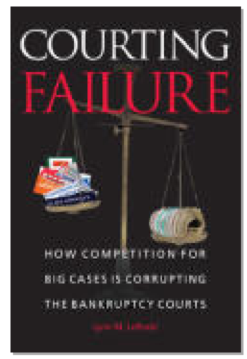
6. Corruption



Published by

LoPucki, Lynn.
Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts.
University of Michigan Press, 2023.
Project MUSE. https://muse.jhu.edu/book/7251.

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Corruption

My client was assured that court approval was
merely a rubber-stamp process.

—Attorney M. Blake Cleary, Young, Conaway, Stargatt & Taylor,
explaining to Delaware bankruptcy judge Mary Walrath why his client
had relied on a sale of assets not yet approved by the court

To understand how competition is corrupting the U.S. bankruptcy courts, begin by distinguishing court competition from mere forum shopping. Courts inevitably differ in ways that advantage one litigant over another. A court may interpret a law differently or favor a particular kind of litigant or case. One court may process cases faster than others or be geographically more convenient. For centuries, lawyers have maneuvered their cases into the courts most advantageous to themselves or their clients. Forum shopping can yield benefits to shoppers without courts changing what they are doing—or even realizing that the shopping is occurring.

By contrast, court competition is an active, deliberate response by the court to forum shopping. When courts compete, they change what they are doing to make themselves more attractive to forum shoppers. If more than one court competes, the process becomes reiterative. Court A offers to do X for shoppers; court B offers to do X plus Y. Court C—or court A—can then offer to do even more. The court that offers forum shoppers the most may be the only one that gets cases in the end, but all of the judges who compete are corrupted along the way. Their actions are "corrupt" in that they are dictated not by an attempt to apply the law to the facts of the case but by the need to remain competitive.

The beneficiaries of competition are the case placers—the debtor's executives, professionals, and DIP lenders. Because the case placers decide which court gets the case, they are the people to whom competing courts pitch their services. The interests of the case placers will sometimes be congruent with those of the company and sometime sharply at odds with them. For example, the case placers may want to minimize the company's problems in order to shift blame away from the company's current management. If the company emerges from bankruptcy and fails a few years later, the failure will appear to be that of a later management.

Serving the case placers usually requires serving the case placers' contractual allies. For example, if the case placers make a prepetition deal with an unsecured creditors' committee or prospective purchaser of the company, a competing court will require the case placers to honor it. The reason is that the case placers need binding deals with creditors' committees and purchasers to achieve the case placers' own goals. If the relevant court allowed case placers to dishonor such deals, case placers couldn't make them in the first place. If a particular court would not honor such a deal, the case placers, creditors' committees, and purchasers would avoid that court by including as part of the deal a commitment to take the deal to a court that will enforce it.

Defenders of court competition frequently seize on examples of courts enforcing such prepetition agreements as proof that the competing courts are serving the interests of both debtors and creditors. But this kind of protection is not available to those whose only relationship to the debtor is as a creditor. In the period immediately prior to bankruptcy, creditors lack sufficient leverage over the case placers to control the choice of a court. Even if a particular court disregarded the creditors' interests, similarly situated creditors in the next case could do nothing about it. The leverage that enables some creditors to benefit from court competition comes not from their status as creditors but from other sources such as their status as future lenders, suppliers, or purchasers.

To ally with the case placers often requires that the future lenders, suppliers, or purchasers offer benefits directly to the case placers. For example, a DIP lender that seeks the debtor's consent to a plan beneficial to itself may need to permit ineffective management to remain in place. A prospective purchaser of the company who seeks the case placer's support for the purchase may need to signal to the current managers that the purchaser will hire them as managers of the purchased company and give them stock in the purchased company. The court will be slow to interfere with such self-dealing because it needs the support of the case placers to maintain its flow of new cases.

Bankruptcy court competition brought quick, fundamental change to the bankruptcy system. Without policy debate or legislation, cases got faster, compensation for professionals and managers increased, and laws and procedures designed to protect small stakeholders were increasingly ignored. The movements in these directions have not been relentless. Sometimes they proceeded by fits and starts. Embarrassed by public criticism, courts sometimes took steps to rein in the most egregious of their practices. Some waver so much it is difficult to say whether they are even in the competition. But once a new practice that benefits case placers is introduced, competition assures its acceptance. The only way for the system to reject the new practice is for every court to reject it. If even a single court breaks ranks, that court tends to get the cases, and the practice becomes dominant.

The most damaging changes competition brought were these.

1. The courts lost control over professional fees.
2. Failed managers tightened their grips on their jobs and companies.
3. Corporate debtors had more difficulty recovering money taken by failed managers.
4. Failed managers began paying themselves huge retention bonuses.
5. The courts began rubber-stamping prepackaged plans.
6. So-called critical vendors began grabbing the shares of other unsecured creditors.
7. Managers began selling their companies at inadequate prices for personal benefit instead of reorganizing them.

In each of these respects, practices changed quickly throughout the United States. In each, the change occurred after 1990, the year in which Delaware initiated the competition. In none were the changes prompted by legislation, judicial decision, or policy debate. In all, the direction of change favored the case placers. The remainder of this chapter explains why each of these seven changes is corruption rather than mere evolution.

Professional Fee Practices

Competition ordinarily holds prices down. Customers seek the supplier who will charge the lowest price for a given level of quality. To attract customers, suppliers compete by lowering the prices their customers must pay. Bankruptcy court competition works precisely the opposite way. To attract companies needing reorganization, courts compete by raising the amounts of the professional fees the courts will approve, thus raising the client-companies' costs for reorganization.

Three factors contribute to make this upside-down competition work. Most important, the professionals themselves usually dominate the company's choice of a bankruptcy court. When they choose among the bankruptcy courts, all most executives know about those courts is what their lawyers and investment bankers have told them. That means lawyers can steer clients away from courts that won't approve high fees toward courts that will. Second, total professional fees are small in relation to the amounts of money at risk—about 1 to 2 percent of the debtor's total assets.[1] A bad result in reorganization can cost 20 to 40 percent of the debtor's total assets.[2] Third, the top executives who hire bankruptcy professionals are spending other people's money. The executives' primary concern may not be how their companies will fare in bankruptcy but how they themselves will. Overcompensating the company's lawyers may engender a feeling of obligation on the part of the lawyers to the executives themselves, and so the executives are happy to do it.

This competitive inversion may at first seem both bizarre and unfamiliar. But the inversion is closely analogous to a common kind of corruption—the bribing of corporate purchasing agents. Just as a supplier of hammers or toilet seats might bribe a customer's purchasing agent to buy at the supplier's high price instead of at a competitor's lower price, so the competing bankruptcy courts offer high fees to bribe the lawyers to bring them cases.

Numerous bankruptcy lawyers have assured me in interviews that they do not let their own fee considerations determine what bankruptcy court they recommend. But many of the very same lawyers acknowledge that courts that don't pay the "going rates" don't get cases. Other lawyers make no attempt to hide the relationship between their own fees and the courts they recommend. In a recent *National Law Journal* interview, for example, leading bankruptcy lawyer Stephen H. Case of New York's Davis Polk & Wardwell "readily admitted steering his clients to venues that will pay his going rate, but added that he explains to clients that his partners will not allow him to work for less."[3]

The evidence that fee practices affect the placement of cases is overwhelming. In our study of forum shopping by large companies in the 1980s, Bill Whitford and I conducted more than 120 interviews with lawyers involved in the cases. On the basis of those interviews, we concluded that other courts' reluctance to approve fees at New York rates was a principal reason for the forum shopping to New York.[4] In 2001, Professor Marcus Cole—an ardent defender of Delaware and court competition—interviewed 30 lawyers regarding the reasons for forum shopping. A majority acknowledged that fees influenced the forum shopping decision and that the direction of influence was to move cases toward the courts paying higher rather than lower fees.[5] The Conference on Large Chapter 11 Cases convened by the Judicial Conference's Venue Subcommittee discussed the "appointment and payment of attorneys and professionals" as one of seven "possible venue drivers."[6]

Most important, the judges themselves understand the role that fees play in the decision to file. When judges throughout the country sought to mollify their local lawyers about the Delaware threat, they almost invariably mentioned their own fee practices. In introducing the new complex court rules intended to make Houston competitive with Delaware, Houston bankruptcy judge William R.

Greendyke reassured the gathered lawyers that "the war on fees is over."[7] In explaining how she countered the "misperceptions" that sent Chicago cases to Delaware, Chicago chief bankruptcy judge Susan Pierson Sonderby told the *Wall Street Journal* that "she began spreading the word to attorneys that if they showed they deserved their pay . . . the [Chicago] judges would accept their fees."[8] In an article published in the local bankruptcy bar newsletter explaining why he would *not* change Miami court practices in an effort to compete with Delaware, Chief Judge Robert A. Mark paused to reassure the lawyers that "I will not suffer from 'sticker shock' when I see large numbers in fee applications or when I am presented with applications to retain consultants or investment bankers which provide for large retainers and non-hourly based fee arrangements."[9] In the wave of local rule changes prompted by lawyer concerns about the loss of cases to Delaware, the New York,[10] Los Angeles,[11] Chicago,[12] Dallas,[13] and Maryland[14] courts all copied the Delaware practice of paying fees at 30-day intervals instead of the 120-day intervals that had been standard practice for a decade. And when the panel of lawyers and judges that would discuss "issues that affect Chapter 11 forum choice" at the National Conference of Bankruptcy Judges' 2003 Annual Meeting settled on the five issues most worthy of discussion, "[professional] retention and compensation orders" appeared second on the list.[15]

From early on, bankruptcy judges took essentially two approaches to controlling fees. One was to review fee applications to determine whether each of the charges was "reasonable and necessary." As discussed in chapter 1, that approach is hopeless. No mechanisms exist by which judges can evaluate each of the thousands of charges that may comprise a single application. The other approach was to impose bright-line limits on the lawyers' hourly billing rates—referred to as "fee caps"—and control the aggregate number of hours based on the judge's sense of the case. For example, a judge might announce that he rarely approved fees in excess of $300 an hour. This method was somewhat arbitrary, but it was sufficiently effective that lawyers avoided the courts using it.

