

FOXES GUARDING THE HENHOUSE: THE MODERN BEST INTERESTS OF CREDITORS TEST IN CHAPTER 11 REORGANIZATIONS

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I. INTRODUCTION

Suppose in early 2001 you had purchased \$1000.00 worth of Enron stock. If you had sold that stock one year later you would be left with less than \$10.00.¹ Suppose instead that in early 2001 you placed that \$1000.00 into WorldCom and then sold your holdings one year later. In WorldCom, your \$1000.00 would now be worth less than \$25.00.² Finally, suppose you had prudently purchased \$1000.00 worth of Budweiser (the beer, not the stock) in mid 2001. You then happily spent the next twelve months consuming that beer and crushing each can as you swallowed the last drop. At the end of those twelve months, if you turned in your cans for the ten-cent deposit you would have been left with roughly \$100.00.³ Clearly then, the best investment advice in this age of corporate shenanigans and declining markets is to drink heavily and recycle.

Of course, it is only wishful thinking to hope that business and investing were so simple. Corporate executives do deceive, and in the cases of Enron, WorldCom and others, that deceit helps force the companies into eventual bankruptcy.⁴ When bankruptcies do occur, individual shareholder claims often become essentially worthless.⁵ Creditors, however, are afforded greater protections with regards to recovering their investment.⁶

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¹ Big Charts, at <http://bigcharts.marketwatch.com/intchart/frames/frames.asp?symb=EA:7178319&sid=779327&time=> (last visited Mar. 17, 2004) (on file with NEVADA LAW JOURNAL).

² See *id.*

³ This calculation assumes a can of beer sells for \$1.00 per can, which might only happen in a perfect world.

⁴ See Shawn Young, *Leading News: MCI Slashes \$3 Billion From '05 Revenue Estimate*, WALL ST. J. ONLINE (July 8, 2003).

⁵ See Douglas G. Baird & Robert K. Rasmussen, Boyd's *Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 406 (1999) [hereinafter "Boyd's Ghost"].

⁶ *Id.*

Perhaps most important of the protections that unsecured creditors enjoy is the “best interests of creditors” test.⁷ The test safeguards those individual creditors who dissent from a proposed chapter 11 reorganization plan.⁸ To comply with the best interests test, a proposed plan must give individual creditors in chapter 11 at least what they would have recovered if the corporation had been liquidated under chapter 7.⁹

The best interests test has been a part of statutory bankruptcy law for over 100 years.¹⁰ The test seeks to balance the need to approve nonconsensual reorganization plans against the need to protect dissenting creditor’s claims.¹¹ The balance is struck by ensuring creditors will receive at least what they would under a chapter 7 liquidation.¹² Creditors cannot be forced to receive less in a chapter 11 reorganization than they would in a chapter 7 liquidation.¹³

The effectiveness of the best interests test as a mechanism to protect creditors depends in large part upon the accuracy of a debtor’s disclosure statement, which estimates creditor recovery in a hypothetical liquidation.¹⁴ However, the preparation of a disclosure statement with estimated liquidation proceeds is a subjective business.¹⁵ A debtor usually prepares an analysis which estimates a liquidation recovery based upon a sort of “fire-sale” conditions resulting in severely depressed liquidation proceeds.¹⁶

This note begins by tracing the historical origins and evolution of the best interests of creditors test from early American bankruptcy law to the present. The analysis section then asks whether, in light of that history, the application of the test in the WorldCom bankruptcy is in keeping with its purpose. The note concludes with a discussion of whether the bankruptcy approach currently followed by the United Kingdom, the United States’ common law parent, would not better protect dissenting creditor interests.

II. HISTORY OF THE “BEST INTERESTS OF CREDITORS” TEST

When Congress enacted Section 1129(a)(7) in 1978, it did not simply pull the words “best interests” out of thin air. Rather, the context of Congress’ action in drafting the Bankruptcy Reform Act of 1978 was an attempt to incorporate a concept from previous bankruptcy statutes that had themselves been attempts to codify existing bankruptcy laws and procedures.¹⁷ When Congress chose the term “best interests” as the test for the confirmation of reorganization plans, despite dissenting individual creditors under 1129(a)(7), it was legislat-

⁷ 11 U.S.C. § 1129(a)(7) (2002).

⁸ *Id.*

⁹ *Id.*

¹⁰ Bankruptcy Act of 1898, ch. 541, § 12, 30 Stat. 544 (repealed 1934).

¹¹ 11 U.S.C. § 1129(a)(7).

¹² *Id.*

¹³ *Id.*

¹⁴ DAVID G. EPSTEIN ET AL., BANKRUPTCY §§ 10-18 (1992).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ See Brief of Amicus Curiae Bruce A. Markell at 7, *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434 (1999) (No. 97-1418) [hereinafter “*LaSalle* Brief”].

ing in the context of nearly 100 years of statutory history and reorganization practice.¹⁸

A. *The History of Two Different Reorganization Approaches*

Before the 1934 changes to the 1898 Bankruptcy Act, a company essentially had three restructuring options instead of liquidation. A debtor could enter into a voluntary contract between it and its debtors¹⁹ or make use of the existing bankruptcy laws under the 1898 Act and enter into a composition agreement with creditors.²⁰ A bankrupt corporation could also turn to the equity powers of the court and the equity receivership.²¹ The modern best interests test can only be understood as the contemporary product of the composition and the equity receivership options.²²

1. *The Bankruptcy Act of 1898*

The concept of a composition was codified in the Bankruptcy Act of 1898 which, in turn, was derived in part from the 1874 federal bankruptcy legislation²³ which had its roots in both English and Scottish common law.²⁴ Under the 1898 statutory approach, the form and extent of debt relief was determined by a vote according to a statutorily determined percentage of creditors.²⁵ The equity receivership option proceeded along an entirely different path that veered away from the concept of democratic voting amongst the creditors themselves.²⁶ Under this approach, the specific form or type of debt relief was determined by a court or administrative agency that was designated to oversee the reorganization process.²⁷ The development of both historical bankruptcy alternatives illustrates the modern best interests test.

The first bankruptcy alternative has its roots in the common law regarding the composition of creditors.²⁸ At common law, a debtor in financial difficulty would enter into a master agreement with most or all of its creditors for debt relief.²⁹ These compositions, as the agreements came to be called, could modify maturity dates, interest rates, and other terms of the debt as needed by the debtor.³⁰

In 1874, federal legislation attempted to foster compositions by providing a statutory mechanism for the first time by which a composition with less than

¹⁸ *Id.*

¹⁹ Bruce A. Markell, *Claims & Opinions: Clueless On Classification: Toward Removing Artificial Limits On Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1, 6 (1994).

²⁰ Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, § 12 (repealed 1934).

²¹ Paul B. Lewis, *Trouble from Down Under: Some Thoughts on the Australian-American Corporate Bankruptcy Divide*, 2001 UTAH L. REV. 189, 205-06 (2001).

²² See generally Markell, *supra* note 19.

²³ Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178 (repealed 1878).

²⁴ Markell, *supra* note 19, at 6-7.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 8.

²⁹ *Id.* at 6-7.

