5.3A. of the Corporate Law Reform Act, 1992, § 447A (Austl.). In addition to these general powers, the court has a few specific powers. It can (1) make orders during the administration for the protection of creditors (§ 447B); (2) declare whether the

confirm the deed of arrangement for the deed to be effective.[217] Court appearances are infrequent or may never occur. The administrator, rather than a judge, is the key player in the administration. The absence of ongoing court involvement makes Voluntary Administration not only more cost-effective than Chapter 11, but also provides greater latitude for the parties to work out a settlement amongst themselves.

4. No Debtor-in-possession in Australia

In Australia, there is no counterpart to the American debtor-in-possession.[218] Rather, an administrator takes control of the business and displaces existing management. Administrators are typically independent chartered accountants. The benefits of such a system include ensuring that when the bankruptcy is in whole or in part endogenously rather than entirely exogenously caused,[219] those who have lead the firm into bankruptcy do not continue to run the firm post-filing.[220]

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appointment of an administrator or deed is valid (§ 447C); (3) give certain directions to the administrator (§ 447D); (4) supervise the administrator and replace the administrator when a vacancy occurs (§ 447E); (5) terminate a deed for limited reasons (§ 445D); (6) vary or void a non-complying deed (§ 445G); and (7) control or restrict certain creditor's ability to vote on a deed (§ 600A). *Id.* §§ 447B, 447C, 447D, 447E, 447G, 600A.

[217]Courts typically do not review deeds of arrangement unless a party in interest requests that they do so.

[218]Interestingly, the Commission on the Bankruptcy Laws of the United States, created by Congress in 1970 to examine the existing bankruptcy laws, proposed that a trustee be appointed for any corporate bankruptcy case involving 300 or more security holders and debts of at least $1,000,000, unless a trustee was found to be unnecessary or the expense would be "disproportionate to the protection afforded." H.R. DOC. NO. 93-137, pt. 2, at 221 (1973). As noted, however, when Chapter 11 was ultimately enacted, the debtor acting as debtor-in-possession was the established norm, and a trustee can only be appointed "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management." 11 U.S.C. § 1104(a)(1) (1994).

[219]Perhaps most notably in recent years, Bradley and Rosenzweig have argued that this is a common occurrence:

> More fundamentally, fashioning a firm's capital structure obviously involves certain choices regarding the use of debt financing. To the extent that managers, influenced by the availability of bankruptcy protection, *choose* to burden their firms with 'too much' debt or 'impossible' debt-payment obligations, financial distress is hardly an entirely exogenous event. On this view, corporate bankruptcy frequently is significantly *endogenous*, chosen by, rather than imposed upon, corporate managers.

Bradley & Rosenzweig, *supra* note 1, at 1047.

[220]There is evidence, however, that in larger Chapter 11 cases management may change, though the Board of Directors does not. *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993) (examining origins of conflict among manage-

The justification for the debtor-in-possession law has historically been that it increases the likelihood of a successful reorganization. If managers believe that their jobs will be preserved in Chapter 11, they will be more likely to put their company into Chapter 11 at an early stage while the company may still be viable.[221] In addition, the argument goes, those most familiar with the company will continue managing it.[222]

One risk inherent in the debtor-in-possession law is that a debtor-in-possession may be tempted to opt for high risk strategies on the basis that it has nothing left to lose by doing so, but potentially a substantial amount to gain. This strategy—surely tempting to the debtor-in-possession of any insolvent company—contains moral hazards analogous to those commonly associated with limited liability. Under state law, equity investors lose their investment before debt investors do. With an insolvent debtor, the equity (in charge as debtor-in-possession) has nothing left to lose. Since the equity of an insolvent debtor does not bear the burden of its risky behavior, an incentive is created for the equity holders to direct a firm to behave in an excessively risky fashion.

In addition to avoiding such improper investment incentives, the Australian system's absence of a debtor-in-possession law eliminates the inherent conflict in fiduciary obligations that exist in the United States. A debtor-in-possession, with all the rights and powers of a trustee in most instances, is responsible during the bankruptcy for, among other things, operating the business, assuming and rejecting executory contracts, and proposing a plan of reorganization. By doing so, the debtor-in-possession makes numerous decisions that affect the value and viability of the business. These decisions may harm some parties and benefit others. Yet a debtor-in-

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ment, creditors, and shareholders in bankruptcy reorganizations); Stuart C. Gilson, *Bankruptcy, Boards, Banks, and Blockholders: Evidence on Changes in Corporate Ownership and Control When Firms Default*, 27 J. FIN. ECON. 355 (1990) (describing processes underlying both private restructuring and Chapter 11 restructuring of financially distressed corporations); Anna Y. Chou, *Corporate Governance in Chapter 11: Electing a New Board*, 65 AM. BANKR. L.J. 559 (1991) (analyzing shareholders' election rights in context of electing new board after Chapter 11 filing).

[221] *See, e.g.*, H.R. REP. NO. 95-595, at 231 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6191 (indicating that debtor-in-possession law is beneficial because debtor maintains control over future of business and therefore will act to benefit corporation).

[222] The Bankruptcy Code does provide some limited safeguards to control management. Committees can be appointed to oversee the activity of the debtor-in-possession. 11 U.S.C. §§ 1102, 1103 (Supp. 2000). Likewise, trustees or examiners can be appointed for cause. *Id.* § 1104. However, the appointment of a trustee is a rare occurrence. *See generally* Barry L. Zaretsky, *Trustees and Examiners in Chapter 11*, 44 S.C. L. REV. 907, 910–11 (1993) (contending that broader use of third party trustees and examiners would be beneficial to Chapter 11 process).

possession simultaneously owes fiduciary obligations to a number of parties—including creditors, officers, directors, and equity—whose interests rarely align.[223]

While the absence of the debtor-in-possession provision has significant advantages for the Voluntary Administration, some concerns about the appointment of the administrator remain. The directors of the Australian company generally determine who becomes the administrator of a Voluntary Administration, a benefit directors are not given in a liquidation. This provides certain potential for abuse. Directors may be tempted to choose "friendly" administrators. For example, a director who knows that the company cannot succeed in Voluntary Administration may nevertheless be tempted to move in that direction fully expecting that liquidation will eventually occur. In doing so, the director gains the benefit of influencing who the liquidator will ultimately be.[224]

5. *Voluntary Administrations Are Resolved Far More Quickly Than Chapter 11 Cases*

The Australian process moves quickly. As noted, the first meeting of creditors must be called within five business days of the commencement of the administration.[225] The company's ultimate disposition is typically decided within a month of the onset of the administration, as the second meeting of creditors must be held within 5 days of the convening period, which is generally the period within 21 days of the commencement of the administration.[226] This rapid process—sometimes criticized as too rapid[227]—results in several key benefits. Most obviously, this process results

[223]For a thorough discussion of the conflict of interests problem, see Raymond T. Nimmer & Richard B. Feinberg, *Chapter 11 Business Governance: Fiduciary Duties, Business Judgment, Trustees and Exclusivity*, 6 BANKR. DEV. J. 1 (1989).