As the competition heated up, the fee caps came off. Judge after judge announced that he or she had seen the error of fee caps and would cease to impose them. Courts continued to go through the motions of fee control, sometimes even appointing fee examiners or fee committees. But the bottom line is that the courts are approving nearly all of the fees for which the professionals apply. In a study of professional fees awarded in 48 large public company bankruptcies concluded from 1998 to June 2002, Joseph Doherty and I found that the judges approved almost 98 percent of the amounts for which the professionals applied. The Delaware court approved more than 99 percent.[16] The bankruptcy courts are operating virtually on an honor system. In a new study just completed as this book went to press, Joseph Doherty and I found that professional fees in large public company bankruptices increased by 47 percent from 1998 to 2003.

Helping Failed Managers Keep Their Jobs

In most of the world's bankruptcy systems, a creditor representative takes control of the debtor company upon the filing of a case. In the United States, the debtor's management ordinarily retains control. That the system should operate this way is somewhat surprising. Experts are in near-universal agreement that bad management is the leading cause of business bankruptcy. In many cases, leaving debtor's management in control means leaving the very people who caused the debtor's failure in control. The United States' "debtor-in-possession" system exists nevertheless because bankruptcy lawyers convinced Congress that if managers lost their jobs too frequently or too easily in bankruptcy, managers would not bring their companies into bankruptcy until it was too late to save them.

U.S. bankruptcy law gives the judge the power to appoint a creditor representative—a trustee—to take control of the debtor company in cases of gross mismanagement, fraud, or similar cause. Even before the onset of court competition, that power was exercised only in extreme cases.[17]

Despite the rarity of trustees, Whitford and I found that the bankruptcy system of the 1980s dealt surprisingly well with the management problem. Through a combination of pressures from creditors, stockholders, suppliers, and others, prepetition managers were almost invariably ousted from control by the end of the reorganization case. In our study of the 43 largest reorganizations of the early part of that decade, we identified the CEO in office at the time the company's financial problems came to light (the "tainted" CEO). In only two of those reorganizations (5 percent) did the tainted CEO manage to remain in office through confirmation of the plan.[18] (Interestingly, the two cases in which tainted CEOs survived in office were in Delaware and New York. In the rest of the country, every tainted CEO was swept from office.) In some cases, the CEOs resigned, in some they were forced from office by the board or the creditors, in some the company failed, and in some the CEOs negotiated their exit. But one way or another, the problem was solved. Other research on management turnover in bankruptcy during that era made similar findings.[19]

In the 1990s—the era of court competition—the dynamic was different. Studying the 98 companies that emerged from reorganization from 1991 to 1996, Doherty and I found that tainted CEOs—and CEOs in general—were significantly more likely to remain in office through the bankruptcy case than were managers in the 1980s.[20] Other researchers have recently made similar findings. The trend for bankrupt companies was particularly surprising because it was the opposite of that for large public companies generally. From the 1980s to the 1990s, the jobs of top managers of big companies grew less secure in the economy as a whole,[21]—the same period in which the jobs of top managers of big bankrupt companies grew more secure.

A study of cases in the early 1980s found that management turnover was significantly higher in companies reorganizing in bankruptcy than in similarly distressed companies reorganizing outside bankruptcy.[22] The bankruptcy process was removing failed managers who otherwise would have remained in place. By 2001, the bankruptcy process was no longer doing so. Turnover was no higher in companies reorganizing in bankruptcy than in companies reorganizing outside bankruptcy.[23]

The inability to force out bad managers in the era of court competition was actually hurting the companies. Examining data from cases in the 1990s, Doherty and I found that when a member of the prepetition management team remained as CEO through the crucial stages of the bankruptcy case, the company was more likely to fail in the five years after it emerged. Although the statistical relationship was weak, firms that "cleaned house" by hiring a new CEO from outside the company before proposing their plan of reorganization were more likely to succeed.[24]

Helping Corporate Thieves Keep the Money

In 2001, a corporate scandal of unprecedented magnitude struck the American economy. It began with the collapse of Enron in late 2001. Within eight months, three other corrupt corporate giants had followed Enron into bankruptcy: Worldcom, Global Crossing, and Adelphia. Each had the same problem: fraudulent managers who had cooked the books and looted the companies.

The bankruptcy remedy for corporate fraud is the appointment of a trustee to replace the suspect management. Bankruptcy Code § 1104 provides that "the court *shall* order the appointment of a trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case" (emphasis added). That language certainly seemed to apply to these four cases. But the New York bankruptcy court—which got all four cases—appointed a trustee in none of them.

Appointment of a trustee is a drastic remedy. A trustee replaces the board of directors as the corporation's ultimate decision maker. Typically, the trustee will retain some members of former management for those members' company-specific knowledge, but it is the trustee who is in charge. Bankruptcy courts have always been reluctant to appoint trustees in situations where the business will continue to operate. But before the era of court competition, operating trustees were appointed in circumstances less extreme than these four cases.[25]

These four cases were among the biggest, boldest frauds in history. The *Wall Street Journal* reported that the shredding of documents in the Enron case continued even after the shredding had been exposed in the national media and the bankruptcy case had been filed.[26] If the appointment of a trustee for fraud and gross mismanagement was not warranted in these cases, it would never be warranted. In the introduction I discussed how New York bankruptcy judge Arthur J. Gonzalez avoided appointing a trustee in the Enron case. What remains to be told is how that failure to appoint a trustee altered the dynamics of the Enron case.

Except for a six-month period in which Jeffrey Skilling was CEO, Kenneth Lay was the CEO and chairman of the board of directors of Enron from the founding of the company until he resigned under public pressure on January 23, 2002. Lay's successor was bankruptcy turnaround manager Stephen F. Cooper. Cooper was a respected outsider, and his hiring was regarded as a transparent effort on the part of Enron's board and creditors' committee to avoid the appointment of a trustee.[27] That effort succeeded.

On January 24—the day after Lay's resignation—the *Wall Street Journal* had the Cooper story by press time.[28] Considering that Enron's management must have arranged Cooper's candidacy and vetted him before setting the appointment with the board reported in the *Journal,* it is a reasonable inference that Ken Lay at least participated in choosing Cooper.

The creditors who sought the appointment of a trustee asked Cooper if he would accept the role of a neutral trustee, along with the responsibility to investigate the fraud. He refused. On the day his appointment was announced, Cooper said that he planned to "spend little to zero of my time" on what happened in the past at Enron. "It's literally of no interest to me."[29] In other words, he wasn't going after Ken Lay or the other members of Enron's deposed management who together had taken hundreds of millions from the company in its last two years and left it mortally wounded.

Nor was the board. The 17 directors in office before the Enron scandal broke in 2001 were Ken Lay's friends and cronies. Like

Lay, the directors had participated in the board meetings at which the transactions with offshore entities that would later lead to indictments had been approved. According to the Senate Permanent Subcommittee on Investigations, the directors had "witnessed numerous indications of questionable practices by Enron management over several years, but chose to ignore them" "knowingly allowed Enron to engage in high risk accounting practices," "exercised inadequate oversight," "knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was," and "failed to halt [compensation] abuse by Kenneth Lay."[30]

Because the court had not appointed a trustee, the board remained in control of Enron—and Cooper. Board members who had approved the offshore transactions in 1999 and 2000 and a $60 million golden parachute for Ken Lay in 2001—and were found by the congressional subcommittee to have knowingly engaged in substantial wrongdoing—remained a substantial majority on the board until Cooper proposed and won acceptance of his plan to liquidate Enron.[31] Then Lay's appointees elected their own successors, who, not surprisingly, didn't go after their benefactors either.[32]

Hiring Cooper under these conditions split Enron's obligation to pursue its fraudulent managers three ways. Cooper and the board controlled Enron, its employees, attorneys, and store of documents. The court appointed an examiner to investigate the fraud but gave the examiner no authority to sue anyone. The court authorized the creditors' committee to bring suits on a case-by-case basis. The effect of this three-way division of authority was to bureaucratize and ultimately cripple the effort to hold Enron's corrupt executives civilly and criminally accountable.

In addition to the awkward triumvirate, criminal prosecutors, the Securities and Exchange Commission, and class action plaintiffs' lawyers were also after Enron's fallen executives. But each worked under limitations that prevented them from being as effective as an Enron trustee might have been.

Prosecutors have little power to require defendants to give them information, yet they must be ready to prove their case beyond a reasonable doubt before they file it. Ken Lay was not indicted until three years after the scandal broke.