³⁰ *Id.* at 6-7.

unanimous creditor approval could be approved.³¹ The 1874 Act had its roots in both English³² and Scottish law³³ and held that if certain procedural requirements were met, the plan would be binding upon all creditors, even those who were not in agreement with the composition.³⁴

In 1898, with the enactment of a comprehensive Bankruptcy Reform Act, Congress gave statutory legitimacy to a concept already well founded in both American and Western European law.³⁵ The 1898 Act incorporated compositions as a fundamental part of the bankruptcy code for the first time.³⁶ The 1898 Act repealed the 1874 Act and introduced two new requirements before the court could confirm a composition.³⁷ Under the new code, for a composition to be confirmed despite dissenting creditors it had to be in the "best interests of creditors" and be proposed in "good faith."³⁸

Unfortunately, Section 12(d), the confirmation section of the 1898 statute, did not explicitly define what sorts or versions of compositions would be in a creditor's best interest.³⁹ However, a composition agreement was understood to satisfy Section 12 if the plan gave creditors a consideration approximately equal to the value they would receive in a straight bankruptcy liquidation sale.⁴⁰ Thus, so long as the unsecured creditors received at the very least what they would receive if the bankrupt's assets were liquidated, the test would be satisfied. Under the 1898 Bankruptcy Act, a composition plan could win approval over the objections of a minority of unsecured creditors so long as the plan: (1) had the assent of the majority and amount of creditors; (2) was proposed in "good faith;" and (3) was in the "best interests of creditors."⁴¹

The 1898 Act only tells part of the story largely due to the fact that the provisions in the act for confirming non-unanimous plans act could only affect

³¹ Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178 (repealed 1878) (amending § 43 of the Bankruptcy Act of 1867).

³² Bankruptcy Act of 1869, 32 & 33 Vict., ch. 71, § 126 (Eng.). Section 126 provided for a court-approved composition instead of bankruptcy. The alternative was attractive because the approval of all the creditors was not a prerequisite to approval. Rather, a composition could be approved by a majority in number, and 75% in value, of creditors at a properly convened meeting would bind dissenting creditors. *Id.*

³³ Bankruptcy (Scotland) Act of 1856, 19 & 20 Vict., ch. 79 (1856) (Eng.). Under the Scottish Act, a majority of creditors who held at a minimum 80% in value could stay the bankruptcy proceedings to work out an arrangement. *Id.* at § 35. If at any time during the two months the creditors were allotted to work out the arrangement, 80% of the creditors holding 80% of the claims were to agree on a plan, they could force the acceptance of the composition despite dissenting minority creditors. *Id.* at § 38.

³⁴ *Id.*

³⁵ Bankruptcy Act of 1898, ch. 541, § 12, 30 Stat. 544 (repealed 1934).

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* The 1898 Act provided that a judge shall confirm a plan if: "(1) it was for the best interest of the creditors; (2) the bankrupt has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to his discharge; and (3) the offer and its acceptance are in good faith and have not been made or procured except as herein provided, or by any means, promises, or acts herein forbidden."

³⁹ *Id.*

⁴⁰ Eugene V. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L.J. 1334, 1354 (1939).

⁴¹ Bankruptcy Act of 1898, ch. 541, § 12, 30 Stat. 544 (repealed 1934).

unsecured debt.⁴² Section 12 was simply inadequate for the large company reorganizations of the time that could only be achieved by affecting the rights of not only unsecured debt, but secured creditors and equity holders as well.⁴³ For the flexibility required for larger corporate bankruptcies, to reach bargains affecting all interested classes, secured and unsecured creditors as well as stockholders, corporations turned to the equity receivership.⁴⁴

2. Equity Receiverships

The history of corporate reorganizations and the equity receivership is largely the history of railroad reorganizations.⁴⁵ The interim between the Civil War and the beginning of the 20th century was a period of explosive growth for railroads.⁴⁶ But due to government regulation, overlaying of track and fierce competition, by 1915 over one-half of railroad debt securities had been in default at one time or another.⁴⁷ To keep this vital part of the American economy running when threatened with insolvency, the railroad concerns of the day turned to the courts of equity and their powers to appoint a receiver to oversee reorganization proceedings.⁴⁸ This practice continued until the enactment of § 77B in 1934.⁴⁹

During the latter part of the 19th century, the debt of:

a paradigmatic railroad in need of reorganization took the following form. There were few general creditors. There were different classes of bonds, each widely held by diverse investors, many of whom were in Europe. One bond was secured by track between point A and point B, another secured by track between point B and C, a third between C and D, and so on. Points B and Y are in the middle of nowhere, and the terminals at points A and Z connect to solvent railroads owned by the shareholders.⁵⁰

Due to the fractured state of railroad debt, if the value of all of the component parts were to be maximized, all of the creditors would have to actively participate.⁵¹ While Congress had the power to enact a federal bankruptcy law and had done so in 1898, it had yet to enact a corporate reorganization statute.⁵² To foster the requisite cooperation amongst the parties, the corporations of the time turned to the equity powers of the court.⁵³ Federal courts of equity had the power to appoint a receiver who could oversee the reorganization process.⁵⁴

⁴² *Id.*

⁴³ Markell, *supra* note 19, at 8. For a generalized overview of the limitations of compositions with regard to large corporate bankruptcies, see 6 COLLIER ON BANKRUPTCY ¶ 7.41, at 1334-35 (14th ed. 1978).

⁴⁴ Boyd's *Ghost*, *supra* note 5, at 403.

⁴⁵ See Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991).

⁴⁶ CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 764 (1997).

⁴⁷ See, e.g., Paul D. Cravath, *Reorganization of Corporations*, in 1 SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 153, 154 (1917).

⁴⁸ Boyd's *Ghost*, *supra* note 5, at 403.

⁴⁹ See Garrard Glenn, *The Basis of the Federal Receivership*, 25 COLUM. L. REV. 434 (1925).

⁵⁰ Boyd's *Ghost*, *supra* note 5, at 403.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.* at 403-04.

To facilitate the pressing problem of the indebted railroads, and with little applicable statutory guidance, the lawyers turned to the equity receivership to bring about the desired reorganization.⁵⁵

Receiverships normally began with a creditor's petition to the federal court to exercise its equity jurisdiction and appoint a receiver to assume control of the corporation's assets.⁵⁶ The process was usually initiated by the insiders who ran the railroad, and were typically also its principal stockholders.⁵⁷ The insiders would convince a friendly creditor to "petition the equity court to place the railroad's assets in the hands of a receiver."⁵⁸ The court appointed receiver was often the individual then already managing the railroad.⁵⁹ Once the receiver was appointed, the reorganization action began in earnest.

The receivership provided an umbrella under which the holders of differing claims could reorganize themselves before the culmination of the entire process in a judicially supervised sale of the company.⁶⁰ Initially, committees were formed to represent the claims of differing classes.⁶¹ Individuals within that class were then pressured to deposit their respective claims with their committee.⁶² Eventually, selected individuals from these class-committees would combine to form a reorganization committee that would then decide on a value for each class's claims.⁶³

Finally, the reorganization committee would attend the sale of the railroad.⁶⁴ "The market was sufficiently illiquid" that the reorganization committee usually was able to purchase the railroad for only a fraction of what it was truly worth when measured as a going-concern.⁶⁵ The real advantage that the equity receivership umbrella provided is apparent in light of the consequences to those creditors who had dissented and refused to cast their lots with those in their respective class. Those who had assented to the plan would receive what they were allotted under the reorganization plan, but those who did not would only receive the value of their share based on what had been recovered at the judicial sale.⁶⁶ The value of those shares after the judicial sale was usually nothing or only a fraction of the original claim.⁶⁷

Despite the obvious disadvantage to dissenting creditors, the equity receivership provided an indispensable mechanism by which investors could organize themselves and take definitive action to save the company.⁶⁸ Central to the success of the entire process was the final judicial sale where the committee was able to purchase the corporation for less than the going-concern value of

⁵⁵ *Id.* at 403.

⁵⁶ *Id.* at 404.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 404.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

the company.⁶⁹ The system had the effect of leaving equity holders in place, even though some creditors were not paid in full.⁷⁰ This worked because the judicial sale minted a new owner (usually the previous stockholders) who took the assets free of all preexisting claims.⁷¹ The situation that emerged was one in which the shareholders could invoke the bankruptcy process, partially shut out the interests of creditors who refused to fall into conformity with the committee, and still remain in control of the corporation.⁷² Of course, this arrangement rested on the stockholders providing the necessary capital for the reorganization in the form of the buyout at the judicial sale.⁷³

This sort of arrangement differs significantly from contemporary reorganization practice. Modern debt contracts are thought to include the right to wipe out the shareholders in the event a firm becomes insolvent.⁷⁴ In situations where the firm's liabilities exceed its assets the shareholders should be eliminated.⁷⁵ However, because of the very fact that some creditors were not being paid in full while equity was able to continue running, the corporation was the one of the primary reasons the equity receivership eventually met its demise.

