Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Antitrust, Commercial and Administrative Law

House Judiciary Committee

United States House of Representatives

July 28, 2021

Thank you for the opportunity to testify about "Oversight of the Bankruptcy Code, Part I: Confronting Abuses of the Chapter 11 System." It is a great honor to appear before you, and to provide this written testimony.

I should start by noting that this testimony reflects my own views, not the views of the University of Pennsylvania Carey Law School, where I work, or of the Financial Oversight & Management Board for Puerto Rico, which I currently chair.

My testimony can be distilled to two simple points. First, the danger of abuses in the system is very real. I applaud you for devoting multiple hearings, starting with this one, to investigating these issues. To the extent third party releases—one of the issues we'll be talking about today—interfere with properly compensating the victims of some of the horrible misbehavior that we'll be hearing about firsthand, for instance, I think it is important to consider how best to address this problem.

But, second, many of the key issues under discussion are complicated and involve provisions or transfers that can be either beneficial or pernicious. In my view, it is very important to take the risk of possible unintended consequences into account before amending the Bankruptcy Code in these areas. Our bankruptcy system generally works quite well, and legislative interventions can sometimes make things worse rather than better.

In this testimony, I'll begin by describing the purpose and general goals of the Chapter 11, as I see them, and several of the key features of bankruptcy process. I'll then talk about two of the issues under discussion today, the "use of nonconsensual nondebtor releases and preliminary injunctions to immunize parties not in bankruptcy from liability for their wrongful acts," and the "payment of large executive bonuses by companies in bankruptcy or on the verge bankruptcy." I'll argue that both releases and bonuses can either beneficial or abusive, depending on how they are used, and I will offer my own views about each. I'll briefly refer to the other listed topics in the course of my testimony.

The Purpose of Chapter 11

The principal purpose of Chapter 11, and of corporate bankruptcy more generally, is to provide a collective solution to final distress.[1] If there were no bankruptcy system, the creditors of a struggling business would race to collect what they are owed. They would file lawsuits against the debtor or if the debtor's equipment or property had been pledged to them as collateral, they might seek to foreclose on the equipment or property. If the creditors could coordinate among themselves, they might agree to hold off on these efforts, since competing to grab whatever assets a creditor can may dismember an otherwise viable business, leaving everyone worse off. But if the creditors are widely scattered, or if they are unable to coordinate for other reasons, each has an incentive to try to collect what it is owed. If they race to collect, they may get paid, but if they don't, they may end up with nothing. The incentive to try to collect, even if it ends up destroying a viable business, historically has described as a "grab race" or a "race to the courthouse."

Bankruptcy solves this problem by providing a collective forum for resolving financial distress. The moment a debtor files for bankruptcy, a standstill known as the "automatic stay" goes into effect—the stay prohibits creditors from continuing to pursue litigation or foreclosure actions against the debtor, and from taking any other steps outside the bankruptcy process to try to collect what they are owed.[2] The stay gives all of the relevant parties an opportunity to come to the table, and to negotiate the most effective and efficient resolution of the debtor's financial distress.

Two additional features of the U.S. system are worth mentioning for the purposes of the discussion in this hearing. First, if a debtor files for Chapter 11, the reorganization chapter of the Bankruptcy Code, the debtors' managers generally continue to run the business (and are referred to as the "debtor in possession.")[3] Historically, this was the feature of U.S. bankruptcy law that was most unusual as compared to other countries' bankruptcy and insolvency laws.[4] Under many countries' laws, the managers were immediately removed, and a trustee or other administrator was put in place, based on the view that the people who were captaining the ship when it crashed are the last people in the world who should run it in bankruptcy. Although this view is quite understandable, it gives the managers of a struggling company a strong incentive to delay filing for bankruptcy as long as possible. They are much more willing to file for bankruptcy if they won't be immediately removed. The American approach has worked well, and it has increasingly been adopted around the world.

---

[1] The perspective described in this paragraph is known as the "Creditors' Bargain" theory of bankruptcy, as discussed in note 8 below.

[2] The automatic stay can be found in section 362(a) of the Bankruptcy Code, 11 U.S.C. § 362(a).

[3] Thus, section 1107 states that the "debtor in possession" has all the rights that a trustee would have. 11 U.S.C. § 362(a).

[4] I discuss this issue in detail in a book that recounts the history and evolution of American bankruptcy law. DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (Princeton University Press 2001).