[224]This risk is offset, however, by the fact that creditors have a right to replace an administrator appointed by directors. Corporate Law Reform Act, 1992, § 436E(4) (Austl.).

[225]*See supra* Part II, Corporate Law Reform Act, 1992, § 436 (E)(2) (Austl.).

[226]§ 439A(5) (Austl.). This period of time may be extended for cause. *Id.* § 439A(6). In addition, the period is routinely extended to twenty-eight days if Christmas or Easter fall within the period. *Id.*

[227]*See, e.g.*, Report of the Companies & Securities Advisory Committee, Corporate Voluntary Administration Final Report, at 31 (June 1998) ("Under the current law, the time limits for holding the major meeting are often inadequate for administrators to conduct a proper investigation of large companies whose affairs are complex or of small companies whose records are in disarray."); Michael Rose & Larelle J. Law, *Voluntary Administrations: Will They Work?*, 3 INSOLV. L.J. 11, 12–13 (noting chaotic nature likely to prevail early in administration and that administrator may not have time to provide creditors with meaningful information). However, the time periods under current law may be extended for cause. *See*

in a speedy determination of the relevant parties' rights. A related point is that because of the speed of the process, there is some incentive for a secured creditor not to opt out of the moratorium period that would not exist if the administration—and thus the moratorium period—were longer.[228] Finally, the speed of the Australian system decreases the debtor's incentive to employ bankruptcy for strategic purposes by using extended delay as a tactic in negotiation.

By contrast, the American bankruptcy system takes time. Estimates of average confirmation times in Chapter 11 vary greatly, but no estimate suggests an average of less than 10 months.[229]

The American Bankruptcy Code typically allows the debtor the exclusive right to propose a plan of reorganization for 120 days following

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Corporate Law Reform Act, 1992, § 439A(6) (Austl.).

[228]Legal Committee of the Companies and Securities Advisory Committee, *Voluntary Insolvency Administration Discussion Paper*, at 22 (January 1997).

[229]The major studies addressing time issues in Chapter 11 cases are summarized in Theodore Eisenberg & Stefan Sundgren, *Is Chapter 11 Too Favorable to Debtors? Evidence from Abroad*, 82 CORNELL L. REV. 1532 (1997). Eisenberg and Sundgren use as their base for statistical purposes the combined results of two significant studies utilizing the same methodology. *Id.* at 1547. Lynn LoPucki studied all Chapter 11 cases in the Western District of Missouri from October 1979 until October 1980. Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANKR. L.J. 99 (1983). Jerome Kerkman studied a random sample of Chapter 11 cases from the Eastern District of Wisconsin in 1982. Jerome R. Kerkman, *The Debtor in Full Control: A Case for Adoption of the Trustee System*, 70 MARQ. L. REV. 159 (1987). The combined LoPucki-Kerkman data suggests a mean time for confirmed reorganization plans (including liquidating plans) of 10.7 months, with a median time of 10 months. Eisenberg &Sundgren, *supra* note 229, at 1557. However, other studies cited by Eisenberg and Sundgren suggest that the time is in fact substantially longer. *Id.* at 1558. In Ed Flynn, *Statistical Analysis of Chapter 11* (1989) (unpublished) (on file with Eisenberg & Sundgren), the mean confirmation time was found to be 24.6 months and the median confirmation time 21.1 months. In Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consumate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 319 (1992), the median confirmation time was found to be 22 months, while in Lisa Hill Fenning & Craig A. Hart, *Measuring Chapter 11: The Real World of 500 Cases*, 4 AM. BANKR. INST. L. REV. 119, 152 (1996), the authors found a median of 13.1 months. In a separate study by Lynn LoPucki examining the Western District of Wisconsin in 1987 and 1988, the mean and median times were found to be 19.4 and 17.5 months respectively. LoPucki, *Trouble*, *supra* note 1, at 741–42. *See generally* Eisenberg & Sundgren, *supra* note 229, at 1557–58 (asking whether Chapter 11 time allowances are overly favorable to debtors).

Even when no plan is confirmed, Chapter 11 is still a lengthy ordeal. Eisenberg and Sundgren report that the combined LoPucki-Kerkman data suggests a mean time for unconfirmed plans in Chapter 11 of 8.6 months and a median of 7 months. Fenning and Hart report a median of 6.7 months from filing to dismissal and a median of 9.4 months from filing to conversion. *See* Eisenberg & Sundgren, *supra* note 229, at 1559 nn.110–111.

the date of filing.[230] This period of time is routinely extended,[231] and a debtor's ability to threaten to extend this time is a strategic element in the negotiations.

By extending its exclusivity period, a debtor may be able to effectively hold a creditor hostage, thus encouraging a settlement that a creditor would not otherwise agree to were the process quicker. The extreme length of time in which cases languish in Chapter 11 has been a regular element of the debate on Chapter 11's vitality.[232] General business uncertainties tend to prevail during a Chapter 11 case, and delays in resolving the issues at stake are costly. Administrative[233] and creditor expenses[234] increase over time, and the movement of assets to more productive uses is delayed.[235] By moving quickly, the Australian system avoids many of these problems.

The speed of the Australian process has been criticized for failing to provide sufficient time for administrators to put together an accurate picture of the debtor, particularly in complex cases. The difficulty is mitigated, however, by the presence in Australian law of a limited opportunity for extensions of time when needed. The twenty one day period during which the meeting of creditors must be convened can be extended for cause but only by court order upon application of the administrator, and importantly, this application must be made within the original twenty-one-day timeframe.[236] The result in Australia, unlike in the United States, is that the possibility of strategically-requested repeat extensions does not exist.

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[230] 11 U.S.C. § 1121(b) (1994). Pursuant to section 1121(c), a competing plan may be filed if "1) a trustee has been appointed . . .; 2) the debtor has not filed a plan before 120 days after the date of the order for relief . . .; or 3) the debtor has not filed a plan that has been accepted, before 180 days after the date of the order for relief." *Id.* § 1121.

[231] *Id.* § 1121(d).

[232] For example, it has been argued that the primary problems associated with Chapter 11—excessive expense, too much debtor control, poor performance once companies emerge, and the high rate of recidivism—all stem from the excessive time it takes to reorganize in many Chapter 11 cases. Lynn M. LoPucki, *Trouble*, *supra* note 1, at 730–31.

[233] LoPucki, *Agenda*, *supra* note 1, at 576.

[234] This includes not only out of pocket expenses—like legal fees—but also the fact that unsecured and undersecured creditors do not obtain interest in bankruptcy. 11 U.S.C. § 506 (1994); United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc., Ltd., 484 U.S. 365, 372–73 (1988).

[235] Eisenberg & Sundgren, *supra* note 229, at 1543.

[236] Corporate Law Reform Act, 1992, § 439A(6) (Austl.).