Shareholders could and did file class actions to recover their losses from the officers and directors legally responsible. But shareholder class actions are a cumbersome and disfavored means of proceeding against corrupt executives[33] and often end in small settlements principally benefiting the lawyers. The federal Multi-District Litigation Panel moved the Enron shareholder fraud actions to the U.S. district court in Houston, where, years after the initial filing, the numerous parties were still squabbling over how they would organize their investigation.[34] In the meantime, the Enron examiner was seeking authority to destroy some of the documents the class action lawyers were seeking because the examiner had promised confidentiality to the sources.[35] Ironically, some of the consolidated cases were "derivative,"[36] meaning that the plaintiffs were suing in the name of Enron because Enron refused to bring the case.[37] That meant the shareholder faced every barrier to recovery Enron faced and, in addition, the barriers Congress had placed in the way of derivative actions.

The recently defanged Securities and Exchange Commission took no action against Lay or Skilling. That left only the conflicted creditors' committee to pursue the cases against Enron's crooked executives. Had the New York bankruptcy court instead treated Enron as the fraud case it was and appointed a trustee, the trustee probably would have concluded that at least five matters required immediate attention.

1. *The unauthorized repurchase case against Kenneth and Linda Lay*. In the year prior to bankruptcy, Kenneth and Linda Lay sold about $74 million of Enron stock to Enron. The Enron examiner concluded that these sales are "voidable at the election of Enron. Upon such event . . . Enron would return to Lay 2,131,282 shares of Enron common stock, and Lay would be liable to repay loans in the amount of $94,267,163."[38] A trustee would have elected to avoid those transactions, but Enron's management did not. That

forced the unsecured creditors' committee to sue on a fraudulent transfer theory,[39] which may be considerably more difficult to win.

2. *The mismanagement case against Kenneth Lay and Jeffrey Skilling.* The Enron examiner found that

> Acting in their capacities as directors, Lay, Skilling and the Outside Directors authorized Enron to enter into the Rhythms hedge and three of the Raptors hedges, none of which had a rational business purpose. . . . There is evidence that Lay, Skilling and the Outside Directors were aware of facts demonstrating this lack of rational business purpose. . . .
>
> Both Lay and Skilling failed to respond to indications of potential problems related to the use of SPE transactions. In addition, Skilling failed to respond to red flags regarding the SPE transactions that Enron entered into with LJM1 and LJM2. By failing to respond to such red flags, Lay and Skilling were at least negligent and, therefore, breached their fiduciary duties as officers.[40]

The SPE (special purpose entity) transactions were entered into to conceal Enron's true financial condition from investors. They injured Enron by postponing reorganization efforts until those efforts were too late.[41] That meant Enron had the right to recover its damages from Lay and Skilling. A trustee would certainly have sued. Neither Enron nor its creditors' committee has done so.

3. *The house builders.* As the possibility Enron would sue its corrupt executives loomed, three of the prime suspects—Jeffrey Skilling, Andrew Fastow, and Michael Kopper—began building new homes in River Oaks, "the neighborhood where the rich live."[42] What the executives were doing was stashing the loot in a place from which even judgment creditors couldn't get it back. Each of the houses cost millions of dollars. Under Texas law, if the executives completed their homes and moved into them, the homes would be "homesteads" and exempt from the claims of their creditors—including Enron. Because the mansions were exempt, the executives would be entitled to keep them even if creditors could prove that the executives sank their money into the mansions for

the purpose of defrauding the creditors.[43] The only way to stop the executives would have been for Enron to make its claim against the three and persuade a court to enter an injunction against the making of the fraudulent transfer. Even though television news programs repeatedly showed the progress of construction on those mansions, Enron didn't even try. At about the same time, Scott Sullivan, the CFO of Worldcom, who had been charged with securities fraud for cooking Worldcom's books, was building a $22 million mansion in Florida. Florida is probably the only other state besides Texas where the law permits a debtor to fraudulently invest ill-gotten gains in a homestead to beat his or her creditors.[44] Worldcom's management, which, like Enron's, was operating under the protection of the New York bankruptcy court without a trustee, also took no action.

4. *The eve-of-bankruptcy bonus case.* About a month before bankruptcy, Enron paid $53 million in deferred compensation to executives.[45] The examiner eventually concluded that these payments were likely avoidable as preferences.[46] Then, less than a week before bankruptcy, Enron paid bonuses totaling $73 million to about 500 key executives, traders, and other employees. Eventually, the Enron employee committee sued to recover the deferred compensation payments, and the Enron creditors' committee sued to recover 292 of the bonuses.[47] The belated lawsuits were predictably ineffectual in recovering the money. Bonus recipients still working for Enron paid back most of the money they owed,[48] but predictably, those no longer working for Enron did not. Recipients who had been allowed to keep the money for a year or two had adjusted their personal finances accordingly, and Enron no longer had the leverage that came from being their employer. As of December 2003, only about $7 million had been recovered for the estate from recipients no longer employed by Enron.[49]

Had the court appointed a trustee in the early days of the bankruptcy case, the demand for return of the illegal payments would have been made before the recipients had met the condition that they remain in Enron's employ for 90 days.[50] Employees who quit instead of repaying would have breached the condition, making their liability for return of the money clear. Much more of the money would have been recovered.

5. *The case against the banks for their participation in the SPE transactions.* The examiner found there was sufficient evidence to proceed against Citigroup/Citibank and JP Morgan Chase & Co.[51] The two banks were, however, prominent members of the committee that was supposed to sue them—the creditors' committee. In September 2003—nearly two years after Enron filed bankruptcy—Enron itself finally brought the action.

Enron and the other parties who wished to sue on Enron's behalf had only two years in which to file their cases or be barred by the statute of limitations.[52] Because the case was handled so awkwardly, nearly six months had passed before the examiner was even appointed.[53] The effect was to rush the investigation.[54] The examiner worked quickly but was still completing his report when the deadline expired. That left parties who discovered their causes of action through the examiner's work little or no time in which to digest the 4,500-page report, retain counsel, and prepare their lawsuits for filing.[55] Cases and issues may have been lost in the shuffle. The appointment of a trustee would have avoided the awkward sharing and sequencing of the investigation and litigation, but court competition had precluded that solution.

Retention Bonuses

Bankruptcy courts commonly review the compensation of incumbent managers for reasonableness. During the 1980s, the issue was usually whether the managers' compensation should be cut. The idea that a bankrupt company should pay its failed managers a bonus to stay with the company had not yet occurred to anyone. After all, those managers had no place else to go. In a study of managers who departed from bankrupt New York Stock Exchange– or American Stock Exchange–listed companies from 1979 to 1984, Professor Stuart Gilson of the Harvard Business School found that none landed another job as the top executive of a New York Stock Exchange– or American Stock Exchange–listed company.[56] Gilson concluded that "top managers leave the labor market in large numbers following their departure from financially-distressed firms."[57]

In the 1980s employers often paid "retention bonuses" to types of employees who were in short supply, such as nurses or pilots. They also paid retention bonuses to employees whose jobs would be terminated at some fixed date in the future—the date of a plant closing or merger—but whose services were needed in the meantime. The bonuses were typically a few thousand dollars per employee.

Beginning in the 1990s some companies also paid retention bonuses to managers working on short-term assignments. For example, a company that sold its entire business might offer a retention bonus to its top managers to keep working until the sale closed. Or a company in financial distress might fire its managers, hire new ones to turn the company around, and pay the new ones retention bonuses to stay with the company until the turnaround was complete.

As executive compensation skyrocketed in the 1990s, the retention bonus idea was quickly put to abuse. Entrenched managers who had caused the downfall of their companies decided that not only should their companies retain them, the companies should pay them "retention bonuses" to stay. Sometimes those managers had sufficient power within their companies to win board approval.

That left the bankruptcy courts as the last line of defense. But bankruptcy courts that were competing for cases were not up to the task—even in cases where the managers had already failed in the jobs they held and had no employment prospects elsewhere. The Kmart case illustrates the nature and extent of the problem.

Kmart hired Charles C. Conaway as CEO in May 2000. Conaway agreed to a salary of $1.4 million a year, an annual bonus of $1.75 million, other benefits worth an additional $447,000, and a onetime signing bonus of $6.3 million.[58] It was a lot of money, but to Charles Conaway's mind, it must not have been enough. Over his 22 months at Kmart, Conaway renegotiated his contract three times, extracting about $26 million in total personal compensation. Some was in the form of retention bonuses and loans.

The extra money was not to reward successful performance. A few months after Kmart hired Conaway, Kmart reported its first quarterly loss. From there, Kmart's performance grew progressively worse. By the end of 2000, Kmart's losses for the year totaled $268 million. The following year, 2001, Kmart lost $2.4 billion. The Conaway team covered up a portion of the 2001 loss by booking $420 million in phantom revenues in the first half of that year.

In December 2001, Conaway persuaded Kmart's board to make $28.5 million in "retention loans" to 22 top executives (Conaway not included). If the managers stayed with the company, the company would later forgive the loans without repayment. The purpose was to induce Kmart's top managers to remain with the firm through its bankruptcy reorganization. The problem with that rationale was that Kmart's top managers were not turnaround experts brought in to clean up someone else's mess. They were the people who made the mess. Kmart would eventually come to its senses and sue to get the money back.[59] But by then it would be too late.