The second feature of bankruptcy that is relevant to the current discussion is that bankruptcy provides "avoidance" or "clawback" provisions that permit the debtor to retrieve payments that were made on the eve of bankruptcy (known as "preferences")[5] and to reverse prebankruptcy transactions that are intended to defraud creditors ("actual fraudulent conveyances")[6] or for which an insolvent debtor did not receive "reasonably equivalent value" ("constructive fraudulent conveyances").[7]

In my view—and here I am following the leading normative theory of Chapter 11, which was developed by Professors Douglas Baird and Thomas Jackson—the Bankruptcy Code generally should not deviate from nonbankruptcy law except where the deviation is needed to provide a collective forum.[8] If bankruptcy alters the rules on issues unrelated to its principal objective, it may create incentives for the parties to engage in costly battles over whether the company files for bankruptcy or stays out.

One implication of this is that, where there are problems in an area of law, it often is best to address them by reforming nonbankruptcy law, so that the reform applies both in bankruptcy and outside of bankruptcy. I don't want to overemphasize this point; sometimes bankruptcy deviates from nonbankruptcy law on issues that do not directly relate to the objective of providing a collective forum for resolving financial distress.[9] But the general principle that bankruptcy law should focus primarily on providing a collective forum should be the starting point, and it is important to recognize that there may be significant costs and unintended consequences with deviations from this.

Nonconsensual Nondebtor Releases

---

5 Under section 547(b), the debtor or trustee can retrieve payments or other transfers made within 90 days of bankruptcy, so long as non of a list of defenses (known as "safe harbors") in section 547(c) applies.

6 The Bankruptcy Code's prohibition of actual fraud is 11 U.S.C. § 548(a)(1)(A). The debtor or trustee can also use any state law fraudulent provision that would apply outside of bankruptcy, because section 544(b) gives it access to nonbankruptcy avoidance provisions.

7 11 U.S.C. § 548(a)(1)(B). This provision and related state law provisions are often used to challenge the corporate spinoffs and other transactions that will be discussed in this hearing, as in the Caesars bankruptcy.

8 The theory is known as the "Creditors' Bargain" theory of bankruptcy. Thomas Jackson introduced the Creditors' Bargain theory in *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 858 (1982). He and Douglas Baird subsequently developed the theory in other articles and a book. E.g., THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 7 (Harvard Univ. Press 1986); 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, 100-01 (1984). Jackson recounts the origins of the Creditors' Bargain theory in a recent essay. Thomas H. Jackson, *A Retrospective Look at Bankruptcy's New Frontiers*, 166 U. PA. L. REV. 1867 (2018).

9 As became clear during the Chrysler and General Motors bankruptcies in 2009, for instance, it may be easier to terminate an auto dealership in bankruptcy than it is outside of bankruptcy, under the sweeping power to "accept" or "reject" contracts provided by section 365(a). One can debate whether this is good, since it may enhance an automaker's ability to reorganize, or problematic.

The first topic listed for this hearing is the use of nonconsensual nondebtor releases (also known as "third party releases"). Nondebtor releases are often preceded and accompanied by the debtor's request to extend the automatic stay to halt actions against the nondebtors. After Purdue Pharma filed for bankruptcy, for instance, it asked the bankruptcy judge to impose a standstill not just on actions by victims and other creditors against the debtor, but also on actions against the Sacklers (the principal shareholders of Purdue Pharma) and other third parties. Under the proposed Purdue Pharma reorganization plan, which is being voted on now, the claims of victims and others against the Sacklers would be released in return for payments totaling $4.5 billion.

Purdue Pharma and the Sacklers need a special dispensation from the bankruptcy court to obtain these benefits because only Purdue Pharma is in bankruptcy; the Sacklers are not. The automatic stay therefore would not ordinarily protect the Sacklers. And under traditional bankruptcy principles, Purdue Pharma's bankruptcy plan would resolve the claims of victims and others against Purdue Pharma, but not the claims against the Sacklers.

In my view, there are good arguments both for and against nondebtor releases, both as a legal matter and as a policy matter. Indeed, on the exam I gave for a bankruptcy class I taught last summer, I asked my students to give me the single best argument for giving the Sacklers a nondebtor release in the Purdue Pharma bankruptcy, and the single best argument against a release.