6. Potential Director Liability for Guarantees and Voidable Transactions

The potential liability of a company's directors may be delayed, limited, or eliminated when the company enters Voluntary Administration. While certainly not without disadvantages, the result is that directors do not have certain negative incentives which could lead them to avoid or delay employing Voluntary Administration. Early intervention is likely to lead to two benefits. First, the likelihood of salvaging the company increases when remedial measures are taken early rather than late; and second, the sooner measures are taken to deal with a troubled firm's problems, the greater the likelihood that the firm's creditors will be able to recover their value.

There are two separate legal rules that impact director liability in this regard. First, unlike American law, where the general rule is that the automatic stay is not routinely extended to other parties,[237] the moratorium under Voluntary Administration does extend to directors and their family members who have guaranteed obligations. This moratorium exists only during the period of the administration. Second, potentially voidable transactions may not be challenged by an administrator, but they may be challenged by a liquidator.[238]

The justification for each of these rules is to create incentives for a troubled firm to be placed in Voluntary Administration. A director who has personally guaranteed obligations of the company will be less likely to appoint an administrator when necessary if the guarantee will become enforceable immediately upon appointment.[239] By eliminating this prospect, directors will be more inclined to make decisions about Voluntary Administration based on what is best for the company and its creditors.[240]

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[237] *See, e.g.*, Credit Alliance Corp. v. Williams, 851 F.2d 119, 120 (4th Cir. 1988) (asserting that stay does not routinely extend to guarantor of debtor); 3 COLLIER ON BANKRUPTCY ¶ 362.04 (stating that stay "does not protect separate legal entities such as corporate affiliates, partners in debtor partnerships or codefendants in pending litigation").

[238] It is worth noting, however, that the administrator in reporting should indicate whether any transactions appear potentially fraudulent. The presence of such transactions may encourage creditors to vote for a liquidation where such transactions can be challenged, rather than for a deed of arrangement.

[239] Corporate Law Reform Bill of 1992, Explanatory Memorandum ¶ 529. There is an argument that directors have an incentive to move quickly anyhow, because if a company outside voluntary administration continues to lose money, potential losses on guarantees may continue to rise. *See* PHILIP CRUTCHFIELD, CORPORATE VOLUNTARY ADMINISTRATION LAW 11 (2d ed. 1997).

[240] A risk does exist, however, that directors will use the moratorium period to dissipate their wealth and make themselves judgment proof. Although legally such transfers are voidable, tracing them can be a difficult and expensive process. *See, e.g.*, Legal Committee

In like fashion, the desire to avoid scrutiny of a potentially voidable transaction may push a director to place a company under the supervision of an administrator rather than a liquidator. A second justification has been proffered for the rule regarding voidable transactions. Voluntary Administration was designed to provide a mechanism for reviving companies, not for pursuing questionable past transactions. The drafters of the law thus deemed it inappropriate to allow administrators to routinely investigate such prior transactions.[241]

7. Personal Liability of the Administrator

In America, a debtor-in-possession of an insolvent company is subject to few constraints. And, as noted, the debtor-in-possession has little incentive to make appropriate cost-benefit determinations because it does not bear the burden of its financial errors. Creditors bear the cost of an insolvent entity losing additional money, but the equity holders can benefit by a risk that is ultimately rewarded. The resulting risk-reward incentives are improperly balanced. Such difficulties are far more limited in Australia.

In Australia, following his or her appointment, an administrator is personally liable for the debts incurred by the company for services rendered, goods bought, or property hired or leased. This personal liability is subject to a right to indemnification from the company's assets.[242] The administrator's right to indemnity generally has priority over unsecured creditors,[243] but not over secured creditors. This has at least two positive ramifications.[244] First, it assures creditors of a strong likelihood of repayment.[245] This is a particularly important assurance for trade creditors, whose willingness to continue doing business with a debtor is frequently a necessary element in any hoped-for reorganization. Second, it provides at least one limitation on excessively risky behavior. The administrator—the person running the bankrupt business, just as the debtor-in-possession does in the United States—continually runs the risk of bearing the cost of his or

of the Companies and Securities Advisory Committee, *Corporate Voluntary Administration Report*, at 102 (June 1998) (stating that in some instances directors use moratorium time to dissipate their personal wealth).

[241]*See* CRUTCHFIELD, *supra* note 239, at 37.

[242]Corporate Law Reform Act, 1992, § 443A(1), (2) (Austl.).

[243]*Id.* § 556.

[244]The downside of personal liability, of course, is that it may cause hesitation in someone asked to be an administrator.

[245]The Law Reform Commission stated that it is "essential to provide [a reasonable assurance of payment] to creditors by requiring the administrator to be personally liable." GENERAL INSOLVENCY INQUIRY, *supra* note 11, at ¶ 88.

her decisions, as he or she may be responsible for any liability he or she incurs that exceeds the value of the unencumbered assets of the firm. While the administrator is given certain protections by being afforded a lien over all unencumbered assets of the debtor ahead of unsecured creditors, the result is that certain constraints are placed on the company's operation, which may impact losses ultimately borne by creditors. That is, the idea behind the potential personal liability of an administrator is to encourage the administrator to be conservative in incurring new obligations or allowing the debtor to continue operating at a loss.

D. Issues Eight and Nine—The Question of Creditor Control

While each of the nine elements identified as distinct differences is significant, the last two—the opt out option for certain secured creditors and the limitations on cram down in Australian law—have at their core a single, fundamental issue: The question of whether the creditors, or some other party such as the firm's management, equity holders, or a judge, should be empowered to decide the fate of an insolvent firm. This Article contends that the final decision making power for an insolvent firm's future should rest with the firm's creditors, who effectively own insolvent firms.[246] The Australian system largely does this; the American system does not.

The concept of keeping ultimate decisionmaking power with those who bear the risk of loss—creditors—is consistent with the notion that when a firm becomes insolvent outside of bankruptcy, the fiduciary duty of the firm's directors and officers shifts from shareholders[247] to creditors.[248] The

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[246]*See generally supra* note 2.

[247]A solvent corporation does not owe creditors the same fiduciary obligations. The court in *In re Ben Franklin Retail Stores, Inc.*, held that

> The shareholders, after all, own the corporation and management of the corporate assets is vested in the directors. The directors are therefore entrusted with the control and management of the property of others. As frequently happens when a person is so entrusted with the property of others, the law imposes fiduciary obligations on that person. Creditors, on the other hand, deal with corporations by entering into contracts. Satisfaction of their claims against the corporate assets requires only compliance with their contracts. So long as the corporation is solvent, they require no additional protection; by definition, a solvent corporation, no matter how badly managed otherwise, is able to satisfy its contractual obligations.

225 B.R. 646, 652–53 (Bankr. N.D. Ill. 1998); *see also* Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1993) (holding that under New York law, it is "well-established that a corporation does not have a fiduciary relationship with its debt security holders").