As was perhaps inevitable with a system with very little oversight, inside deals eventually became common in receiverships and abuses became commonplace.⁷⁶ The system often operated to pay massive fees to professionals, many of who were cohorts of the debtor's managers.⁷⁷ Reorganization plans were consistently approved which favored junior interests represented by management at the expense of senior creditors who were not so lucky.⁷⁸ The situation was ripe for a change, but though the Supreme Court had taken steps to limit the corrupt receivership regime, it wasn't until the Depression that Congress finally responded.⁷⁹

B. 1930s Statutory Modifications and Chapter X and XI

In response to the rampant abuses in equity receivership practice, several judicial doctrines appeared, most important of which was the "absolute priority rule."⁸⁰ In very general terms, the absolute priority rule recognizes nonbankruptcy priorities in corporate reorganizations.⁸¹ The rule presents the general principle that "creditors, in the order of their nonbankruptcy priorities, are to be satisfied in full from the debtor's assets before the debtor may retain any interest in those assets."⁸² This rule became part of reorganization practice through

⁶⁹ *Id.*

⁷⁰ *Id.* at 405.

⁷¹ *Id.*

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.* at 406.

⁷⁵ *Id.*

⁷⁶ See generally Jacob Trieber, *The Abuses of Receiverships*, 19 YALE L.J. 275 (1910).

⁷⁷ *Id.*

⁷⁸ Rostow & Cutler, *supra* note 40, at 1345.

⁷⁹ LaSalle Brief, *supra* note 17, at 9.

⁸⁰ See generally Boyd's Ghost, *supra* note 5.

⁸¹ J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For the Benefit of Creditors or Stockholders?*, 21 UCLA L. REV. 540, 541 (1973).

⁸² *Id.*

the United States Supreme Court case *Northern Pacific Railway Co. v Boyd*,⁸³ and has been further developed through subsequent Supreme Court cases.⁸⁴

Boyd dealt with the principles governing the fairness of distributions between both creditors and shareholders in equity receiverships.⁸⁵ The *Boyd* court applied to equity reorganizations the reasoning of the court in *Louisville Trust Co. v. Louisville Railway*: “[A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of [a] class of creditors comes within judicial denunciation.”⁸⁶ If a plan satisfied this “fixed principle” from the *Boyd* case, it had to be “fair and equitable.”⁸⁷

1. Sections 77 and 77B

In 1933, Congress enacted Section 77 which amended the 1898 Bankruptcy Act and permitted railroads to be bankrupts.⁸⁸ In addition to permitting railroads to qualify as bankrupts for the first time, Section 77 also codified the existing receivership practices.⁸⁹ One equity receivership practice that was retained was the drafting and approval of plans of reorganization which stated the revised capital structure of the reorganized entity, and which also provided for distributions to creditors.⁹⁰ To confirm such a proposal under equity receivership principles, a plan had to be “fair and equitable,” a requirement that Section 77 retained.⁹¹

Section 77 was an amendment to the already existing 1898 bankruptcy code that had been based on the principle of compositions in reorganization practice.⁹² While section 77 extended to “railroads engaged in interstate commerce” the statutory right to reorganization proceedings, it did not extend that right to all corporations generally.⁹³ More importantly, insofar as the amendment maintained the separation between compositions for the benefit of bankrupt individuals and reorganizations for the benefit of insolvent railroads, Section 12(d) of the 1898 Act was unaffected.⁹⁴ Thus, under the Act as it stood in 1933, compositions for the benefit of individuals must be “for the best interests of all creditors”⁹⁵ while railroad reorganizations could not be “unfair” with respect to all classes of creditors or stockholders.⁹⁶

⁸³ *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

⁸⁴ *Marine Harbor Props., Inc. v. Mfrs. Trust Co.*, 317 U.S. 78 (1942); *Consol. Rock Prods. Co. v. du Bois*, 312 U.S. 510 (1941); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939).

⁸⁵ *Boyd*, 228 U.S. 482.

⁸⁶ *Louisville Trust Co. v. Louisville Ry.*, 174 U.S. 674, 684 (1899).

⁸⁷ *Trost*, *supra* note 81, at 542.

⁸⁸ Act of March 3, 1933, ch. 204, 47 Stat. 1467 (repealed 1938).

⁸⁹ *LaSalle Brief*, *supra* note 17, at 9.

⁹⁰ *Boyd's Ghost*, *supra* note 5, at 403-06.

⁹¹ *LaSalle Brief*, *supra* note 17, at 9.

⁹² *Id.*

⁹³ Act of March 3, 1933, ch. 204, 47 Stat. 1467 (repealed 1938).

⁹⁴ *Id.* While § 77 extended railroads the right to be bankrupt, Congress had still not extended reorganization relief to corporations generally.

⁹⁵ Act of March 3, 1933, ch. 204, § 74(g), 47 Stat. 1467 (repealed 1938).

⁹⁶ *See id.* at § 77.

The best interests test is conspicuously absent from the first real American corporate reorganization statute.⁹⁷ In 1934, Congress again amended the 1898 Act, this time extending bankruptcy relief to corporations generally.⁹⁸ In passing the Section 77B amendment Congress broadened the term "unfair" to read "fair and equitable," which defined the phrase more clearly as incorporating the priority rule from equity receivership practice.⁹⁹ The best interests of creditors test is found nowhere in Section 77B.¹⁰⁰ Of course, Section 77B applied specifically to corporate reorganizations,¹⁰¹ and from the 1898 Act until the 1934 amendment, the best interests test had been applied to compositions, which usually were not used for large corporate reorganizations.¹⁰² Not until the next comprehensive revision of the bankruptcy code was the best interests test applied to corporations generally.

2. *The Chandler Act of 1938 and Chapters X and XI*

In 1938, Congress radically overhauled the corporate reorganization laws.¹⁰³ Section 77B was split into three chapters each of which addressed specific corporate reorganization situations.¹⁰⁴ The first, Chapter X, was intended to facilitate the reorganizations of large public companies and was enacted against a backdrop of perceived abuse of public creditors and investors under then-current reorganization laws.¹⁰⁵ Chapter X incorporated Section 77B's confirmation requirement that a reorganization plan be "fair and equitable."¹⁰⁶

By including the phrase in Chapter X, Congress retained the priority provisions with regard to creditor classes that had descended from the Supreme Court's decision in *Boyd*.¹⁰⁷ However, not until 1939, one year after Chapter X was adopted, did Justice William O. Douglas offer some clarity on the intended rigidity of those class priorities.¹⁰⁸ Under Justice Douglas' interpretation, "fair and equitable" meant absolute priority.¹⁰⁹ That meant that beginning

⁹⁷ Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (repealed 1938). See also Rostow & Cutler, *supra* note 40, at 1353 ("the phrase 'best interest of creditors' as applied to composition as it has been suggested, some of the qualities of a term of art; there may be corresponding significance in the fact of its omission from [Section 77B and Chapter X] the two real corporate reorganization chapters of the Bankruptcy Act").

⁹⁸ Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (repealed 1938).

⁹⁹ *Id.* See also *LaSalle* Brief, *supra* note 17, at 9 (Congress first used the complete phrase "fair and equitable" in 1934 when it used Section 77 as a template and extended bankruptcy protection to municipalities. Act of May 24, 1934, ch. 345, §80(e), 48 Stat. 798 (repealed 1938)).

¹⁰⁰ Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911 (repealed 1938).

¹⁰¹ *Id.*

¹⁰² Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, § 12 (repealed 1934).