On January 22, 2002, less than two months after making the retention loans, Michigan-based Kmart filed for bankruptcy in Chicago. In early March, Kmart's board forced Conaway out of office. Instead of suing him for the mismanagement that landed Kmart in bankruptcy, the board—under the leadership of its new chairman, James B. Adamson—approved a $4.5 million severance package for Conaway and proposed to forgive a $5 million retention loan Conaway had received as part of his May 2001 renegotiation. As is usual in such transactions, Kmart sought the approval of the bankruptcy court. The Conaway-Adamson grab put Chief Bankruptcy Judge Susan Pierson Sonderby in a difficult position. In an article published later that same year, the *Wall Street Journal* described Sonderby as having led "a decade-long mission to keep major cases in her city."[60] Conaway had helped make that mission a success by bringing one of the largest debtors in history to Sonderby's court. (With a workforce of 225,000, Kmart had more employees than any company that had ever filed bankruptcy anywhere.) Approval of the severance pay and loan forgiveness would be the first and last thing Conaway would seek from Sonderby in return. In the eyes of future CEOs in search of an accommodating bankruptcy court, Sonderby's ruling on Conaway's pay would be the measure of how the Chicago court responded to CEOs who brought the court cases. Yet Sonderby's signature on an order giving $9.5 million to the fired executive who led the company into bankruptcy would have been embarrassing. Sonderby finessed the issue by announcing orally in court that the payments did not require her approval.[61] Conaway got the $4.5 million and didn't have to repay the $5 million he had borrowed.

Within two months after Kmart filed bankruptcy, 16 of the 22 executives that received the $28.5 million to stay had left—taking Kmart's money with them. Kmart demanded the money back, but only three of the executives paid.[62] If the retention loans had not been a fraud, they had at least been a monumental stupidity.

To replace Conaway as CEO, the board chose one of the architects of the retention loan program, the Kmart board's own chairman, James B. Adamson. The board touted Adamson as an experienced turnaround manager. The record didn't support it.

Adamson had been successful at Burger King in the early 1990s. He rose to CEO in just two years and held that position for two more years. In 1995, Adamson left Burger King to take the top job at Denny's, which he held for six years. At Denny's however, Adamson clearly failed. Two-and-a-half years after Adamson took over, the company filed bankruptcy. Denny's discharged $1 billion in debt, but even that wasn't enough to turn the company around. Denny's unbroken string of annual losses continued for the rest of Adamson's tenure in office. In January 2001, at the age of 54, Adamson "retired"—a corporate euphemism for unemployment. But in April 2002, the Kmart board—headed by Adamson—chose Adamson as Kmart's new CEO. A month later, a major portion of Denny's that Adamson had supposedly "turned around"—the Carrows and Coco's restaurants—slipped quietly back into bankruptcy. In 2004, Denny's—which had never recovered from the Adamson era—itself appeared close to refiling.[63]

Adamson had landed his spot on the Kmart board in 1996, on the heels of his success at Burger King. When he lost his job at Denny's, he stayed on the Kmart board, rising to chairman under Conaway. When Adamson became chairman of Kmart's board—four days before the company filed bankruptcy—Kmart set his director's fee at $1 million per year.[64] That was about seven times what successful companies of Kmart's size paid directors annually.[65] In addition, Adamson was paid an "inducement fee" of $2.5 million and promised a $4 million bonus if Kmart emerged from bankruptcy by July 31, 2003. Kmart also agreed to pay Adamson's taxes on all these amounts. Last, to assure that Adamson would get his money even if Kmart failed, Kmart established a $10 million bank letter of credit in Adamson's favor.[66] Even by the lax standards of corporate America, it was an astonishing grab. And it was just the prelude.

Two months later, with Kmart in bankruptcy, Adamson took over as CEO. His new compensation contract in that position provided for a salary of $1.5 million a year and an annual bonus of $1.9 million.[67] It specifically provided that he could keep the $2.5 million inducement fee he had just received for becoming chairman and promised him an additional $5.9 million on termination of his employment—even if he was fired.[68] Adamson's contract also provided for continuation of what the company called "certain reasonable travel and housing benefits as were originally provided under his contract as Chairman of the Board." *Fortune Magazine* described those benefits as "weekly private plane service between his residences in Detroit, New York, and Florida, a car and driver in Michigan and New York, and temporary accommodations at the swanky Townsend Hotel near Kmart headquarters. A standard room there costs $320 a night."[69] The deal was expressly subject to court approval.[70]

One of Adamson's first moves as CEO was to seek court approval of another retention bonus plan. On April 23, 2002, Judge Sonderby approved the first three tiers of Kmart's Corporate Annual Performance Plan—the tiers that gave money to 45 top executives. That day, she decided that Kmart's compensation contract with Adamson did not require her approval. The contract was binding without it.[71] Nine months later, with Kmart still mired in bankruptcy, Kmart's board fired Adamson and paid him $3.6 million in settlement.[72] The last five remaining executives who had shared in the December 2001 retention loans Adamson had approved left along with him.

In the early 1990s, retention bonuses for top managers were rare. The numbers increased in the late 1990s and then exploded in 2001. Late that year, the *Wall Street Journal* cited pay-to-stay bonuses in Chapter 11 cases as "an increasingly popular trend" and highlighted four cases in which such bonuses doubled or tripled CEOs' pay during Chapter 11.[73] Some of the retention bonuses were necessary to induce managers from outside the company to accept jobs and stick with them through the bankruptcy. But others were paid to managers who were responsible for the company's problems and had no other job prospects. The competing bankruptcy courts approved them all. (The Salt Lake City bankruptcy court initially rejected a retention plan proposed by Geneva Steel but approved the company's second try.)[74]

Apologists for the companies and the courts defended retention bonuses with the argument that the companies needed continuity and institutional memory in a time when organizational instability was already high. But the data indicated otherwise. Companies that brought in a new management team for the reorganization fared better than those that did not. A court not hobbled by its own need to attract cases could simply order the former managers to furnish information the new managers needed.[75]

Locked in competition for big cases, the bankruptcy courts were in no position to resist firms' requests for authority to pay retention bonuses. The same executives who sought the bonuses brought the cases. The bonuses would be one of the first issues on each court's agenda when a case was filed. Bankruptcy judges could not fail to realize that if they interfered with the top executives' retention bonuses, future CEOs would take their business elsewhere.

Rubber-Stamping Prepackaged Cases

Generally speaking, a bankruptcy reorganization case consists of three steps. First, the debtor discloses its financial condition, future prospects, and reorganization plan to its creditors and stockholders. Second, the creditors and stockholders vote on the plan. Third, if the court is satisfied that the plan has been properly proposed and accepted, the court confirms it. Confirmation makes the plan binding on the debtor and all of its creditors and shareholders—including those who voted against it or did not vote at all. Ordinarily, all these events occur while the debtor is in bankruptcy, a period that averages about one year.

The same three steps occur in a prepackaged bankruptcy case. The difference is that the first two steps—plan proposal and voting—occur before the debtor files the bankruptcy case. The debtor arrives in court with a "package" of plan, disclosure statement, and cast ballots already in hand. The purpose of the bankruptcy filing is to impose the plan on the creditors and shareholders who did not vote for it. The confirmation order does that.

In each case, the court enters two key orders. The first is an order approving the debtor's disclosure statement as providing adequate information for voting on the plan. The second is the confirmation order. The Bankruptcy Code requires that the debtor give a minimum of 25 days notice to creditors of the hearing on each of these two matters. In designing the procedure, the drafters of the Bankruptcy Code assumed that the court would enter an order approving the disclosure statement before the court set a hearing on confirmation of the plan. Under that assumption, a prepackaged case would take a minimum of about 60 days from filing to confirmation.

Shortly after the Bankruptcy Code became effective in 1979, Palo Alto attorney Lincoln A. Brooks realized that the two 25-day notice periods could run simultaneously. That is, the court could hold both hearings on the same day without necessarily violating any provision of the code. Based on this realization Brooks began doing some prepackaged bankruptcies for small and midsized companies in about 30 days.

Despite the fact that language of the code permitted these 30-day prepacks, the reorganization process did not fit comfortably into that period. When a debtor files bankruptcy, the United States Trustee appoints an official creditors' committee to represent the creditors as a group. The members of that committee have fiduciary duties to act in the creditors' interests.[76] The committee can hire professionals to represent it and charge their fees to the debtor. The committee is the eyes, ears, and voice of the unsecured creditors. But the time required for the United States Trustee to appoint the creditors' committee, the committee to organize and select professionals to represent it, and the professionals to familiarize themselves with the case alone is about 30 days. A 30-day prepackaged case may be over by the time a committee is ready to participate.

That is not the only problem with trying to squeeze a bankruptcy reorganization into 30 days. The rules require the debtor to file schedules of debts and assets and a statement of the company's financial affairs within 15 days after the filing of the case. The courts are permitted to extend that period and do so in large cases. Thus, in a 30-day prepackaged case, the debtor will furnish these documents when it is already too late for them to be of much use. The Bankruptcy Code also requires that the debtor appear at a meeting of creditors held 20 to 40 days after the filing of the petition and submit to examination under oath. In a 30-day prepack, the meeting would occur only a few days before the confirmation hearing—or even after it. Either way, the meeting could not serve its purpose of enabling the representatives of creditors and shareholders to prepare for participation in the case. The bankruptcy reorganization process simply can't work in 30-day cases.

Only a single large public company filed a prepackaged case before 1990. For tax reasons, Crystal Oil was rushing to complete its reorganization in 1986. Despite its hurry, Crystal Oil proceeded traditionally, obtaining approval of the disclosure statement before seeking confirmation of the plan.