[248]Many courts have supported this proposition. *See, e.g.*, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. CIV. A.12510, 1991 WL 277613, at *34 (Del Ch. Dec. 30, 1991) (stating that "[a]t least where a corporation is operating in the

rationale for this shift is straightforward. As the *In re Ben Franklin Retail Stores, Inc.*[249] court explained,

> the economic rationale for the "insolvency exception" is that the value of creditors' contract claims against an insolvent corporation may be affected by the business decisions of managers. At the same time, the claims of the shareholders are (at least temporarily) worthless. As a result it is the creditors who "now occupy the position of residual owners."[250]

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vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." In such instances, "circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders . . . would make if given the opportunity to act."). FDIC v. Sea Pines Co., 692 F.2d 973, 976–77 (4th Cir. 1982) (holding that "[w]hen a corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors"); *In re* Kingston Square Ass'n, 214 B.R. 713, 735 (Bankr., S.D.N.Y. 1997) ("[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors."); Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992) ("When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors."); *see also* Christopher W. Frost, *The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations*, 72 AM. BANKR. L.J. 103, 108 (1998). Frost states that

> In a growing number of cases, courts hold that managerial allegiance must shift to the creditors when the corporation approaches insolvency. Upon insolvency, the residual claims of the shareholders become economically worthless. Creditors who will go unpaid in the event of complete financial failure now occupy the position of residual owners. Thus, it is not surprising that managerial allegiance should depend upon the fortunes of the business.

Id. See generally Michael D. Sabbath, *Liability of Officers and Directors for Pre-Petition Management of the Financially Troubled Company* (reprinted in Southeastern Bankruptcy Law Institute 2000 Annual Meeting materials) (on file with author).

A number of courts have held that while a fiduciary duty extends to the creditors upon insolvency, it also remains with the shareholders as well. *See, e.g.*, Sanford Fork & Tool Co. v. Brown & Co., Ltd., 157 U.S. 312, 317–19 (1895) (finding that directors of insolvent corporation, which was still going concern intending to continue its business, stand in fiduciary relationship to both stockholders and creditors); *In re* MortgageAmerica Corp., 714 F.2d 1266, 1277 (5th Cir. 1983) (declaring that officers and directors of insolvent corporations "are fiduciaries to the corporations' stockholders and creditors" (quoting *In re* O.P.M. Leasing Servs., Inc., 28 B.R. 740, 759 (Bankr. S.D.N.Y. 1983))); Geyer v. Ingersoll Publications Co., 621 A.2d 784, 789 (Del. Ch. 1992) ("The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors['] only concern.").

[249]225 B.R. 646 (Bankr. N.D. Ill. 1998).

[250]*Id.* at 653 (quoting *Geyer*, 621 A.2d at 787). This shift in fiduciary duty is often described in terms of the creation of a trust fund to be managed for the benefit of corporate creditors. *See, e.g.*, Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944) ("An insolvent corporation is civilly dead in the sense that its property may be administered in

1. The Eighth Element—Australian Secured Creditors with a Lien on All or Substantially All of the Debtor's Assets May Opt out of the Bankruptcy Proceeding

As noted, secured creditors effectively own firms in bankruptcy, and therefore, should be accorded the right to make the determination about an insolvent firm's future. Voluntary Administration provides this opportunity in an extreme form for those secured creditors who possess a lien on all or substantially all of the debtor's assets. These creditors have the right during the decision period to enforce their lien and effectively opt out of the bankruptcy proceeding.[251]

A secured creditor may choose to opt out and enforce its lien for obvious reasons—namely, it believes that the company has no chance to survive and it wants to realize its value before the company's assets further decrease in value. However, there are also several situations where a secured creditor might refuse to opt out and instead support a reorganization. First, an undersecured creditor who believes that a liquidation will not allow recoupment of value and further believes that a reorganization stands a likely chance of providing viability to a financially distressed firm will not opt out of a reorganization when its presence will be beneficial. Second,

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equity as a trust fund for the benefit of creditors."); Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) ("If the corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor-beneficiaries." (quoting New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d 397, 398 (N.Y. 1953))); *see also* DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE 597 (5th ed. 1998) (noting that while shareholders own corporation prior to insolvency, it is creditors who become "equitable owners" upon insolvency due to their financial interest in company assets). *But see* St. James Capital Corp. v. Pallet Recycling Assoc. of N. Am., Inc., 589 N.W.2d 511, 516 (Minn. Ct. App. 1999):

> Creditors are not owed a duty by an insolvent corporation's directors and officers to minimize any loss that may occur as a result of the corporation's insolvency. To hold otherwise would allow creditors of a corporation, solvent or insolvent, to interfere unduly and interject themselves in the day-to-day management of the corporation. While it is axiomatic that creditors have the right to be repaid, it is equally true that they do not have the right, absent an agreement to the contrary, to dictate what course of action the directors and officers of a corporation shall take in managing the company, or . . . to direct how the assets of the corporation shall be disposed of to satisfy the debts of the corporation.

Id.

[251]There is no question that this provision provides secured creditors an incentive to take liens over substantially all of the company's assets. One argument against this provision, therefore, is that it accordingly provides improper incentives for secured creditors to take excessively broad liens, leaving little for unsecured creditors to look to in the way of non-encumbered assets.

concerns about negative publicity may encourage the creditor to support the administration.[252] Third, administration may be an effective tool for a creditor concerned about fraudulent conduct of directors and desiring an investigation. Fourth, there may be reasons why the creditor does not want to foreclose, and the appointment of an administrator may be a way of recouping value without doing so. And finally, the creditor may be concerned that a transaction will be challenged as fraudulent during a liquidation, something the administrator is not empowered to challenge.[253] The critical element is that the secured creditor, not the firm's equity, decides whether the secured creditor of an insolvent firm continues to remain at risk.

American bankruptcy law forbids opt outs.[254] The rationale for this, presumably, is that nobody would agree to be a part of a bankruptcy proceeding unless the proceeding was mandatory upon all creditors.[255] This, however, creates significant difficulty for secured creditors. Those who bear no risk (like the equity of an insolvent company) have every incentive to engage in behavior which maximizes their own prospects of recovery while

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[252]No lender will want to be seen as sounding the death knell of financially viable firms prematurely. Such a lender will have more difficulty attracting business in the future. Thus, one can expect creditors to make economically-rational decisions about when opting out is appropriate.

[253]*See* CRUTCHFIELD, *supra* note 239, at 31–32.

[254]The only real exception is that the stay may be lifted by a secured creditor either for cause, including the lack of adequate protection, or if the debtor has no equity in the property and the property is not needed for an effective reorganization. 11 U.S.C. § 362(d) (1995).