¹⁰³ The Chandler Act, Act of June 22, 1938, ch. 575, 52 Stat. 840 (repealed 1978).

¹⁰⁴ U.S. BANKR.COMM'N, REPORT OF THE COMM'N ON THE BANKR. LAWS OF THE U.S., H.R. DOC. NO. 93-137, pt 1-2 (1973) [hereinafter "COMMISSION REPORT"].

¹⁰⁵ *Id.*

¹⁰⁶ *LaSalle* Brief, *supra* note 17, at 13.

¹⁰⁷ *Id.* at 12-13.

¹⁰⁸ *Case v. Los Angeles Lumber Prod. Co.*, 308 U.S. 106 (1939). Justice William O. Douglas concluded that the phrase "fair and equitable" carried forward the practices and precedents of equity receiverships and to that extent the phrase meant the absolute priority rule.

¹⁰⁹ *Trost*, *supra* note 81, at 542.

with the topmost class of claims, each lower class must be paid in full before lower classes could participate.¹¹⁰

Chapter XI was a different reorganization chapter intended to serve a different need within the universe of reorganization practice.¹¹¹ The chapter as it was originally envisioned was to facilitate the reorganization of smaller, closely-held corporations.¹¹² The application of Chapter XI was also restricted to only unsecured debt¹¹³ and it did not require debtors to satisfy an absolute priority rule.¹¹⁴

Chapter XI required that confirmation of a reorganization plan must be “for the best interests of the creditors.”¹¹⁵ The phrase was intended “to accommodate the retention of any equity interest even though the creditors were scaled down”¹¹⁶ and was to incorporate flexibility: the standards of a fair plan established in *Boyd*.¹¹⁷ Plans were “fair” under Chapter XI if creditors received more under the reorganization plan than they would have received in liquidation.¹¹⁸

While the drafters of the Chandler Act of 1938 had intended that Chapter X, not Chapter XI, would handle the bulk of large corporate reorganizations, the reality of bankruptcy practice was something completely different.¹¹⁹ Chapter X was never widely used as corporations sought, instead chose, to reorganize under Chapter XI.¹²⁰ Corporations preferred Chapter XI for several reasons. In Chapter XI, the debtor initiated the proceedings and held the exclusive right to propose a plan.¹²¹ The debtor usually continued to operate the business, which in turn usually meant that the debtor’s attorney was ensured continual employment.¹²² Proponents of Chapter XI argued that the ability to avoid the interference of a third party, such as a trustee, allowed for greater reorganization speed and economy.¹²³ While the inability to effect secured creditors or equity security interests in Chapter XI made the chapter appear, at least superficially, impractical for most large corporate reorganizations, by the 1970s bankruptcy lawyers had been able to overcome those limitations.¹²⁴

¹¹⁰ *Id.* at 541

¹¹¹ *LaSalle* Brief, *supra* note 17, at 13.

¹¹² *Id.* See also COMMISSION REPORT, *supra* note 104, pt. 1, at 245. Those involved in drafting the 1938 Chandler Act had intended that Chapter XI would be for “small, closely held corporation[s]” although Chapter 11 itself was silent as to its intention.

¹¹³ *Id.* at 240.

¹¹⁴ *Id.* Chapter XI appeared to also require adherence to the absolute priority rule because the Chapter also required that plans be “fair and equitable.” However, in 1952 Congress amended the act to remove the “fair and equitable” requirement from Chapter XI. See Act of July 7, 1952, ch. 579, § 35, 66 Stat. 420, 433.

¹¹⁵ Act of June 22, 1938, ch. 575, 52 Stat. 840, 911.

¹¹⁶ COMMISSION REPORT, *supra* note 104, pt 1, at 245.

¹¹⁷ *Id.*

¹¹⁸ DAVID G. EPSTEIN ET AL., BANKRUPTCY §10-18 (1992).

¹¹⁹ COMMISSION REPORT, *supra* note 104, pt 1, at 246.

¹²⁰ *Id.*

¹²¹ *Id.* at 247.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* While Chapter XI had the limitation that plans could not affect secured creditors or equity interests, case law had evolved to such a point that secured creditors were effectively precluded from realizing on their collateral as long as the bankruptcy proceedings continued.

Chapter X differed dramatically in that once a reorganization process was initiated, a disinterested trustee was appointed and the role of the debtor and its counsel were greatly reduced.¹²⁵ In its recommendation to Congress before the enactment of the 1978 Bankruptcy Reform Act, the Commission on Bankruptcy Laws found that corporate debtors did not choose Chapter XI because of its advantages of speed and economy as its proponents asserted.¹²⁶ Rather, corporations chose Chapter XI because it allowed for greater debtor control as well as a standard of fairness determined by the "best interests" test in lieu of the absolute priority rule.¹²⁷

C. *The 1978 Bankruptcy Reform Act*

By 1978, Congress concluded that any justification for the distinct chapters had disappeared.¹²⁸ Chapter X had been intended to provide public protection to investors that had been lacking under equity receivership practices.¹²⁹ Under the realities of reorganization bankruptcy practice, as it stood in the 1970s, investors once again were exposed to the avarice of the debtor.¹³⁰

In response to the inadequacies of Chapters X and XI, Congress combined them into a single, comprehensive reorganization chapter in the 1978 Act.¹³¹ The goal in creating the new single chapter was to "adopt in part the flexibility of chapter XI and incorporate the fundamental public protection features of current chapter X."¹³² The new code greatly reduced the role of the SEC¹³³ and allowed debtors to remain in control of the business during the reorganization.¹³⁴

The 1978 Act also drastically altered the absolute priority rule.¹³⁵ Under the new law, only a *class* of creditors could challenge a plan on the grounds that it was not "fair and equitable."¹³⁶ While in Chapter X, no *individual* dissenting creditor, however, could challenge the plan on the grounds it did not comply with the absolute priority rule.¹³⁷

In place of the absolute priority rule, individual creditors received the best interests test, now codified in Section 1129(a)(7).¹³⁸ Thus, once a creditor was granted value equal to the value it would have received under liquidation in chapter 7, the surplus going-concern value of the corporation would be allocated by democratic vote within classes of creditors.¹³⁹ In this way, the new code embraced two distinct statutory tests for dealing with dissenting creditors.

¹²⁵ *Id.*

¹²⁶ COMMISSION REPORT, *supra* note 104 pt 1, at 247.

¹²⁷ *Id.*

¹²⁸ *Id.*

¹²⁹ See generally Markell, *supra* note 19, at 9-13.

¹³⁰ COMMISSION REPORT, *supra* note 104 pt 1, at 242.

¹³¹ *Id.* at 237.

¹³² CHARLES JORDAN TABB, *THE LAW OF BANKRUPTCY* 764 (1997).

¹³³ *Id.*

¹³⁴ COMMISSION REPORT, *supra* note 104 pt 1, at 237.

¹³⁵ *Id.*

¹³⁶ LaSalle Brief, *supra* note 17, at 16-17.

¹³⁷ *Id.*

¹³⁸ 11 U.S.C. § 1129(a)(7).

¹³⁹ Trost, *supra* note 81, at 550-51.