The first attempt to combine the hearings on disclosure and confirmation in a big prepackaged case occurred in Dallas, Texas, at the end of 1990. Judge Harold Abramson set the disclosure and confirmation hearings for Southland Corporation (now 7-Eleven Stores) for December 14, 1990, 50 days after the filing of the case.[77] The United States Trustee appointed the prebankruptcy bondholder's committee as the official creditors' committee over the objection of creditors who opposed the plan. The dissidents formed their own, unofficial committee and objected to confirmation. (Their "unofficial" status meant that they were paying their own attorneys' fees while the debtor was paying the fees of their opponents.) The grounds for their objections were that the disclosure statement was confusing, the creditors were given only eight days in which to vote, errors were made in the tabulation of the votes, and the tabulation of votes ignored the numbers of bondholders whose bonds were held in the names of trustee banks, counting only a single vote by the bank.[78] Judge Abramson agreed with the objectors and ordered that a new vote be held. Before the new vote was held, the parties settled on a plan that gave more value to the dissidents.

Judge Abramson confirmed the amended plan on February 21, 1991, just 120 days after the case was filed. Although the case took longer than expected, Southland's reorganization was a success for the company. Southland was profitable immediately after confirmation. Thirteen years later, the firm has changed its name to 7-Eleven and continues to thrive.

In the view of Southland's case placers, however, Judge Abramson had shown himself to be "unpredictable" by failing to confirm the plan presented to him. Abramson was tagged as a toxic judge. Sixty big public companies have filed prepacks since Southland, including three companies headquartered in Dallas. None have chosen the Dallas bankruptcy court.

JPS Textile's prepackaged case, filed in New York in February 1991, was the mirror image of Southland. JPS Textile's case went smoothly, and the court confirmed JPS's plan in just 42 days. For the company, disaster ensued. After it emerged from bankruptcy, JPS Textile's operations lost money for five years in a row. The company fell back into bankruptcy in 1997. But by confirming the plan without incident on the debtor's schedule, the New York bankruptcy court had proven itself trustworthy. Five of the 59 big public companies that have filed prepacks since JPS Textile have filed them in New York. Four of the five were—like JPS—forum shops by companies based elsewhere. Together, the two cases illustrate the incentives competition provides for bankruptcy courts to serve the case placers' interests—even when those interests are squarely in conflict with the interests of the debtor and its creditors and shareholders.

Delaware, with a prepack refiling rate even higher than that of New York, is the most popular venue for prepackaged cases. The reasons are subtle. Prepacks do not go to Delaware because other courts refuse to confirm them. Every large public company prepack filed in any U.S. bankruptcy court since prepacks were authorized by law in 1979 has been confirmed. Nor do they go there for speed. The median time to confirmation for prepacks in Delaware is 44 days—exactly the median time for prepacks in other courts (i.e., all courts other than Delaware and New York) and shorter than the 59.5-day median time in New York. Even excluding Delaware's Glenoit prepack, which fell apart and lasted 773 days, the average time to confirmation in a prepack is only two days shorter in Delaware than in other courts. Nor does the Delaware bankruptcy court exercise any great skill or sophistication. The court does little except sign the orders approving the disclosure statement and confirming the plan. The difference must be that—despite the statistics—the case placers put greater trust in the Delaware court.

In the earliest prepacks, the parties sought to comply with the procedural requirements of bankruptcy law. They hurried the filing of documents, the organization of committees, and the holding of meetings of creditors. But in a system where the courts always approved the plan anyway, the hurried compliance did little or nothing for creditors and shareholders. Little by little, in the early 1990s the parties and the competing courts stopped trying to comply with the law. United States Trustees began reporting that they

TABLE 10. Delaware Dominates the 30-Day Prepack

	Delaware	Days	New York	Days	Other Courts	Days
1986					Crystal Oil	91
1990					Southland	120
1991			JPS Textile	42	Trump Taj Mahal	43
					Edgell	31
1992	SPI Holding	42	West Point	87	Hadson	46
	Charter Medical	36			Gaylord Container	35
	Memorex Telex	32			Trump Plaza	52
					Mayflower Group	45
					Trump's Castle	57
1993	USG Corp.	37	Petrolane	35	Great American	32
	Restaurant Enterprises	45			Live Entertainment	43
	Cherokee	39			Calton	58
	Thermadyne	47			Ladish	46
1994	Kash N' Karry	33				
	Memorex Telex	31				
	Resorts International	32				
	Westmoreland Coal	38				
1995					Americold	41
					TWA	35
					Mortgage & Realty	35
1996	Heilman Brewing	84				
	Morrison Knudsen	62				
	Bibb Co.	71				
	Ithaca Industries	45				
1997	Koll Real Estate	36	JPS Textile Group	39		
	Consolidated Hydro	38				
1998	CAI Wireless	62			Grand Union	42
	Farm Fresh	44				
1999	Goss Graphics	83				
	Trism	84				
	Wilshire Financial	40				
	Zenith Electronics	74				
2000	Pathmark Stores	57				
	Tokheim	37				
	DecisionOne	36				
	Glenoit	773				
2001						
2002	Globix	39	APW Ltd.	77	Orius	59
	Leiner Health	46	ViaSystems	105		
2003	Aurora Foods, Inc.	71				
	Redback Networks	49				
	Neenah Foundry	51				
	Chart Industries	58				
2004	Tower Records	36				

Source: Data from Lynn M. LoPucki's Bankruptcy Research Database.
Note: Cases are listed in year of filing.

were "unable to form committees" even though unofficial committees (whose fees were being paid by the big bondholders) filed appearances in many of the cases. Courts began excusing the filing of schedules and statements of affairs. The New York bankruptcy court adopted General Order 2002, providing for the cancellation of the meeting of creditors if it had not been held by the time the plan was confirmed—a rule that is flatly illegal because it contradicts section 341 of the Bankruptcy Code. A general order adopted in Los Angeles in 2002 cut straight to the chase, declaring that "a hearing on confirmation of a [prepackaged] plan . . . shall be scheduled, if practicable, no more than 30 days after [filing of the case]."[79] By 2002, almost all pretense of deliberation had disappeared from prepackaged cases. The bankruptcy courts had become mere rubber stamps.

No one argues that the procedures followed in 30-day prepacks comply with a literal reading of the code or afford a fair opportunity for creditors, shareholders, and other affected parties to participate in the case. The procedures don't. Instead, defenders of the 30-day prepack argue that such participation is unnecessary because the parties voluntarily fixed the terms of reorganization before the debtor filed the case. That defense, however, fails the test of logic. The purpose of the bankruptcy procedure is to determine *whether* the parties voluntarily fixed the terms of reorganization before the debtor filed the case. Until the court determines that the disclosure statement is adequate and the votes fairly counted, it is too soon to draw any conclusions about what the creditors wanted. Bankruptcy law requires that the determination be made by an adversary process. The purpose is to protect the typically large majority of creditors who voted against the plan, voted for the plan without attempting to understand it, or did not participate in the voting at all.

Thirty-day prepacks appeal to case placers because they provide no opportunity for opposition to form. For the debtor companies, however, the results have generally been bad. Prepackaged cases have been significantly more likely to fail than nonprepackaged cases,[80] and the little evidence available suggests that the failures of prepackaged cases are more costly than the failures of non-prepackaged cases.[81]

"Critical" Vendors

From the moment a debtor files bankruptcy, its creditors are prohibited by the "automatic stay" from making any further effort to collect their debts. The stay will continue in effect until the end of the case, when the court confirms the reorganization plan. For debtors, the stay provides welcome relief. They can use their revenues to pay current operating expenses and make improvements in the business instead of applying them to the payment of past debts.

When the plan is finally confirmed, whatever is available for unsecured creditors is divided pro rata among them. That is, each general unsecured creditor receives the same proportion of the debt owing to it, whether that is two cents on the dollar, 47 cents on the dollar, or 100 cents of the dollar. Achieving this equality among similarly situated creditors in distribution has historically been considered one of the most important policies of bankruptcy law. It reduces the incentives for wasteful, strategic activity designed merely to shift recoveries among creditors.

Critical vendor payments threaten the policy of equality. A critical vendor is a supplier the debtor cannot replace or can replace only at great expense. Consider the example of a reorganizing debtor that manufactures an appliance from purchased parts, some of which are made by Motorola. To continue in business after filing the bankruptcy case, this debtor may need to buy more parts from Motorola. If so, Motorola is, for this debtor, a critical vendor.

What if Motorola refuses to sell more parts to the debtor until the debtor pays in full the debt owing for parts Motorola sold the debtor before bankruptcy? Before the bankruptcy courts were corrupted by court competition, all pretty much shared the same view. Payment of a prepetition debt, even to a critical vendor, violated the Bankruptcy Code because it enabled some unsecured creditors to recover a greater portion of the debts owing to them than others.[82] Courts rarely approved them.

How, then, could this hypothetical business survive? If the Motorola case had arisen during the 1980s, the bankruptcy court would likely have persuaded Motorola to change its mind about refusing to sell to the debtor. Suppliers have an absolute right to refuse to deal with a debtor in bankruptcy. But suppliers do not have the right to condition their refusal on payment of their prepetition debt. Any act to collect a prepetition debt—including a simple request for payment—violates the automatic stay. At a supplier's first suggestion that the debtor should pay its prepetition debt, the 1980s courts threatened to hold the supplier in contempt of court.[83] Because the courts took this hard line, few critical vendors made the suggestion. And because the courts firmly took the position that debtors could not make critical vendor payments, suppliers could gain nothing by seeking them. With the possibility of prepetition debt repayment off the table and most debtors paying cash for postpetition deliveries anyway, few vendors demanded special treatment.