[255]*See generally* JACKSON, *supra* note 180, at 12–13 (commenting that "[b]ankruptcy provides a way to make . . . diverse individuals act as one, by imposing a *collective* and *compulsory* proceeding on them"). In addition, courts have uniformly held that it violates public policy for a party to agree to waive the right to file a bankruptcy petition. *In re* Jenkins Court Assoc., Ltd. P'ship, 181 B.R. 33, 37 (Bankr. E.D. Pa. 1995) (holding *ipso facto* clauses precluding right to seek bankruptcy protection *per se* invalid). It may, however, be possible to waive the bankruptcy automatic stay, though a motion for a court order enforcing the waiver is likely necessary. *In re* Cheeks, 167 B.R. 817, 818–19 (Bankr. D.S.C. 1994) (enforcing pre-petition agreement stating that mortgagor would not oppose mortgagee's relief from stay motion in event of bankruptcy). Increasingly, courts have seen pre-petition waivers of the stay as being just one factor in considering whether they should ultimately grant relief from the stay. *Compare In re* Powers, 170 B.R. 480, 482–83 (Bankr. D. Mass. 1994) (enforcing pre-petition waiver), *with* Farm Credit of Cent. Florida, ACA v. Polk, 160 B.R. 870, 873–74 (M.D. Fla. 1993) (refusing to enforce pre-petition waiver). For a discussion of this issue, see Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice and Law*, 82 CORNELL L. REV. 301, 355 (1997) (positing that creditors attempting to "opt out" of their duty to assist should "raise eyebrows").

threatening the value held by secured creditors.[256] Secured creditors, by contrast, have a fixed upside but bear the risk of loss.[257]

The Australian opt-out option for secured creditors with liens over the majority of the company's assets is absolute—courts cannot prevent a creditor from so acting. The results are twofold. First, the decisionmaking process is placed in the hands of the appropriate party—the creditors who bear the primary burden of an improper decision to reorganize a non-viable company. And second, by providing additional protections to the secured creditor, it helps to insure both that the availability of credit will remain ongoing[258] and that the risk of non-enforcement of secured creditors' rights will not lead them to raise the cost for others obtaining credit.[259]

2. The Ninth Element—Cram Down in Australia Is More Limited Than in the United States

(a) Cram Down in Australia and America

Cram down—the term for the confirmation of non-consensual plans of reorganization—forms a significant feature of American bankruptcy law. It is far more limited in Voluntary Administration. Cram down exists on two levels—one for fully secured creditors, and one for undersecured and

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[256]Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 107 (1984) ("Members of any group of investors that would be eliminated by a present liquidation or sale of assets have nothing to lose by seeking a solution that avoids a final distribution today.").

[257]Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 123 n.105 (1997) ("Because such claimants have fixed claims, they will not benefit from any potential increase in value resulting from the reorganization. In the event of catastrophe, however, such creditors may bear some of the losses.").

[258]As the Australian Law Reform Commission noted: "[A]s a matter of economics, it would be undesirable to impede the flow of credit by devaluing the security or other rights which a creditor may require as a condition of giving credit." Australian Law Reform Commission, General Insolvency Inquiry (Discussion Paper 32) at 31 (1987).

[259]Robert J. Rosenberg, *Beyond Yale Express: Corporate Reorganization and the Secured Creditor's Rights of Reclamation*, 123 U. PA. L. REV. 509, 515–16 (1975):

> [T]he institution of secured credit, which makes capital available to high risk enterprises which could not otherwise obtain it, is making a vital, and perhaps an irreplaceable, contribution toward economic expansion. . . . While the contingency of nonenforcement will not affect all potential borrowers equally, since the stronger would just have to pay more for their credit, while the weaker would be denied credit altogether, its effect on the cost of credit, and thereby upon economic growth, is undeniable.

Id.

unsecured creditors. In Australia, fully secured creditors with a lien on substantially all of the debtor's property can avoid any risk of cram down by opting out during the decision period and enforcing their liens. A secured creditor who fails to opt out during the decision period but dissents from the deed of arrangement can generally still enforce its lien unless a court determines that doing so will have a "materially adverse" impact on the purpose of the deed and that the secured creditor is adequately protected. Thus, fully secured creditors are in a substantially better position in Australia than they are in the United States, where secured claims are subject to cram down.[260]

At first blush, undersecured and unsecured creditors in Australia appear to be in essentially the same position as their American counterparts. In each country, the prospect exists for undersecured or unsecured creditors to be bound by a reorganization plan that they oppose.[261] On further analysis, however, the imposition on Australian undersecured and unsecured creditors is more limited and reflects a radically different view of who makes the ultimate decisions regarding the debtor's future. This is due in large part to the presence in the United States of the new value exception to the absolute priority rule.

(b) The New Value Exception

The new value exception raises the question of whether existing shareholders who make additional necessary cash contributions to a reorganized entity can retain their equity under a non-consensual plan which fails to satisfy the absolute priority rule.[262] The absolute priority rule states

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[260]Again, for dissenting secured creditors, a plan is fair and equitable and can be crammed down if the secured creditor effectively receives the full economic equivalent of its secured claim. Chapter 11 provides three methods of accomplishing this. First, a dissenting secured creditor may keep its lien and receive payments on the plan's effective date equal to the amount of the secured claim; second, the creditor may receive the indubitable equivalent of its claim; or third, the property can be sold free and clear of the lien, with the creditor's security interest attaching to the proceeds of the sale. This lien on proceeds may then be treated under either of the other two options. 11 U.S.C. § 1129(b)(2)(A) (1994).

[261]In Australia, dissenting undersecured and unsecured creditors are bound by the vote of the majority. In America, recall that impaired, dissenting unsecured creditors can have a plan crammed down upon them if the plan satisfies the absolute priority rule in 11 U.S.C. § 1129(b)(2)(B) (1994), which holds that a plan is fair and equitable with respect to an impaired class if that class will receive full compensation for its allowed claims before any junior class receives any distribution.

[262]The United States Supreme Court phrased the following question:

> The issue in this Chapter 11 reorganization case is whether a debtor's prebankruptcy equity holders may, over the objection of a senior class of

that shareholders have to pay dissenting, general unsecured creditors in full before they are allowed to retain any interest in the new firm. Yet a number of courts have allowed shareholders to retain an interest in a reorganized entity notwithstanding the plan's inability to satisfy the absolute priority rule based on the so-called "new value exception."

To understand why some courts have so ruled, a brief review of the history of the exception is necessary. The statutory language of the Bankruptcy Act of 1898 provided, *inter alia*, for creditors to consent to plans of reorganization that impaired their interests, and required plans of reorganization to be "fair and equitable." However, the old Bankruptcy Act did not define what that phrase "fair and equitable" meant.

The idea of a new value exception arose in dicta as a result of the equitable principles inherent in the bankruptcy process. The first case to note the exception was *Kansas City Terminal Railway Company v. Central Union Trust Company of New York*.[263] In dicta, the court noted that it had the right to modify, on equitable grounds, the strict priority scheme over the objection of junior creditors when the senior secured creditor, whose claim exceeded the value of the firm, consented, as long as the shareholder of the debtor agreed to contribute new value to the reorganized company.[264] In *Kansas City*, the junior claimants would have received nothing under any circumstances because the senior claimant's claim exceeded the value of the assets. Thus, the key to this dicta is that the proposal in question did not materially differ from a scenario whereby the firm was sold to the secured creditor, who then allowed the old equity to buy into the new firm.