Nonconsensual plans could be confirmed over dissenting classes so long as the absolute priority rule was satisfied, and individual dissenters were bound so long as the plan was in their "best interest."¹⁴⁰

D. *The Best Interests Test in Chapter 11*

The modern best interests test codified in Section 1129(a)(7)¹⁴¹ is an "individual guaranty to each creditor or interest holder that it will receive at least as much in reorganization as it would in liquidation."¹⁴² Operationally, this guaranty indicates that any value exceeding the liquidation value of the corporation is subject to group vote rather than individual demand.¹⁴³ Thus, section 1129(a)(7) requires that each individual member of a class either accept the reorganization plan, or receive (i) property (ii) that has a present value equal to (iii) that participant's hypothetical chapter 7 distribution (iv) if the debtor were liquidated instead of reorganized on the plan's effective date.¹⁴⁴

None of these components of the liquidation analysis are closed to debate.¹⁴⁵ However, the calculation of the hypothetical Chapter 7 distribution is of particular interest.¹⁴⁶ To the extent that the corporation's present value has already been calculated, it must equal or exceed "the amount that [the] holder would . . . receive or retain if the debtor were liquidated under chapter 7" of the Code.¹⁴⁷ Practically, to comply with the best interests test, every debtor proposing a bankruptcy plan must perform a liquidation analysis and present it to the creditors.¹⁴⁸ That analysis proceeds under the assumption that Chapter 7 is controlling which modifies some nonbankruptcy liquidation rules.¹⁴⁹

Liquidation distributions in Chapter 7 are governed by section 726 of the Code which is largely consistent with nonbankruptcy practice.¹⁵⁰ However, section 726 makes exception for "tardily filed claims, for fines, penalties and punitive damages and for postpetition interest."¹⁵¹ Section 726(a)(4) subordinates the payment of certain penalty claims and mandates that "a claim . . . for any fine, penalty or forfeiture, or for multiple, exemplary or punitive damages . . . to the extent that such [amount is] not compensation for actual pecuniary loss" be subordinated to non-penalty unsecured claims.¹⁵²

¹⁴⁰ See 11 U.S.C. § 1129(a)(7) (codifying the best interests of creditors test); 11 U.S.C. § 1129(b)(2)(B) (codifying the concept of the absolute priority rule).

¹⁴¹ 11 U.S.C. § 1129(a)(7).

¹⁴² 5 COLLIER ON BANKRUPTCY ¶ 1129.03[7] (15th rev. ed.) (1996) [hereinafter COLLIER].

¹⁴³ *Id.* at ¶ 1129.03[7].

¹⁴⁴ See *id.* at ¶ 1129.03[7][b].

¹⁴⁵ See *id.* at ¶ 1129.03[7][b][iii].

¹⁴⁶ *Id.*

¹⁴⁷ 11 U.S.C. § 1129(a)(7).

¹⁴⁸ COLLIER, *supra* note 142, at ¶ 1129.03[7][b][iii] n.87. The liquidation analysis does not have to take the form of a separate document labeled as such. However, the analysis does have to be presented to the creditors in some form such that they can understand it. Otherwise, the best interests requirement is not satisfied. *Tranel v. Adams Bank Trust Co.* (*In re Tranel*), 940 F.2d 1168, 1172 (8th Cir. 1991).

¹⁴⁹ COLLIER, *supra* note 142, at ¶ 1129.03[7][b][iii].

¹⁵⁰ *Id.* at ¶ 1129.03[7][c].

¹⁵¹ 11 U.S.C. § 726(a)(3)-(5).

¹⁵² *Id.* at § 726(a)(4).

In connecting the liquidation analysis to Chapter 7, Congress indicated that “in order to determine the hypothetical distribution in a liquidation, the court will have to consider the various subordination provisions of proposed 11 U.S.C. 510, 726(a)(3), 726(a)(4), and the postponement provisions of proposed 11 U.S.C. 724.”¹⁵³

III. ANALYSIS

In most bankruptcy cases the liquidation analysis will form part of the disclosure statement that will be given to claim and interest holders.¹⁵⁴ In fact, a debtor must perform a liquidation analysis to fully comply with section 1129(a)(7).¹⁵⁵ In preparing a proper liquidation analysis, a debtor must set out: the “value of the debtor’s assets, the secured claims against those assets, projected Chapter 11 and 7 administrative expenses, priority claims and unsecured claims, and a calculation of the percent distribution to each type of claim.”¹⁵⁶ Of course, to the extent the debtor itself is charged with proposing the plan and preparing the liquidation analysis, the results are very subjective.¹⁵⁷

WorldCom’s liquidation analysis illustrates this subjectivity and implicates other issues. First, what might be the implications of the recently enacted Sarbanes-Oxley Act¹⁵⁸ with respect to WorldCom’s liquidation analysis? Second, is the WorldCom liquidation analysis, to the extent that it is a fire-sale approach to estimated liquidation proceeds, the desired method of devising a plan that is in the “best interests” of creditors?

A. *WorldCom Disclosure Statement*

On July 9, 2003, WorldCom filed a “Supplement to Debtors’ Disclosure Statement” that included the requisite liquidation analysis.¹⁵⁹ The table below presents the estimated liquidation proceeds of a WorldCom liquidation in a hypothetical Chapter 7.¹⁶⁰ Under WorldCom’s analysis, in liquidation its secured creditors would recover 100% of their investments, priority claimholders would recover 92.4%, and WorldCom’s unsecured creditors would recover nothing.¹⁶¹

¹⁵³ H.R. REP. NO. 95-595, at 412-13 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6368.

¹⁵⁴ COLLIER, *supra* note 142, at ¶ 1129.03[7][b][iii].

¹⁵⁵ *Id.* at ¶ 1129.03[7][b][iii]. The best interests test of section 1129(a)(7) cannot be satisfied without a liquidation analysis. *In re Modern Steel Treating Co.*, 25 C.B.C.2d 292, 130 B.R. 60 (Bankr. N.D. Ill. 1991).

¹⁵⁶ EPSTEIN, *supra* note 118, at §§ 10-18.

¹⁵⁷ *Id.*

¹⁵⁸ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308(a), 116 Stat. 745, 784-85.

¹⁵⁹ Supplement to Debtor’s Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, *In re WorldCom, Inc.*, No. 02-13533, 2003 Bankr. LEXIS 1401 (Bankr. S.D.N.Y. 2003), at <http://www.elawforworldcom.com/worldcomdisclosureFrame.htm> [hereinafter “WorldCom Disclosure Statement”].

¹⁶⁰ *Id.* at F-3.

¹⁶¹ *Id.*

	Projected Book Value as of 9/30/03 (\$ in millions)	Recovery Percent	Estimated Recovery Proceeds (\$ in millions)
Proceeds from Liquidation			
Cash and cash equivalents	4,524	100.0%	4,524
Accounts receivable, net	3,794	24.6%	935
Other current assets	584	3.9%	23
Property, plant and equipment, net	5,585	16.4%	918
Other long term assets	1,580	9.1%	143
Proceeds from non-debtor subsidiaries	—	—	25
Gross liquidation proceeds	\$16,067		\$6,568
Chapter 7 Administrative Expense Claims			
Trustee and receiver fees			61
Counsel for trustee and other professional fees			24
Wind-down costs			1,230
Chapter 7 administrative expense claims			1,315
Net proceeds available for distribution			5,253
Secured claims			142
% Recovery			100.0%
Net proceeds available after secured claims			5,111
Less:			
Estimated aggregate unpaid administrative expense, priority, and tax claims			5,529
% Recovery			92.4%
Net proceeds available after priority claims			0
General unsecured claims			39,762
% Recovery			0.0%

B. Sarbanes-Oxley Implications

The year 2002 may well be remembered by the business community as one in which the bear market revealed the fraudulent shenanigans of a frightening fraction of Wall Street.¹⁶² In late 2001, in what was to only be the tip of the iceberg of corporate scandal, Enron revealed that it had fraudulently misstated financial statements.¹⁶³ The resulting scandal ultimately forced Enron to file for Chapter 11 protection in December 2001.¹⁶⁴ The Enron bankruptcy was only a prelude to further scandals involving one of the big five accounting firms,¹⁶⁵ fraudulent analyst stock recommendations,¹⁶⁶ and Adelphia Communications' enormous undisclosed loans benefiting founder Rigas and family.¹⁶⁷

Then in June 2002, WorldCom sharply cut its sales forecast, after denying it had any accounting issues.¹⁶⁸ Shortly thereafter, Bernie Ebbers resigned as its CEO.¹⁶⁹ Later, in what would develop into the largest corporate scandal in

¹⁶² See Jarrod Wilcox, *2002's Top Investment Story – Fraud Revealed*, WILCOX INV., INC. ONLINE (Jan. 1, 2003), http://www.wilcoxinvest.com/market/WSfraud_Dec202.htm.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

¹⁶⁵ *Id.*

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ See Shawn Young, *Leading News: MCI Slashes \$3 Billion From '05 Revenue Estimate*, WALL ST. J. ONLINE (July 8, 2003).