The legal arguments over nondebtor releases are both statutory and Constitutional. The statutory argument often focuses on the bankruptcy court's equitable powers under section 105 of the Bankruptcy Code, which permits the judge to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of bankruptcy law. Advocates of releases argue that the releases are closely related to the bankruptcy case and properly within the bankruptcy judge's powers, whereas critics contend that the bankruptcy process is only intended to encompass the debtor and its creditors, not third parties.[10] The Constitutional debate centers on questions such as whether nondebtor releases violate separation of power principles, whether they exceed the powers of bankruptcy judge (because bankruptcy judges' authority comes from under Article I of the Constitution, rather than Article III), and whether they violate the due process rights of affected parties such as victims.

Many of these issues have arisen in the asbestos bankruptcies of the past forty years and more. In 1994, Congress added a section to the Bankruptcy Code to address asbestos bankruptcies.[11] This section explicitly provides for nondebtor releases in asbestos bankruptcies. For other bankruptcies, however, the Bankruptcy Code does not address the question of nondebtor releases. The releases are permitted in most circuits, at least under some circumstances, but they are treated quite differently in different circuits.

---

[10] The classic article questioning whether releases are an appropriate use of the bankruptcy judge's powers is Ralph Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. 959 (1997).

[11] 11 U.S.C. § 524(g).

From this point on I will assume that nondebtor releases are legally permissible, and I will focus on the question whether they should be permitted as a policy matter. One argument against nondebor releases is the argument that the benefits of bankruptcy should not be extended to individuals or entities that are not in bankruptcy. If they want the benefits of bankruptcy, according to this argument (and it is an argument I have made myself), they should file for bankruptcy. Another argument is that it is unfair to release claims that victims or others would otherwise be able to bring if the victims themselves did not agree to release the claims. In the Purdue Pharma bankruptcy, for instance, it is possible that opioid victims could receive a much bigger recovery if they pursued their claims against the Sacklers outside of bankruptcy.

On the other side are arguments that the treatment of nondebtors such as the Sacklers is so closely linked to the debtor's bankruptcy case that it is not really possible to fully resolve the company's financial distress without also resolving the claims against the nondebtors. The parties cannot determine how the victims should be treated in the Purdue Pharma bankruptcy, the argument might go, without also knowing what their recoveries are likely to be against the Sacklers. Advocates of releases also argue that victims may actually receive better compensation in connection with a release than they would if they litigated against the nondebtors outside of bankruptcy. The Sacklers have insisted, for instance, that victims would be forced to litigate for years and would receive much less than $4.5 billion if the request for nondebtor releases in the Purdue Pharma case were rejected.

It is important to keep in mind that the strength of these policy arguments in any particular case depends on how the case is handled by the bankruptcy judge and the parties in the case. If the bankruptcy judge gives victims a meaningful opportunity to participate and to speak about the harm they have suffered, they are less likely to feel as though their opportunity for a day in court has been cut off.[12] If the parties negotiate aggressively to ensure the nondebtors contribute as much as they should, the nondebtor release may be justified.

What should be done to limit abuses? It seems to me that the most sensible solution might be insist that there be more transparency about the nondebtors' assets and ability to contribute, and perhaps that there be a structured inquiry by the bankruptcy court into the question whether the nondebtor has made a sufficient contribution. One scholar has recently argued that bankruptcy's "best interests" of the creditors test could be adapted to this purpose.[13] This approach is based on the premise that, if nondebtors ask for access to some of the core benefits of bankruptcy, they should be required to provide full transparency and meet some of the other obligations that are expected of debtors in bankruptcy. Bankruptcy judges could adopt this approach, or another like it,[14] through the use of their discretion whether or not to approve nondebtor releases.

---

[12] For a discussion of the importance of such messages, and of the efforts of the bankruptcy judge in the Detroit bankruptcy to include Detroit residents in the bankruptcy process, see Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. REG. 55, 94 (2016).

[13] Lindsey Simon, *Bankruptcy Grifters*, YALE L.J. (forthcoming, 2021). Professor Simon's article provides an excellent analysis of how this approach might be applied.

[14] Douglas Baird, Anthony Casey, and Randal Picker have suggested that courts should consider factors such as whether a supermajority of the members of a class of victims or other creditors that are affected by the releases

Payment of Executive Bonuses

Another issue on this hearing's agenda is the companies' payment of bonuses in bankruptcy or shortly before they file for bankruptcy. As with nondebtor releases, bonuses can be pernicious or beneficial, depending on how they are used.[15]

Arguments in favor of permitting executive bonuses include the contention that a bonus can be used to encourage executives who might otherwise leave a struggling company to remain on the job (so called "stay bonuses"), or that a bonus that is based on performance may give executives an incentive to achieve the performance metrics of the bonus—such as improving the performance of the company or completing the reorganization process in a timely fashion.