Maintaining this hard line against critical vendor payments required effort and risk on the part of reorganizing debtors. The debtors had to confront overreaching suppliers, perhaps take legal action against them, and run the risk—however small—that some suppliers would ultimately refuse to deal even under the threat of contempt. For any particular debtor, the path of least resistance was to give in to the demands of its critical vendors, pay them with other creditors' money, and leave the line-holding duties to others. For that reason, managers preferred courts that would permit critical vendor payments.

In the mid-1990s, the Delaware bankruptcy court began routinely authorizing critical vendor payments. In the early cases, approval was usually for the payment of a single critical vendor or a short list. But as creditors realized that money was available, more and more decided that their principles did not allow them to continue doing business with debtors who had not paid them in full. Critical vendor payments made were like blood in the water, driving suppliers into a feeding frenzy and driving cases into Delaware. As the number of demands for critical vendor payments increased, the lists of critical vendors got longer. Eventually, the increasing cash demands became a significant burden on the reorganization process. By that time, however, it was too late for managers to put a stop to them. The process had acquired a life of its own. To make their assertions that they would not sell without payment of prepetition debt credible, some critical vendors—Motorola was an example—had irretrievably committed to that position. Such policies assured that the first reorganizing debtors to resist the feeding sharks would be torn to shreds. To avoid being those first, debtors flocked to the safety of the courts most likely to approve their critical vendor orders. By the late 1990s, the competing bankruptcy courts were all following Delaware in approving long lists of "critical" vendors. The size of the payments often reached tens of millions of dollars and sometimes hundreds of millions of dollars. In cases where debtors requested it, some courts authorized slush funds for the payment of critical vendors not yet identified. The debtors' managers could decide later which vendors would get the money. As prominent practitioner Tom Salerno put it, critical vendor payments had "gone from an extraordinary remedy to something that is simply done as a matter of course in almost all cases."[84]

The critical vendor payment problem came to a head in the Kmart case. Chicago bankruptcy judge Susan Pierson Sonderby authorized Kmart to use $200 million to $300 million of cash—cash that otherwise could have been used to make improvements in the business—to pay prepetition debts to supposedly critical suppliers instead. The 2,300 suppliers who received those payments recovered 100 cents on the dollar of their prepetition debts. The 43,000 unsecured creditors who were not included on the list of critical vendors received only about ten cents on the dollar of their prepetition debts, and they got their money more than 15 months later.[85] A nonvendor creditor of Kmart appealed Judge Sonderby's order to the Chicago district court. In April 2003, that court reversed the order, saying that the Bankruptcy Code does not authorize critical vendor payments in any circumstances. The debtor appealed the district court's decision to the Seventh Circuit Court of Appeals.

Determined to remain in the competition for cases, Judge Sonderby refused to order the recipients of the critical vendor payments to return the money pending the outcome of the appeal. In February 2004, the Seventh Circuit Court of Appeals sided with the district court against Judge Sonderby. In the opinion, Judge Frank Easterbrook wrote that the doctrine of necessity—the doctrine used to justify critical vendor payments—"is just a fancy name for a power to depart from the Code."[86] The court stopped short of saying that preferential payments to prepetition suppliers were always improper, but it went far enough to seriously impair the Chicago court's ability to attract future cases.

In addition to the threat critical vendor orders pose to the policy of equality of distribution, economy of bankruptcy administration, and the survival of debtor companies, they also provide managers with a new—and abusable—source of power. Minneapolis lawyer Bill Kampf tells the story of his client Riscomp Industries, a small janitorial firm that was reorganizing in bankruptcy in late 2002. Riscomp had the contract to clean the United Airlines terminal at the Los Angeles airport. From reading the newspapers, Riscomp's CEO knew that United was preparing to file bankruptcy. Riscomp needed the United work, but it wouldn't do them any good if they weren't paid for it. Riscomp discussed the problem with United's managers. The two agreed that Riscomp would do the work and United would put Riscomp on its critical vendor list. Riscomp performed, and when United filed bankruptcy, it owned Riscomp $300,000. Ignoring its promise, United omitted Riscomp from its critical vendor list.

Riscomp had no legal remedy. United's prepetition promise—even if made fraudulently—is merely a prepetition debt dischargeable in bankruptcy. United didn't pay Riscomp, and as a result, Riscomp's business failed. Kampf reports rumors that United also duped other creditors with the promise of critical vendor treatment.

By 2003, bankruptcy lawyers and judges were acknowledging that the bankruptcy courts had grown too lax in granting critical vendor orders. The problem was how to stop. As one court put it in a memorandum opinion: "[B]ecause payment of prepetition claims outside of a plan has become commonplace in some jurisdictions, the court recognizes that a vendor might condition future dealings with Debtors on payment of its prepetition claim, whether or not payment of that claim could be justified . . . ."[87] What the court should have added was that the problem resulted from bankruptcy court competition.

Section 363 Sale Practices

The filing of a bankruptcy reorganization case gives managers tremendous power. They remain in office and control the company, the case, and the flow of information. Increasingly, neither shareholders nor creditors can oust them. The plan process is an important limit on their power. To complete the bankruptcy, the managers must make extensive disclosures to shareholders and creditors and persuade requisite majorities that confirmation of the plan is in the shareholders' and creditors' interests.

The power of managers is particularly problematic when managers try to sell the company. The managers may arrange a sale to themselves or their allies or to a buyer who will continue the managers' employment on generous terms. Partly for this reason, the appellate courts have held that management can sell the business during bankruptcy only through the plan process—unless there are sound business reasons why they need to deviate from that process.[88]

The alternative to sale through the plan process is sale under section 363 of the Bankruptcy Code. That section authorizes trustees to sell property of the estate—a routine, uncontroversial part of every Chapter 7 case. Other sections of the Bankruptcy Code provide that section 363 applies in Chapter 11 cases and that debtors-in-possession have the rights of trustees. The result is to set up section 363 as an alternative procedure for selling an entire business without the plan process safeguards for creditors and shareholders.

The drafters of section 363 probably thought in terms of sales of particular assets, not entire businesses.[89] But the text of the section contains no such limitation. Absent court competition, that would not have been a problem. The courts would have imposed reasonable restrictions on the use of section 363 to sell entire businesses.

As the courts apply section 363, a debtor that proposes to sell its entire business may disclose the proposal only to the unsecured creditors' committee and the court. The disclosure may consist of nothing but a ten-page summary of the terms of sale. Management need not make the extensive disclosures of the debtor's financial condition, reasons for sale, alternatives to sale, and ulterior motives for sale that would be required as part of the plan process. Nor does management need to tell the creditors what their recoveries will be if the sale goes through. The courts generally require that the debtor afford others who wish to bid for the company an opportunity to do so, but the dissemination of information to bidders and the bidding itself are largely secret processes, accessible only to the professionals representing official committees—and to them only grudgingly. Creditors and shareholders not on official committees may be unable to discover even the nature of the assets being sold. The sale of a company worth billions of dollars may be concluded in less than two months—less than the time most people take to sell their homes.

During the 1980s, few large public company debtors had "sound business reasons" to sell their entire businesses outside the plan process. By the end of that decade, only three large public companies had done so. These few exceptions were emergencies in which there was not sufficient time to comply with the plan process.

Table 11 lists all cases since 1979 in which the bankruptcy courts allowed managers to bypass the plan process to sell large public companies under section 363. The number of such cases increased rapidly in the late 1990s and then exploded in 2000.

Delaware did not invent the quick section 363 sale, but table 11 shows that Delaware perfected it. If a "quick sale" is defined as one that takes place within 130 days of the filing—a time short enough to suggest that the debtor had sale in mind when it chose the court—Delaware conducted all eight of the quick section 363 sales from 1992 through 2000. Companies filed in other courts, encountered adversities, and eventually ended up selling their businesses under section 363. But companies came to Delaware with section 363 sales already in mind. Many of them—like Trans World Airlines—first contracted to sell the business and only then filed bankruptcy to obtain a sale approval order.

In late 2000 and 2001—following the spread of competition from Delaware to New York and other courts—other courts began welcoming managers who brought their companies into bankruptcy only to sell them. Since January 1 of 2001, 11 of 21 quick section 363 sales (52 percent) were conducted in courts other than Delaware. Numerous courts were allowing debtors to sell their entire companies without complying with the requirements of the plan process.

The order approving a bankruptcy sale binds everyone with an interest in the case and prevents them from later challenging the sale. No appeal from the order is permitted; the order is final when entered. If corrupt managers and purchasers can get their sale past the bankruptcy court, they are home free. Bankruptcy sale orders are so appealing to buyers and sellers that companies that would otherwise conduct their sales outside bankruptcy sometimes file bankruptcy cases to get them.

Managers seeking to deliver a company to themselves or their accomplices at a bargain price tend to announce their intention to sell only at the last minute and then seek to conclude the sale as quickly as possible. That minimizes the opportunity for discovery of the true identities of the buyers or the emergence of other bidders for the company. The case of Derby Cycle Corporation, manufacturer of Raleigh and Diamondback bikes, illustrates.