¹⁶⁹ See Wilcox, *supra* note 162.

Wall Street history, WorldCom admitted that it had broken accounting rules to enhance profit.¹⁷⁰ While the WorldCom scandal was not the final saga in accounting fraud for the year,¹⁷¹ it was, and still is, the largest, weighing in at some ten billion dollars in financial misstatements.¹⁷²

Congress officially waded into the fray of corporate scandal on July 31, 2002, with the passage of the Sarbanes-Oxley Act.¹⁷³ Section 308 of the Act, known as the "Fair Funds For Investors" provision changes how the SEC may distribute civil penalties.¹⁷⁴ Section 308(a) provides in part that:

If in any judicial or administrative action brought by the [Securities and Exchange] Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.¹⁷⁵

Under § 308, if the SEC obtains a disgorgement order that returns funds to victims of securities violations, the amount of any additional civil penalty the SEC also obtains may be added to the fund.¹⁷⁶

Of course, the rights under § 308 belong to the SEC and do not accrue to the bankruptcy estate.¹⁷⁷ That fact would make it appear that the provision would have only passing relevance to bankruptcy practice. However, the operation of the Securities and Exchange Commission's use of the Fair Funds Provision may have some implications with regard to the best interests test of § 1129(a)(7).

In May 2003, WorldCom and the SEC agreed to a \$1.5 billion penalty.¹⁷⁸ Subsequently, the amount WorldCom would pay was reduced to \$500 million to reflect the two-thirds discount that creditors are receiving for their claims.¹⁷⁹ However, the district court overseeing the securities litigation expressed concern that the amount wasn't sufficient and the parties then submitted a new plan.¹⁸⁰ The new plan raised the payout for shareholders who had lost money due to the company's fraud.¹⁸¹ Under the final settlement plan, shareholders and bondholders who qualify would receive \$750 million in compensation.¹⁸² The SEC has invoked the new Fair Funds Provision and intends to distribute the \$750 million penalty to victims of WorldCom's securities fraud, most of

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² See Rebecca Blumenstein, *WorldCom Fraud Was Widespread*, WALL ST. J. ONLINE (June 20, 2003).

¹⁷³ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308(a), 116 Stat. 745, 784-85.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ See SEC Litigation Release No. 18147 (May 19, 2003), at <http://www.sec.gov/litigation/litreleases/lr18147.htm> (last visited Mar. 15, 2004) [hereinafter SEC Release].

¹⁷⁹ See Young, *supra* note 168.

¹⁸⁰ *Id.*

¹⁸¹ *Id.*

¹⁸² *Id.*

who will be former WorldCom shareholders.¹⁸³ However, the net effect of the SEC's actions is to use the creditor's money to reimburse these shareholders.

Since the SEC expressly acknowledges the settlement to be a civil penalty,¹⁸⁴ the best interests test possibly precludes the agreement. Under § 726(a)(4) a fine, penalty, or forfeiture is paid only after unsecured claims are paid in full.¹⁸⁵ While it is true that the prioritization scheme in § 726(a)(4) is exclusive to Chapter 7 bankruptcies,¹⁸⁶ by operation of the WorldCom settlement, \$750 million that would have gone to satisfy unsecured claims instead goes to reimburse defrauded shareholders, a result that may violate the best interests test.¹⁸⁷

But as the WorldCom disclosure statements show, even with the SEC settlement, the reorganization plan appears to satisfy the best interests test since creditors will receive \$500 million more through the Chapter 11 plan than they would in a Chapter 7 liquidation.¹⁸⁸ The best interests test appears to be satisfied because even with the payment of the extra \$750 million in Chapter 11, unsecured creditors still receive more in chapter 11 than in liquidation. Indeed, both the District Court and the Bankruptcy Court concluded that the bankruptcy plan complied with § 1129(a)(7) in that it was in the best interests of creditors.¹⁸⁹

The WorldCom liquidation analysis does not include the value of the SEC's \$750 million fine.¹⁹⁰ However, the \$750 million difference might not have affected the analysis to any great degree since the Bankruptcy Court found that the best interests test was satisfied because "[t]he distributions . . . under the Plan . . . far exceed the distributions under a chapter 7 liquidation."¹⁹¹ Since WorldCom's value outside of liquidation far exceeds its projected \$6.5 billion value in Chapter 7, it clearly appears to have been in the best interests of creditors to avoid liquidation.¹⁹²

However, the issue becomes much more salient in bankruptcies where the corporation's reorganized value does not exceed the hypothetical liquidation value by an amount greater than a fine levied by the SEC against the corporation under the Fair Funds for Investors provision. In a hypothetical bankruptcy such as this, the critical question is whether the best interests test of § 1129(a)(7) incorporates the priority scheme of § 726(a)(4). The legislative history supports such a result¹⁹³ and leading commentators reach the same conclusion,¹⁹⁴ while in the courts a split of authority has evolved.¹⁹⁵

¹⁸³ *Id.*

¹⁸⁴ See SEC Release, *supra* note 178.

¹⁸⁵ 11 U.S.C. § 726(a)(4).

¹⁸⁶ *Id.*

¹⁸⁷ 11 U.S.C. § 1129(a)(7).

¹⁸⁸ WorldCom Disclosure Statement, *supra* note 159, at F-3.

¹⁸⁹ See Young, *supra* note 168.

¹⁹⁰ WorldCom Disclosure Statement, *supra* note 159, at F-3.

¹⁹¹ *In re WorldCom, Inc.*, No. 02-13533, 2003 Bankr. LEXIS 1401, at 165 (Bankr. S.D.N.Y. 2003).

¹⁹² *Id.*

¹⁹³ See H.R. REP. NO. 95-595, at 412-13, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6368.

¹⁹⁴ See COLLIER, *supra* note 142, at ¶ 1129.03[7][c][ii].

The split focuses on whether language in Chapter 7 precludes application outside of that chapter or whether reading Chapter 7 in isolation is inconsistent with § 1129(a)(7). Those who favor the latter interpretation can be called incorporation proponents because they believe § 1129(a)(7) requires that Chapter 7 be read in conjunction with the priority scheme of § 726(a)(4). Incorporation proponents argue that if penalties in Chapter 11 cases are treated on parity with unsecured claims “the amount of unsecured liabilities would increase, and the proportional dividend to chapter 11 unsecured creditors would not be equivalent to their distribution in Chapter 7.”¹⁹⁶

To illustrate, corporation X manufactures widgets. The company has reported stellar earnings for several years and the stock price has responded positively. However, X’s rosy earnings reports have been fraudulently inflated and that fact is eventually revealed to (understandably upset) public investors. As a result, X’s stock price plummets, its bond rating is reduced and the company is forced to file for Chapter 11 protection. In response to the public outcry over the fraud, the SEC levies a civil penalty under the Fair Funds Provision.¹⁹⁷

To comply with the best interests test, X presents the estimated proceeds from a Chapter 7 liquidation in the disclosure statement. The company’s gross liquidation proceeds are estimated at \$100 million and after all of the administrative expense claims there is a net of \$90 million available for distribution. The creditors hold \$10 million in secured claims that will be satisfied in full. There are also over \$200 million in unsecured general claims that will receive the remaining \$80 million or a recovery of about 40%. Company X is valued at \$150 million as a going-concern. Under the proposed Chapter 11 plan, X’s unsecured creditors will receive about \$140 million or a recovery of about 70%.