In *Case v. Los Angeles Lumber Products Company Limited*,[265] a major transformation occurred. The district court judge allowed equity to retain an interest in the reorganized debtor based on the promise of continuing management, influence and good will in the community.[266] Unlike the Court in the *Kansas City* decision, the district court in *Case* allowed this result

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> impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. We hold that old equity holders are disqualified from participating in such a "new value" transaction by the terms of 11 U.S.C. §1129(b)(2)(B)(ii), which in such circumstances bars a junior interest holder's receipt of any property on account of his prior interest.

Bank of Am. Nat'l Trust & Sav. Ass'n. v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 437 (1999) (citing 11 U.S.C. § 1129(b)(2)(B)(ii) (1994)).

[263] 271 U.S. 445 (1926).

[264] *Id.* at 454–55.

[265] 308 U.S. 106 (1939).

[266] *Id.* at 112–13.

over the objection of the senior creditors. The Supreme Court reversed this decision. In an opinion by Justice Douglas, the Court held that what was proffered by the equity was insufficient to allow equity to retain an interest in a non-consensual plan.[267] The proposal was not tangible cash, and it had no place in the asset column of the business's balance sheet.[268] But, without noting the factual differences between *Kansas City* and *Case,* Justice Douglas indicated that the Court had not categorically rejected a new value exception. It might be a different story, he suggested, had the shareholders contributed "money or money's worth" to get the business back on its feet.[269]

The 1978 Bankruptcy Code codified the meaning of the phrase "fair and equitable" as requiring satisfaction of the absolute priority rule of § 1129(b)(2).[270] The meaning of the phrase thus appeared to no longer depend upon common law analysis. This did not end the debate. Prior to the United States Supreme Court's 1999 decision in *Bank of America National Trust and Savings Association v. 203 N. LaSalle Street Partnership,*[271] courts had essentially taken three approaches to the question of the new value exception. One approach followed the reasoning of *Dewsnup v. Timm,*[272] in which the Supreme Court stated that the 1978 Bankruptcy Code did not alter pre-Code judicially created practice unless the legislative history contains at least some discussion of the intent to do so.[273] Thus, the argument goes, since the Bankruptcy Code is silent on the subject and the legislative history is virtually silent, the rule of *Los Angeles Lumber* survived the enactment of the 1978 Code.[274]

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[267]*Id.* at 122.

[268]*Id.* at 122–23.

[269]*Id.* at 122.

[270]11 U.S.C. § 1129(b)(2) (1994).

[271]526 U.S. 434 (1999).

[272]502 U.S. 410 (1992).

[273]*Id.* at 419–20.

[274]Courts following this view include *In re* Bonner Mall P'ship v. U.S. Bancorp Mortgage Co., 2 F.3d 899, 912 (9th Cir. 1993) ("When Congress amends the bankruptcy laws, it does not start from scratch. The Bankruptcy Code should not be read to abandon past bankruptcy practice absent a clear indication that Congress intended to do so.") (citations omitted); Coones v. Mutual Life Ins. Co., 168 B.R. 247, 255 (D. Wyo. 1994) (noting that new value exception survives because it is "a well-established pre-Code principle which Congress failed to explicitly repudiate when it enacted the 1978 Bankruptcy Code"); *In re* Sovereign Group 1985-27, Ltd., 142 B.R. 702, 707 (E.D. Pa. 1992) ("Where Congress intends for legislation to change the interpretation of judicially created concepts, it makes that intent specific; absent such specific intent, it is presumed that Congress did not intend to change prior-existing law.").

A second and opposite approach is based on the fact that § 1129(b)(2)(B)(ii) of the 1978 Code replaced the *Los Angeles Lumber* standard of "fair and equitable" with a congressionally-enacted standard.[275] This new standard contains no reference to a new value exception, and since the words of the statute are clear on their face, the appropriate conclusion appears to be that the new value exception failed to survive the enactment of the 1978 Code.[276]

The third approach suggests that the new value exception is not an exception to the absolute priority rule at all. The absolute priority rule prohibits retention of one's interest in a reorganized entity "on account of" old interests. In cases where old equity is contributing new capital, the argument goes, its retained interest in the reorganized debtor is based on this new, necessary contribution, not "on account of" its prior interest.[277]

In 1999, the Supreme Court decided *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*.[279] Prior

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[275]11 U.S.C. § 1129(b)(2)(B)(ii) (1994).

[276]*See, e.g., In re* Drimmel, 108 B.R. 284, 289 (Bankr. D. Kan. 1989) (stating that it views "Congress' failure to include the exception in this new definition as the significant factor here rather than its failure to expressly repudiate the exception"); Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351, 1361 (7th Cir. 1990) ("The language of the Code strongly suggests that [the new value exception] did not [survive], and we are to take this language seriously even when it alters pre-Code practices."); Piedmont Assocs. v. CIGNA Property & Cas. Ins. Co., 132 B.R. 75, 79 (N.D. Ga. 1991) ("This court believes that the plain language of § 1129(b)(2)(B) and the intent of Congress precludes the existence of any new value exception to the absolute priority rule.").

[277]*In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), illustrates this approach. The case involved a traditional single asset scenario, and the debtor's plan provided, *inter alia*, for the partners to receive nothing on their claims. *Id.* at 905. However, to raise additional capital for the new corporation, the partners would contribute a total of $200,000 in cash to Bonner Mall Properties in exchange for 2 million of the 4 million authorized shares of the new corporation's common stock. *Id.* No other persons were designated to receive stock in exchange for such contributions. *Id.*

The Court held that "the Code permits the confirmation of a reorganization plan that provides for the infusion of capital by shareholders of the bankrupt corporation in exchange for stock if the plan meets the conditions required prior to the Code's adoption." *Id.* at 911. Furthermore, the Court held that if the value added by the old equity was in fact "new, substantial, [in] money or money's worth, necessary for successful reorganization, and reasonably equivalent to the value or interest received," the plan will not violate the absolute priority rule. *Id.* Under these circumstances, no violation is present because the plan will not give old equity property "on account of" prior interests, but instead will allow the former owners to participate in the reorganized debtor though a substantial, necessary, and fair new value contribution. *Id.* at 900, 909.

[279]526 U.S. 434 (1999). Prior to *LaSalle*, *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), was the only post-Code case in which the Supreme Court dealt with the new value exception. *Ahlers* considered whether the promise by the owners of a failing family farm of future "labor, experience, and expertise" was sufficient for the confirmation of a plan

to this decision, cram down of unsecured creditors in the United States reflected very different values than cram down in Australia. In Australia, while cram down is possible, it is imposed by the majority will of the creditors, not by the firm's equity holders (or by a court). Thus, the binding of a non-consensual plan in Australia is something akin to the "rule" that *Kansas City* created, whereby the dissenting creditors could be bound if the dominating group of creditors (secured with a lien on everything in the case of *Kansas City*, and a majority of all creditors in the Australian scenario) determined to do so.[280] For those American courts that have historically accepted the vitality of the new value exception, the decision to bind dissenting unsecured creditors is made not by other creditors, but rather by the equity holders (and a court) who, if the firm is insolvent, bear no risk if the reorganization ultimately fails.