Arguments against bonuses include the concerns that they may simply be used to line the executives' pockets, and thus are squandering the company's money; or, relatedly, that major creditors may agree to them in exchange for debtors' managers willingness to pursue objectives desired by the creditors (such as a sale of the company's assets to the creditors). Bonuses can thus be a form of self-dealing.

Concerns that bonuses too often are a form of self-dealing by the executives are not new. In the last major set of revisions to the Bankruptcy Code, in 2005, Congress included provisions that were designed to restrict the use of bonuses. These revisions made it easier to challenge a prebankruptcy bonus as a fraudulent conveyance,[16] and they essentially prohibited "stay" bonuses during the bankruptcy case.[17] Reasonable minds can differ as to whether these reforms were an improvement, but my own view, the prohibition on stay bonuses was not. Debtors and their managers almost immediately began circumventing the prohibition on stay bonuses by dressing up their proposed bonuses as performance-based bonuses, which are not prohibited. The leading empirical study of bankruptcy bonuses found that the use of bonuses is more often challenged than in the past,[18] so defenders of the reforms can point to the chilling effect the prohibition had. But there is little or no evidence that the provision distinguishes between beneficial bonuses and pernicious ones.

---

voted in favor of the reorganization plan containing the releases. Douglas Baird, Anthony Casey, and Randal Picker, *The Bankruptcy Partition*, 166 U. PA. L. REV. 1675, 1686-90 (2018).

[15] I discuss this issue in more detail in a forthcoming article. David A. Skeel, Jr., *Taking Stock of Chapter 11*, SYRACUSE L. REV. (forthcoming, 2021).

[16] Under section 548(a)(1)(B)(IV), a bonus or other transfer to an insider can now be "avoided" if it is made without the company receiving reasonably equivalent value, regardless whether the company was insolvent at the time.

[17] 11 U.S.C. § 503(c) (2018). This provision does not explicitly prohibit stay bonuses, but it imposes conditions that essentially have this effect. A bonus would not be allowed, for instance, unless the debtor could show that the executive had a job offer in hand from another company.

[18] Jared Ellias, *Regulating Bankruptcy Bonuses*, 92 S. CAL. L. REV. 654, 664–65 (2019).

In my view, the risk of self-dealing is much more severe if the bonus is given prior to bankruptcy, as increasingly has been the case.[19] Arranging bonuses after the debtor files for bankruptcy ("post-petition") ensures more transparency, given the requirement of notice and a hearing as a prerequisite for approval.[20] Moreover, prebankruptcy bonuses can be used to help cement the control of inside lenders. Pre-bankruptcy bonuses should therefore be viewed with more skepticism than post-petition bonuses, not less.

These considerations seem to me to weigh against a blanket ban on executive bonuses before and during the bankruptcy case. Indeed, they suggest that the prohibition on stay bonuses should perhaps be removed, since it precludes even beneficial stay bonuses.

In my view, the task of determining whether bonuses should be permitted is best performed by a bankruptcy judge, exercising her discretion, rather than through legislative change. As in other contexts, judges can adopt appropriate rules of thumb to guide this decision, such as a presumption against ever permitting pre-bankruptcy bonuses and closer scrutiny of stay bonuses than true performance bonuses that are proposed after the debtor files for bankruptcy.

Conclusion

The issues I have discussed each create the possibility of abuse, but can be used in more beneficial ways. Some of the other issues that will be discussed have similar qualities. Given the complexity, it is especially important, in my view, to be mindful of the risk of unintended consequences if the Bankruptcy Code were amended.

---

[19] See, for example, Mike Spector & Jessica DiNapoli, *On eve of bankruptcy, U.S. firms shower execs with bonuses*, REUTERS (July 17, 2020, 7:05 A.M.) https://www.reuters.com/article/us-health-coronavirus-bankruptcy-bonuses/on-eve-of-bankruptcy-u-s-firms-shower-execs-with-bonuses-idUSKCN24I1EE.

[20] 11 U.S.C. § 363(b)(requiring court approval of transactions out of the ordinary course of business).