Under this scenario, the best interests test is easily satisfied.¹⁹⁸ The plan leaves the unsecured creditors with \$140 million which is significantly greater than their \$80 million hypothetical recovery in Chapter 7 liquidation. Roughly stated, this is the situation in the WorldCom bankruptcy – the unsecured creditors’ recovery under Chapter 11 significantly exceeds their hypothetical recovery of 0.00% in liquidation.¹⁹⁹

But what of the \$80 million fine levied by the SEC? The prioritization scheme indicates that the fine should be subordinated to the unsecured credi-

¹⁹⁵ *Compare Compton Corp. v. United States*, 40 B.R. 875 (Bankr. N.D. Tex. 1984), *rev’d on other grounds*, 90 B.R. 798 (N.D. Tex. 1988) (section 1129(a)(7) does incorporate section 726(a)(4)), and *Erlin Manor Nursing Home, Inc. v. Rate Setting Comm’n*, 36 B.R. 672 (Bankr. D. Mass. 1984) (same), with *Virtual Networks Servs. Corp. v. United States*, 98 B.R. 343 (N.D. Ill. 1989) (section 1129(a)(7) does not incorporate section 726(a)(4)), and *In re Colin*, 44 B.R. 806 (Bankr. S.D.N.Y. 1984) (nothing in the Code or the legislative history indicates that Congress intended section 726(a)(4) to be read into the best interests test of section 1129(a)(7)).

¹⁹⁶ *Erlin Manor Nursing Home, Inc. v. Rate Setting Comm’n (In re Erlin Manor Nursing Home, Inc.)*, 36 B.R. 672, 678 (Bankr. D. Mass. 1984).

¹⁹⁷ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 308(a), 116 Stat. 745, 784-85.

¹⁹⁸ 11 U.S.C. § 1129(a)(7) (2002).

¹⁹⁹ WorldCom Disclosure Statement, *supra* note 159, at F-3.

tors' claims if the company were in Chapter 7.²⁰⁰ But the effect of paying the \$80 million penalty in Chapter 11 when X's company creditors have not been paid in full is to treat a penalty on parity with unsecured claims. As a result of paying the fine in Chapter 11, X's unsecured liabilities increase and the proportional dividend to the Chapter 11 unsecured creditors is not greater than the Chapter 7 creditors. In the hypothetical Chapter 7 liquidation, the unsecured creditors would have received \$80 million, but after the operation of the Fair Funds provision in Chapter 11 that recovery would drop to \$70 million. With regard to X's Chapter 11 reorganization, the best interests test of 1129(a)(7) would not be satisfied.

While incorporation of the 726(a) prioritization scheme into chapter 11 cases through the best interests test of 1129(a)(7) is appealing in that it would place creditors above shareholders, the code itself may preclude such a reading. Title 11 U.S.C. § 103(b) explicitly states that subchapters I and II of Chapter 7 (and section 726(a) is part of subchapter II) "apply only in a case under [chapter 7]."²⁰¹ Several jurisdictions have embraced this textualist interpretation and held that § 103(b) precludes reading the priority scheme of 726(a) into the best interests test.²⁰² These courts have also argued that reading the statutory provisions together would "add an additional layer of constraints to negotiation of plans that Chapter 11 is designed to foster, a flexibility that is largely limited only by protection of minority creditors and dissenting classes."²⁰³

Of course, the stated rationale for the best interests test has always been the protection of those creditors who dissent from a proposed plan. If creditor protection is the real motivation for the statutory provision, then maybe the best approach to affording that protection is to reduce the role of the debtor, which has little motivation to look out for the creditor's interest. In this regard, the United Kingdom may provide some guidance. England and the United States have both evolved from the same common law bankruptcy roots, but each has taken a very distinct approach to corporate reorganizations.²⁰⁴

C. *Insights from the United Kingdom*

The American concept of the best interests test establishes a statutory standard by which plans can be confirmed in spite of dissenting creditors, but not unduly at their expense. Under the best interests test, unsecured creditors must receive at least as much under a proposed Chapter 11 plan as they would under a hypothetical Chapter 7 liquidation.²⁰⁵ Because of the standard in 1129(a)(7), the safeguard afforded to the dissenting unsecured creditor under the American system is entirely contingent upon the reliability of the liquidation analysis.

²⁰⁰ 11 U.S.C. § 726(a)(4) (2002).

²⁰¹ 11 U.S.C. § 103(b) (2002).

²⁰² See, e.g., *Virtual Networks Servs. Corp. v. United States*, 98 B.R. 343 (N.D. Ill. 1989) (section 1129(a)(7) does not incorporate section 726(a)(4)); *In re Colin*, 44 B.R. 806 (Bankr. S.D.N.Y. 1984).

²⁰³ *In re Colin*, 44 B.R. at 809-810.

²⁰⁴ Nathalie Martin, *Common-Law Bankruptcy Systems: Similarities and Differences*, 11 AM. BANKR. INST. L. REV. 367 (2003).

²⁰⁵ 11 U.S.C. § 1129(a)(7) (2002).

The liquidation analysis is subjective²⁰⁶ at best and the values assigned to a corporation's assets inspire even less confidence when, as in the American system, the plan has been prepared and proposed by the debtor. British reorganization procedure more carefully secures the "best interests" of unsecured creditors in that (1) management does not continue in control of the company, and (2) liquidation presumes it is not a "fire-sale" liquidation, but a sale of the company as a going-concern.²⁰⁷

The United Kingdom has developed a system that is far more skeptical of the American model that usually leaves the debtor in possession of the reorganizing corporation.²⁰⁸ The American bankruptcy tradition evolved the concept of a "debtor-in-possession," which simply means that the corporate management that is in place when reorganization proceedings are initiated presumably controls the bankruptcy process.²⁰⁹ While this presumption is accurate in the case of smaller corporations, in the case of larger, publicly traded companies, while management may initiate the process, it is often replaced during the chapter 11 reorganization.²¹⁰

The operation of the debtor in possession model in smaller Chapter 11 cases is of particular interest since they comprise the majority of Chapter 11 cases,²¹¹ and the best interests test as it was originally intended under Chapter XI was to facilitate smaller corporate reorganizations.²¹² In smaller Chapter 11 cases, management usually remains in place.²¹³ Often this is the case because in small firms there is no difference between the management and the stockholders.²¹⁴

If the best interests test is to safeguard individual creditor interests, then the liquidation analysis itself must genuinely reflect the company's true liquidation value. To ensure the liquidation analysis truly reflects what the company would be worth in liquidation the better rule would be to remove the debtor from oversight of the analysis preparation. There is no evidence that the liquidation analysis in the WorldCom bankruptcy is inaccurate. However, the prospect of ethically-challenged corporate executives, who in large part are personally responsible for their company's demise, overseeing the preparation of a liquidation analysis does not engender trust in the process. If WorldCom executives cannot be trusted to oversee honest accounting at their own firms, it follows that there is little reason to trust them in bankruptcy proceedings.

In light of the prevalent corporate fraud revealed in 2002,²¹⁵ the British bankruptcy rules appear better suited to protecting creditor interests. The appointment of an impartial administrator to oversee the preparation of a reor-

²⁰⁶ EPSTEIN, *supra* note 118, at §§ 10-18.

²⁰⁷ Martin, *supra* note 204, at 396-97.

²⁰⁸ *Id.* at 390.

²⁰⁹ *Id.* at 390-91.

²¹⁰ *Id.*

²¹¹ See, e.g., Brian A Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 185 (2000) ("[S]mall businesses constitute the overwhelming majority of business bankruptcies . . .").

²¹² LaSalle Brief, *supra* note 17, at 13.

²¹³ Martin, *supra* note 204, at 391.