LaSalle provides some relief for unsecured creditors, but it does not return the cramdown decision in the United States to creditors, which would be something akin to the *Kansas City* model. The debtor in *LaSalle* was a single asset limited partnership that owned fifteen floors of a downtown Chicago office building.[281] Bank of America had lent the debtor $93 million, secured by a non-recourse first mortgage on the debtor's principal asset, its office space.[282] Following default and the commencement of foreclosure proceedings, the debtor filed under Chapter 11.[283]

The Debtor proposed a plan that provided for the following: Pursuant to § 506, the Bank's $93 million claim was split into a secured claim of $54.5 million and an unsecured deficiency claim of $38.5 million.[284] The bank's secured claim was to be paid in full over a period of seven to ten years by means of a note secured by a mortgage on the property.[285] The

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of reorganization that otherwise did not satisfy the requirements of the absolute priority rule. *Id.* at 199. The Court found that the owner's promise was "intangible, inalienable, and, in all likelihood, unenforceable," and, quoting the language of *Case*, held that it "has no place in the asset column of the balance sheet of the new [entity]." *Id.* at 204 (quoting *Case*, 308 U.S. at 122–23). The *Ahlers* Court went on to state that "the statutory language and the legislative history of § 1129(b) clearly bar any expansion of any exception to the absolute priority rule beyond that recognized in our cases at the time Congress enacted the 1978 Bankruptcy Code." *Id.* at 206. In 1994, the Court granted certiorari on a new value exception case called *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 510 U.S. 39 (1994). However, this case settled before ever reaching the Court.

280 *Kansas City*, 271 U.S. at 455.

281 *LaSalle*, 526 U.S. at 438.

282 *Id.*

283 *Id.*

284 Bank of Am., Ill. v. 203 N. LaSalle Street P'ship, 195 B.R. 692, 696–97 (N.D. Ill. 1996).

285 *Id.* at 698.

bank's unsecured deficiency claim was classified separately from the unsecured claims of trade creditors—an issue whose legitimacy was not raised before the Supreme Court—and would be discharged for an estimated 16% of its present value.[286] The remaining $90,000 of unsecured claims would be paid in full, without interest, on the plan's effective date.[287] As no interest would be paid, this class was deemed impaired; thus, a vote in favor of the plan by this class would satisfy the § 1129(a)(10) requirement that at least one class of impaired claims accept the plan.[288] Certain of the debtor's former partners would contribute $6.125 million in new capital over a five-year period (worth $4.1 million in present value) in exchange for 100% ownership of the reorganized debtor.[289] The debtor's former equity holders were the only parties eligible to contribute new capital.[290]

The bank voted its unsecured claim against the plan, and then objected to confirmation of the plan on the grounds of the absolute priority rule—former equity holders would receive property even though the Bank's unsecured deficiency claim would not be paid in full.[291] The Bankruptcy Court approved the plan nevertheless, and the district court and the Seventh Circuit both affirmed.[292]

The Supreme Court did not decide whether the Code includes a new value exception. Rather, the Court determined that even if the exception was encompassed within the Code, the debtor's proposed plan would still fail to satisfy §1129(b)(2)(B)(ii).[293] The core rationale of the opinion is that § 1129(b)(2)(B)(ii) was violated since the plan, adopted without consideration of alternatives and over the objection of a senior class of impaired creditors, gave the debtor's pre-bankruptcy equity holders the *exclusive* opportunity to contribute new capital and receive ownership interests in the reorganized entity.[294]

The Court began its analysis by noting that the statutory language is "inexact."[295] It then traced the development of the pre-Code absolute priority rule, now codified at § 1129(b)(2)(B)(ii), emphasizing that the new value exception pre-Code "never rose above the technical level of dictum in any opinion of [the] Court," and before the enactment of the current Code, no

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[286] *Id.* at 694.
[287] *Id.* at 698.
[288] *Id.* at 694.
[289] *Id.* at 698.
[290] *LaSalle*, 195 B.R. at 698.
[291] *Id.* at 707.
[292] *Id.* at 708.
[293] *LaSalle*, 526 U.S. at 458.
[294] *Id.* at 456.
[295] *Id.* at 444.

court ever relied on the dictum in *Case* to approve a plan that gave old equity a property interest after reorganization.[296]

The Court next determined that the legislative history did not eliminate the possibility that the codified absolute priority rule has a new value exception.[297] The Court stated:

> Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.[298]

Turning to the statutory language, the Court considered three possible meanings of the phrase "on account of." The first was that the language "on account of" means something like "in exchange for," or "in satisfaction of." The court rejected this interpretation.[299] The second position, also rejected by the court, is the more common understanding that "on account of" means "because of."[300] Rather, the Court turned to a "less absolute statutory

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[296] *Id.* at 445.

[297] *Id.* at 448.

[298] *Id.* at 449.

[299] *LaSalle*, 526 U.S. at 449. The Court did so for two reasons, one textual, the other practical. As for the former:

> Subsection (b)(2)(B)(ii) forbids not only receipt of property on account of the prior interest but its retention as well. A common instance of the latter would be a debtor's retention of an interest in the insolvent business reorganized under the plan. Yet it would be exceedingly odd to speak of "retain[ing]" property in exchange for the same property interest, and the eccentricity of such a reading is underscored by the fact that elsewhere in the Code the drafters chose to use the very phrase "in exchange for," §1123(a)(5)(J) (a plan shall provide adequate means for implementation, including "issuance of securities of the debtor . . . for cash, for property, for existing securities, or in exchange for claims or interests.")

Id. at 449–50 (citations omitted) (alterations in original). As for the latter:

> The unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if "on account of" meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds but permit one whenever substantial funds changed hands. "Substantial" or "significant" or "considerable" or like characterizations of a monetary contribution would measure it by the Lord Chancellor's foot, and an absolute priority rule so variable would not be much of an absolute.

Id. at 450.