Alan Finden-Crofts founded Derby in the late 1980s and sold it in January 1999. The new owners quickly got the company into financial difficulty. Two years later, they invited Finden-Crofts to return as a turnaround manager. He became CEO in January 2001 and brought in several of his associates as top managers.[90]

Five months later, on June 3, 2001, Finden-Crofts announced that he and a group of managers proposed to buy the company—

TABLE 11. Section 363 Sales of the Entire Company, 1980–2003

	Court	Date of 363 Sale	Date of Filing	Days from Filing to 363 Sale
McLouth Steel Corporation	Detroit	11/15/82	12/8/81	342
Air Florida System Inc.	Miami	9/15/84	7/3/84	74
Frontier Holdings Inc.	Denver	10/17/86	8/28/86	50
Daisy Systems Corporation	Denver	1/3/91	5/30/90	218
Telesphere Communications Inc.	Chicago	10/25/91	8/19/91	67
Days Inns of America Inc.	**Wilmington**	**1/9/92**	**9/27/91**	**104**
FoxMeyer Health Corporation	**Wilmington**	**11/15/96**	**8/27/96**	**80**
Plaid Clothing Group Inc.	New York	11/22/96	7/17/95	494
Mid-American Waste Systems, Inc.	**Wilmington**	**3/11/97**	**1/21/97**	**49**
Ernst Home Center, Inc.	**Wilmington**	**3/14/97**	**7/12/96**	**245**
Best Products Company, Inc.	Richmond	5/29/97	9/24/96	247
McCrory Corporation	New York	7/31/97	2/26/92	1,982
Molten Metal Technology, Inc.	Boston	11/24/98	12/3/97	356
Caldor Corporation	New York	2/11/99	9/18/95	1,242
Thorn Apple Valley, Inc.	Detroit	8/26/99	3/5/99	174
Renaissance Cosmetics, Inc.	**Wilmington**	**9/10/99**	**6/2/99**	**100**
Hechinger Company	**Wilmington**	**2/15/00**	**6/11/99**	**249**
Costilla Energy, Inc.	Midland-Odessa	6/9/00	9/3/99	280
Cambridge Industries, Inc., of DE	**Wilmington**	**6/23/00**	**5/10/00**	**44**
System Software Associates, Inc.	**Wilmington**	**7/10/00**	**5/3/00**	**68**
Stone & Webster, Inc.	**Wilmington**	**7/14/00**	**6/2/00**	**42**
New American Healthcare Corporation	Nashville	9/14/00	4/19/00	148
GST Telecommunications, Inc.	**Wilmington**	**9/21/00**	**5/17/00**	**127**
Flooring America, Inc.	Atlanta	11/27/00	6/15/00	165
Bradlees Inc. (2000)	New York	2/6/01	12/26/00	42
Drypers Corporation	Houston	3/1/01	10/10/00	142
Grand Union Company	Newark	3/5/01	10/3/00	153
Trans World Airlines, Inc.	**Wilmington**	**3/12/01**	**1/10/01**	**61**
NorthPoint Communications Group	San Francisco	3/23/01	1/16/01	66
Orbcomm Global, LP	**Wilmington**	**4/23/01**	**9/15/00**	**220**
U.S.A. Floral Products, Inc.	**Wilmington**	**5/1/01**	**4/2/01**	**29**
Vlasic Foods International, Inc.	**Wilmington**	**5/31/01**	**1/29/01**	**122**
Einstein Noah Bagel Corporation	Phoenix	6/11/01	4/27/00	410
Payless Cashways, Inc.	Kansas City, MO	9/19/01	6/4/01	107
Derby Cycle Corporation	**Wilmington**	**10/2/01**	**8/20/01**	**43**

Winstar Communications, Inc.	**Wilmington**	**12/19/01**	**4/18/01**	**245**
ABC-NACO, Inc.	Chicago	1/11/02	10/18/01	85
Network Plus Corporation	**Wilmington**	**3/15/02**	**2/5/02**	**38**
International Fibercom Inc.	Phoenix	4/16/02	2/13/02	62
IT Group, Inc. (The)	**Wilmington**	**4/25/02**	**1/16/02**	**99**
Casual Male Corporation	New York	5/7/02	5/18/01	354
U.S. Aggregates, Inc.	Reno	5/23/02	3/11/02	73
e.spire Communications, Inc.	**Wilmington**	**3/22/01**	**6/4/02**	**439**
Kellstrom Industries, Inc.	**Wilmington**	**6/10/02**	**2/20/02**	**110**
Polaroid Corporation	**Wilmington**	**7/3/02**	**10/12/01**	**264**
Coho Energy, Inc.	Dallas	8/15/02	2/6/02	190
Republic Technologies International	Akron	9/1/02	4/2/01	517
Phar-Mor, Inc.	Youngstown	9/1/02	9/24/01	342
Velocita Corporation	Newark	11/7/02	5/30/02	161
Budget Group Inc.	**Wilmington**	**11/8/02**	**7/29/02**	**102**
Iridium LLC (and six subsidiaries)	New York	11/20/02	8/13/99	1,195
RSL Communications, Ltd.	New York	12/9/02	3/19/01	630
Asia Global Crossing, Ltd.	New York	1/29/03	11/17/02	73
Clarent Corporation	San Francisco	2/4/03	12/16/02	50
Genuity Inc.	New York	2/4/03	11/27/02	69
DTI Holdings, Inc./Digital Teleport	St. Louis	2/13/03	12/31/01	409
Graham-Field Health Products, Inc.	**Wilmington**	**4/14/03**	**12/27/99**	**1,204**
National Steel Corporation	Chicago	4/21/03	3/6/02	411
Bethlehem Steel Corporation	New York	4/23/03	10/15/01	555
Carbide Graphite Group, Inc.	Pittsburgh	9/21/02	7/24/03	671
Read-Rite Corporation	Oakland	6/17/03	7/24/03	37
ANC Rental Corporation	**Wilmington**	**11/13/01**	**8/6/03**	**631**
Wherehouse Entertainment, Inc.	**Wilmington**	**1/21/03**	**9/29/03**	**252**
Pillowtex Corporation	**Wilmington**	**10/7/03**	**7/30/03**	**69**
AT&T Latin America Corporation	Miami	4/11/03	11/4/03	207
Globalstar LP	**Wilmington**	**2/15/02**	**11/21/03**	**644**
Republic Engineered Products Holdings, Inc.	Akron	10/6/03	12/16/03	71
Rouge Industries, Inc.	**Wilmington**	**10/23/03**	**12/22/03**	**60**

Source: Data from Lynn M. LoPucki's Bankruptcy Research Database.
Note: Delaware court cases are shown in bold.

not including its European subsidiary, Gazelle—for a purchase price that ultimately turned out to be about $40 million.[91] From the moment of that announcement, everything was suddenly urgent. According to Derby's attorneys, "in mid-July, 2001, after extensive marketing by Lazard, the Debtor, in consultation with the Bondholders' Committee, decided to sell" Gazelle, and "the Gazelle Sale closed on July 19, 2001"[92] for a purchase price of about $120 million. (The money went to pay Gazelle creditors.)[93] "Without Gazelle's revenues," the attorneys continued, "the Debtors' business is not viable on a stand-alone basis" and so "must be sold as soon as possible or liquidated."[94] On August 20, 2001, the debtor signed a contract to sell all of Derby's assets to the Finden-Crofts group for about $40 million and filed for bankruptcy in Delaware. The following day, the debtor's attorneys filed a statement with the court stating that "debtor needs to consummate this sale no later than September 28, 2001" and that "unless there is a sale by September 28, there is not likely to be a business to sell."[95] The attorneys explained that "[t]he major bike trade shows start on September 30, 2001. It is vital to the ongoing business that a buyer be selected prior to these shows, so that orders can be secured by the buyer for the following season."[96]

The court set September 26 as the last day for the submission of competing offers. The court did not meet Derby's deadline for approving the sale, but luckily, there still was a business to sell when the court approved the sale on October 2, 2001. The sale was completed on October 29, 2001.[97] Derby's estate received $23 million of the $40 million purchase price. The buyer paid the remaining $17 million by assuming secured debt.

Based solely on the record, Derby's sale looks suspicious. The Finden-Crofts management took nearly eight months to put Derby into bankruptcy and then insisted that the court approve a sale to themselves in just five weeks. If it took Finden-Crofts—the former owner of Derby—five months to evaluate the company from the inside and prepare a bid, how were competing bidders supposed to do it from the outside in five weeks? The trade shows and the approaching Christmas selling season were the "emergency" used to justify the hurried schedule, but that emergency could hardly have come as a surprise to anyone. As the United States Trustee put it in an objection to the sale:

> [T]he rushed nature of this sale appears to be a creation of the Buyer's own doing, who, it can be assumed, as Chief Executive Officer of the Debtor, played some role in the decision to delay the filing of Chapter 11 until shortly before these events. Indeed, it is arguable that the Buyer's actions caused the quickly deteriorating conditions that Debtor now alleges require a quick sale.[98]

No proof exists that Derby Cycle was worth more than the $40 million Finden-Crofts paid. Two well-known investment banking firms—Lazard Frères on behalf of the debtor and Jefferies & Company, Inc., on behalf of the creditors' committee—had supposedly shopped the company and found no one else interested.[99] But Lazard was hired by Derby, and Finden-Crofts was in control of Derby, so in failing to find another interested buyer, Lazard was telling its client what the client wanted to hear. Jefferies's final fee application—which lists all of the services performed on behalf of the committee during the case—makes no mention of any attempts to discover or interest additional buyers.[100] As soon as the debtor signed the sale agreement, it sought court approval of bidding procedures that contained a "no-shop" provision—that is, a provision restricting the debtor's efforts to interest additional bidders in the property during the open bidding period that the bankruptcy court would require.[101]

The Polaroid case provides another illustration of the problem of conflict of interest in section 363 sales. Shortly after Polaroid filed for reorganization in Delaware on October 12, 2001, the company entered into a contract to sell its Identification Systems Division unit to the manager in charge of it for $32 million. The sale required court approval after a public opportunity to bid. Insisting that the sale was urgent, Polaroid sought to limit the opportunity for outside bidding to the extent it could.[102] Polaroid's investment bankers, Dresdner, Kleinwort, Wasserstein, said they had shopped the Identification Systems Division thoroughly and $32 million was the best offer they could get. But when Polaroid tried to get Judge Walsh to approve the sale for $32 million, several would-be bidders appeared in court to protest that they hadn't been solicited, that they had encountered difficulty in getting bid packages from Dresdner, Kleinwort, Wasserstein, and that Polaroid was trying to push the sale through without giving them time to prepare their bids.[103] Judge Walsh extended the bidding period by 10 days, and competitive bidding pushed the price to $60 million.[104] Later, an Identification Systems executive said that in shopping the company, Dresdner, Kleinwort, Wasserstein, had been asking $75 million to $125 million, an excessive asking price that had discouraged bidding.[105] It appears that bidders who came forward on their own thwarted Polaroid management's attempt to sell Polaroid's Identification Systems Division to one of their colleagues at a bargain basement price.