²¹⁴ *Id.*

²¹⁵ See WILCOX, *supra* note 162.

ganization plan seems to be a better procedure to devise a plan in the creditors' best interests than to entrust that duty to executives who are often concerned for no one's best interest but their own. The present system, to the extent that it restructures a corporation, but leaves corrupt management in control, suffers from many of the same ills that plagued the equity receiverships of 100 years ago.

Of course, unreliable liquidation analyses are not always the result of a debtor-in-possession reorganization regime. The analysis itself may not be based upon the right assumptions. The American understanding of the term "liquidation" in bankruptcy is very different from the meaning British bankruptcy practitioners attach to the term.²¹⁶ While under the American system liquidation often assumes a sort of "fire-sale" immediate selling of the assets, the British approach is to view the company as a going-concern or as several component going-concerns that could be sold to pay creditors.²¹⁷

The reorganization process most prevalent in the United Kingdom is the "Administration."²¹⁸ Under the administration procedure, an administrator is appointed who then assumes control over the company.²¹⁹ Shortly thereafter, the administrator proposes a reorganization plan that then goes before a vote of the creditors.²²⁰ If both a quantitative and qualitative majority of creditors approve of the administrator's proposed plan, they can vote for it.²²¹ If those creditors do not approve the plan, then a traditional liquidation occurs.²²²

The administrator system does result in some reorganizations.²²³ The reorganization that is actually envisioned, however, is in actuality very different from the American concept of reorganization under Chapter 11. As English attorney John White has explained, "[i]f the proposal is approved by the creditors, then the administrator moves forward, realizes assets, and sells."²²⁴ In this regard the usual use of the Administration is to "sell companies as going concerns rather than in piece-meal form."²²⁵ This is the opposite of the typical American chapter 11 reorganization which usually has very little to do with realizing assets and "selling."²²⁶ In short, the approach in the United Kingdom

²¹⁶ See Martin, *supra* note 204, at 396-97.

²¹⁷ *Id.*

²¹⁸ See Richard F. Broude, et al., *The Judge's Role in Insolvency Proceedings: The View from the Bench; The View from the Bar*, 10 AM. BANKR. INST. L. REV. 511, 516 (2002) (stating that administration is the United Kingdom's "most popular and most effective rehabilitative procedure").

²¹⁹ Martin, *supra* note 204, at 393-94.

²²⁰ See Insolvency Act, 1986, c. 45 § 5(2) (Eng.) (establishing the voting procedure for approval of an administrator proposed plan). See also Martin, *supra* note 204, at 394.

²²¹ See Martin, *supra* note 204, at 394.

²²² See Insolvency Act, 1986, c. 45 § 5(2) (Eng.)

²²³ See Evan D. Flaschen, *Sorting Out Mr. Maxwell's Tangled Webs*, NAT'L L.J., Oct. 5, 1992, at 19 ("[British administration] proceedings are the English version of reorganization under chapter 11 of the Bankruptcy code.").

²²⁴ See Broude, *supra* note 219, at 517.

²²⁵ See Martin, *supra* note 204, at 396-97.

²²⁶ See Judy Beckner Sloan, *Current Problems in International Insolvency*, 2 SW. J. L. & TRADE AM. 175, 177 (1995) (book review) ("[M]ost administrations in the United Kingdom result in the sale of the business, while in the United States, the business tends to remain in the hands of the debtor.").

is to displace management and liquidate the company not in piece-meal form, but while still operational.²²⁷

Liquidation along British lines, which calculates the company's value as an operational entity rather than as a fire-sale of its parts, may better serve the best interests test. If the baseline for determining whether the claims of dissenting individual creditors under Chapter 11 is what they receive in liquidation, then that liquidation should be consistent with the real value of the company. The real value of many companies lies not in their component assets, but in their value as a going concern.

The estimated liquidation proceeds WorldCom set forth in its disclosure statement placed the value of the company's assets at roughly \$16 billion, of which \$6.5 billion was considered recoverable after a fire-sale sort of liquidation.²²⁸ The company would be sold in small non-operational pieces that would recover only 16.4% on assets such as the company's property, plants and equipment.²²⁹ Under that analysis almost \$40 billion in general unsecured claims recover nothing.²³⁰

Under a British liquidation proposal, however, the company would not be sold under an asset sale.²³¹ The liquidation would either take place by selling the company as a going-concern to a willing buyer or by selling off pieces of the company as smaller going concerns.²³² Of course, a buyer of a bankrupt WorldCom is not going to purchase the company for sufficient value to repay in full all of the roughly \$50 billion in claims.²³³ But selling off the component parts as going-concerns, which is consistent with the British concept of liquidation, would raise much more than the wholly insufficient \$6.5 billion projected in the liquidation analysis.

WorldCom's three core assets could be sold off to willing buyers.²³⁴ MCI Group, WorldCom's consumer-long-distance company had projected revenue of \$8.3 billion for 2002.²³⁵ UUNET, WorldCom's worldwide data network, accounts for over 30% of U.S. internet traffic and had sales of \$4.7 billion in 2002.²³⁶ The sale of these two assets alone would likely raise much more than the \$6.5 billion projected proceeds in a fire-sale liquidation. In addition, WorldCom's core corporate long distance services would likely fetch billions in addition to MCI and UUNET.²³⁷

Maybe the best way to ensure the protection of dissenting creditors is not to trust a liquidation analysis that presumes a fire-sale liquidation. Rather,

²²⁷ Martin, *supra* note 204, at 396.

²²⁸ WorldCom Disclosure Statement, *supra* note 159, at F-3.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ See Martin, *supra* note 204, at 396-97.

²³² *Id.*

²³³ WorldCom Disclosure Statement, *supra* note 159, at F-3.

²³⁴ Charles Haddad et al., *Bankruptcy Might Whip WorldCom Into Shape*, Bus. WK. ONLINE (Aug. 5, 2002), http://www.businessweek.com/magazine/content/02_31/b3794006.htm (in mid-2002 potential WorldCom suitors might have been plentiful in a telecommunications industry that was in real need of consolidation. Perhaps a sleeker, more competitive post-bankruptcy WorldCom is exactly what the industry did not need).

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.*

creditor claims might be more realistically preserved by valuing a company under the British approach that would sell a company's component parts as valid, running business concerns. That would appear to be truly in the best interests of creditors and would reflect more accurately the real value of the bankrupt company.

IV. CONCLUSION

The best interests of creditors is a statutory standard under which Chapter 11 bankruptcy plans can win approval despite dissenting individual creditors. A Chapter 11 reorganization plan that complies with the test proposes to pay creditors at least what they would have received if the company were liquidated under Chapter 7. The test itself is a contemporary fusion of the concept of composition agreements as it appeared in the Bankruptcy Act of 1898, and the practices derived from the 19th century equity receivership. These two approaches to reorganizations were eventually combined in 1978 to comprise the modern best interests test presently found in the Bankruptcy Code.

The effectiveness of the best interests test depends entirely upon the accuracy of the hypothetical liquidation analysis. The WorldCom bankruptcy is an example of a modern reorganization that complies with the current interpretation of the best interests test. Yet, that bankruptcy implicates scenarios where the SEC's application of the Fair Funds provision would pay shareholders under a Chapter 11 plan while creditors received less than they would in a Chapter 7. In that scenario, the Fair Funds provision seriously undermines the best interests test.

However, to the extent that the test is to safeguard creditor recovery while facilitating plan proposal and acceptance, the United Kingdom, which places an impartial Administrator in control of preparing and proposing a plan, might better safeguard the reliability of the liquidation analysis itself. The better approach might be to move away from the American debtor-in-possession bankruptcy model, at least to the extent that the debtor prepares and presents the liquidation analysis. Furthermore, British liquidations, which value the company, not through a hypothetical "fire-sale," but through a projected sale of the company as a going-concern are more likely to provide a better return to creditors. If the test is to truly safeguard individual creditor recovery, the British approach appears to more consistently reach that end.