[300] *Id.* While recognizing that "what activates the absolute priority rule" is "a causal relationship between holding the prior claim or interest and receiving or retaining property," *Id.* at 451, the court's rationale for rejecting this standard was the following:

> If, as is likely, the drafters were treating junior claimants or interest holders as a class at this point then the simple way to have prohibited the old interest holders

prohibition" that would better "reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors."[301] The Court suggested that a new value plan would violate absolute priority:

> whenever old equity's later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid. A truly full value transaction, on the other hand, would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money's worth.[302]

The Court, however, specifically declined to decide what level of causation was required to bar a new value plan. Although the Court stated that "the debtor's exclusive opportunity to propose a plan under § 1121(b) is not itself 'property' within the meaning of subsection (b)(2)(B)(ii)," the Court observed that the debtor's plan was "doomed . . . by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan."[303] The Court emphasized that

> the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners' right a property interest extended "on account of" the old equity position and therefore subject to an unpaid senior creditor class's objection.[304]

> from receiving anything over objection would have been to omit the "on account of" phrase entirely from subsection (b)(2)(B)(ii). On this assumption, reading the provision as a blanket prohibition would leave "on account of" as a redundancy, contrary to the interpretive obligation to try to give meaning to all the statutory language. One would also have to ask why Congress would have desired to exclude prior equity categorically from the class of potential owners following a cramdown. Although we have some doubt about the Court of Appeals's assumption that prior equity is often the only source of significant capital for reorganizations, old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.

Id. at 452–53 (citations omitted).

[301] *Id.* at 453.

[302] *Id.* at 453–54 (citations omitted).

[303] *Id.* at 454.

[304] *Id.* at 456.

The Court further observed that although it could be argued that the opportunity has no market value, "the law is settled that any otherwise cognizable property interest must be treated as sufficiently valuable to be recognized under the Bankruptcy Code."[305]

The critical issue in the opinion seems to be the Court's statement that it would be "necessary for old equity to demonstrate its payment of top dollar," to ensure that it did not receive its interest in the reorganized debtor "on account of" its former equity interest.[306] And, "the best way to determine value is exposure to a market,"[307] not by judicial valuation. However, the Court declined to give detailed guidance regarding the means of accomplishing this. It concluded:

> Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).[308]

Not surprisingly, the decision in *LaSalle* has come under careful scrutiny. Most commentators believe that the opinion is an implicit recognition of the ongoing viability of the new value exception.[309] It seems clear, however, that the debtor cannot retain the exclusive opportunity in a cram down to contribute to the reorganized entity because this would be "on account of" their former equity interest. What this actually means is less clear. It appears that there must be some exposure to the market, but it is unclear whether this exposure can be satisfied by the presence of competing

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[305]*LaSalle*, 526 U.S. at 455 (citations omitted).

[306]*Id.* at 457.

[307]*Id.*

[308]*Id.* at 458.

[309]*See* David R. Kuney, *The Supreme Court and New Value: The Elusive Search for "True Value" and Neutral Bargaining Devices: Market Value vs. Judicial Value,* 8 J. BANKR. L. & PRAC. 505, 507 (1999). Support for this position is typically found in several places. First, the Court's conclusion that the legislative history does not eliminate the possibility that the absolute priority rule may contain a new value exception. Second, the Court's rejection of the argument that former equity holders should be barred across the board from participating in the reorganized debtor. And third, the Court's belief that the statute's "on account of" language was intended to reconcile the two policies underlying Chapter 11 of preserving going concerns and maximizing property available to satisfy creditors.

plans or solely by competing bids. The likely result of this ambiguity is increased uncertainty accompanied by increased litigation.[310]

LaSalle provides additional financial protection for undersecured and unsecured creditors in Chapter 11. As noted, the Supreme Court determined that to be consistent with the goal of maximizing creditor return, old equity needs to pay at least as much as any third party would pay for a bankruptcy court to conclude that their interest in the reorganized entity is not "on account of" their prior interests.[311] In addition, by reflecting a general preference for economic self determination,[312] rather than a view that Chapter 11 should be a court-driven, debtor-protective regime, the Court suggested that decisions ultimately should be creditor-driven.[313]

But *LaSalle* failed to normalize investment incentives by returning them to a scenario where bankruptcy investment incentives remain economically comparable to those that exist under non-bankruptcy law.[314] To do this, investment incentives must reflect both potential gain and potential loss. Outside bankruptcy, equity has both something to gain and something to lose. They thus will make economically rational decisions. Inside bankruptcy, these incentives change, and equity has reasons for making unduly risky decisions. This result is antithetical to the primary goals of bankruptcy.[315]

So while *LaSalle* guaranteed unsecured creditors the maximum value the market would bear in return for their being forced to accept a plan they

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[310]*See generally* Bruce A. Markell, *LaSalle and the Little Guy: Some Initial Musings on the Ultimate Impact of Bank of America, NT & SA v. 203 North LaSalle Partnership*, 16 BANKR. DEV. J. 345, 355–60 (2000) (positing that Court's ambiguity in *LaSalle* will result in increased reorganization and Chapter 11 litigation.).

[311]*LaSalle*, 526 U.S. at 453–54. "A truly full value transaction, on the other hand, would pose no threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money's worth." *Id.*

[312]Congress enacted Chapter 11 with the "view that creditors and equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees, or [governmental agencies such as] the SEC." *Id.* at 458 n.28 (quoting G. Eric Brunstad, Jr., Mike Sigal, & William H. Schorling, *Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One*, 53 BUS. LAW. 1381, 1405–06 n.136 (1998)).

[313]*See* G. Eric Brunstad Jr. & Mike Sigal, *Competitive Choice Theory and the Broader Implications of the Supreme Court's Analysis in* Bank of America v. 203 North LaSalle Partnership, 54 BUS. LAW. 1475, 1479–80 (1999).

[314]*Id.* at 1480 (arguing for competitive choice theory in bankruptcy context, meaning that "the best decisions regarding what is to be done with bankrupt debtors, their obligations, and their assets are more likely to be realized if decision-making in the bankruptcy context is made to approximate decision-making in the context of financially healthy firms outside the bankruptcy arena").

[315]*Id.* at 1482–83.

opposed, it did not return control to the creditors themselves to determine the firm's future. By contrast, in Australia, control is with the creditors. Thus the creditors who own bankrupt firms make the decisions about the firm's future, a normalization of bankruptcy investment incentives. If it is in a creditor's best interest that a company be continued or that equity retain a stake under a deed that impairs unsecured creditors, the creditors may so opt. As Professors Baird and Jackson have written, "[b]ankruptcy law makes a grave mistake if it assumes that a junior (or another class) will make the correct decision about the deployment of the assets without a legal rule that forces it to take account of investors as a group. . . . [T]he best way of ensuring the correct decision—by which we mean that the decision that is not distorted by the self-interest of individuals at the expense of the interests of the group—is to create a legal rule that imposes upon the person who makes the decision all the benefits if he decides correctly and all the costs if he guesses wrong."[316]

V. CONCLUSION

In contrast to the Australian model, the American approach to corporate reorganization is relatively ineffective. Not only is it slow, expensive, and administratively cumbersome, it also provides inefficient and otherwise inappropriate investment incentives and it frequently empowers the wrong party to make vital decisions. As a result, the American model fails to consistently achieve the primary goal of a corporate bankruptcy system—distinguishing those firms with long term potential viability from those firms without such prospects, and assuring continuance of the former and liquidation of the latter.

[316]Baird & Jackson, *supra* note 256, at 124–25.