Most section 363 sales of big companies are not to the managers themselves. But preliminary results from an empirical study I am conducting indicate that the debtor's managers get some kind of publicly announced payoff—in the form of employment or consulting contracts—from the buyer in a substantial proportion of all entire-business 363 sales. These payoffs are facilitated by a custom that has arisen for the buyers in section 363 sales to hire the debtors' managers and reward them with stock totaling in value as much as 5 percent to 10 percent of the entire company.[106] The custom amounts, in effect, to a standing bribe offer for managers to arrange sweetheart deals on the sales of their companies. The incumbent managers don't have to get the buyer's agreement in advance to pay the bribe; they can do the deal on the basis of trust. The custom played a key role in the controversial sale of the remainder of Polaroid.

On its petition, Polaroid claimed assets of $1.8 billion and liabilities of $948 million. Dresdner, Kleinwort, Wasserstein and Pirella had begun shopping the entire company even before the bankruptcy filing. Wasserstein contacted some 170 possible purchasers.[107] About 60 of them signed the confidentiality agreements required before a prospective purchaser could get information about Polaroid.[108] Only two, however, expressed serious interest in bidding, and only one actually bid.

Six months into the case, on April 18, 2002, Polaroid petitioned to sell its assets to that sole bidder. OEP Imaging was a newly incorporated firm set up by venture capitalists at Bank One Equity. The identity of its owners has never been publicly disclosed. OEP's bid was $265 million. The purchaser would take the assets subject to about $200 million in debt, which meant the deal implicitly valued Polaroid's assets at about $465 million. Following the customary procedure for section 363 sales, the Delaware court required that Polaroid offer prospective purchasers one last opportunity to outbid OEP. On May 10, the court fixed procedures for competitive bidding, and Polaroid conducted an auction on June 26 in the offices of Polaroid's attorneys, Skadden, Arps. At the auction, OEP's bid was again the only one presented.

The creditors' committee opposed the sale to OEP because they considered the price to be grossly inadequate. Polaroid had valued its assets at $1.8 billion on the petition it filed in October 2001. Two months later, Polaroid filed schedules that listed each of its assets and placed values on most. The values listed totaled $715 million, even though no values were listed for many of Polaroid's most valuble assets. The unvalued assets included Polaroid's more than 1,000 patents, 2,000 trademarks, and 24,000 art objects and the stock of about two dozen foreign subsidiaries. The foreign subsidiaries continued to operate, were not in bankruptcy, and owned—among other things—about $100 million of the $948 million in debt owed by the bankruptcy estate. Taken as a whole, the schedules suggested that Polaroid's assets might be worth the full $1.8 billion previously estimated. Now, just four months later, Polaroid's managers were trying to sell Polaroid for $465 million.

That price did not reflect the entire extent of the bargain. More than $200 million of Polaroid's assets were cash. After various credits OEP would receive at closing, OEP would pay $225 million in cash for Polaroid. Thus, on paying $225 million in cash OEP would own a company that had $200 million in cash. In effect, OEP was buying Polaroid for $25 million in cash and the assumption of $200 million in secured debt.

The unsecured creditors' committee vehemently objected to the sale and by threatening to try to reorganize the company themselves eventually managed to force a settlement. The deal was that Polaroid would sell to OEP on OEP's terms and Polaroid's unsecured creditors would get 35 percent of the stock of OEP.

The day after the auction and settlement, Delaware bankruptcy judge Peter J. Walsh heard testimony regarding the sale, overruled the objections of Polaroid's stockholders and retirees, and approved the sale. From the first public announcement of intent to sell Polaroid to the entry of a binding, unappealable order approving the sale, the sale process took only 70 days.

The sale hearing transcript shows Judge Walsh to have been completely uninterested in any evidence that might have been presented as to the true value of Polaroid's assets. As Judge Walsh put it:

> [T]he principal conflict here is between those persons and entities who preach and believe that there must be some valuation done which would demonstrate that this enterprise is [not] worth more than what is being proposed by the proposed transaction. . . . I have never accepted the proposition that the court should be guided by valuation when a sale transaction, and in many of these cases, including this one, an appropriately shopped sale transaction, is the alternative. And even in this case where the disparity is dramatic, to say the least, I think the fundamental proposition, which this court has fought for a lot of years, is that a transaction appropriately conducted is the better test of value . . . . I favor the market test approach and that was done in this case.[109]

To put Judge Walsh's argument another way, because Dresdner, Kleinwort, Wasserstein found no buyer willing to pay more than $465 million for a $1.9 billion company with $200 million in cash, Judge Walsh concluded that Polaroid's noncash assets were worth no more than $265 million.

Walsh's logic was faulty. The sale arranged by Dresdner, Kleinwort, Wasserstein, obviously wasn't for the full market value of the company. By settling with the creditors' committee for 65 percent of Polaroid, but paying the same price it had bid for 100 percent, OEP acknowledged that it would have bid about 50 percent more than the $465 it actually bid. How much more it would have bid is anyone's guess.

Companies can and do sell for market prices when a motivated buyer appears, and the company has the right and ability to refuse to sell until the deal is right. But the market for large public companies is thin. At any given time there may or may not be someone willing to pay a fair price. A traditional justification for bankruptcy reorganization is that reorganization enables the company to keep going on its own until a buyer willing to pay a fair price comes along.

Instead, Polaroid's top managers insisted that Polaroid was "a melting ice cube" that could not reorganize. Testifying at the sale hearing in mid-2002, William L. Flaherty, Polaroid's CFO, said that Polaroid's sales for 2002 were down 25 to 30 percent from the previous year and would continue to decline at about that rate through 2004.[110] Along with that assessment, Flaherty opined that Polaroid was projecting operating losses "in every quarter of 2002." Repeating Flaherty's testimony regarding sales and his characterization of Polaroid as a "melting ice cube," Judge Walsh concluded that "it is inconceivable to me that anybody could put together a plan which would produce any value whatsoever for the equity interests in this corporation."[111]

The Polaroid sale closed on July 31, 2002, just over a month after Flaherty pronounced Polaroid a melting ice cube. The following day, Flaherty and Neal Goldman—the two executives who performed the function of CEO for Polaroid in its final days—went to work for OEP in the same capacity. Miraculously, the ice cube immediately stopped melting. As shown in table 12, Polaroid's sales increased and its losses shifted to profits as of the day the sale closed.

Nor did the 25 percent to 30 percent annual decline in sales and the continuing operating losses Flaherty predicted in his June 27 testimony[112] occur. A year after approval of the sale, a merger and acquisition specialist consulted by the *Boston Globe* estimated that, based on earnings alone, OEP could sell Polaroid for $500 to $900 million.[113] At the top of that range Polaroid's stockholders would have been in the money. (Recall that $100 million of Polaroid's $948 million in debt was owed to Polaroid's foreign subsidiaries. Polaroid's real debt was only $848 million.)

Suspicions focused on Goldman and Flaherty. Polaroid had paid them generously for their loyalty during the bankruptcy case. Goldman's base salary at bankruptcy was $375,000; Flaherty's was $390,000. As the only employees in "Tier One" of Polaroid's retention bonus plan, each received a retention bonus of 62.5 percent of his annual salary and an additional 62.5 percent of his annual salary in severance pay on termination of his employment—75 per-

TABLE 12. Polaroid's Profits and Losses

	Net Sales	Operating Profit (loss)	Net Profit (loss)
1991	2,070.6	246.6	683.7
1992	2,152.3	213.8	99.0
1993	2,244.9	141.4	(51.3)
1994	2,312.5	200.3	117.2
1995	2,236.9	(157.8)	(140.2)
1996	2,275.2	51.8	(41.1)
1997	2,146.4	(159.1)	(126.7)
1998	1,845.9	(49.0)	(51.0)
1999	1,978.6	107.6	8.7
2000	1,855.6	109.1	37.7
2001 Q1	330.8	(118.0)	(90.9)
2001 Q2	333.5	(51.8)	(109.9)
2001 Q3	Not disclosed		
2001 Q4	189.4	(76.2)	(112.3)
2002 Q1	158.8	(20.8)	(20.3)
2002 Q2 (4 months)	224.2	(32.4)	(183.1)
	Polaroid sale closes		
2002 Q3 (2 months)	152.6	1.8	0.2
2002 Q4	211.3	22.8	14.5
2003 Q 1	183.0	22.9	16.2
2003 Q2	195.8	29.7	16.5

Source: Compiled by the author from Polaroid financial statements.

cent more than any other Polaroid employee. In the year before the sale, Polaroid paid Goldman a total of more than $844,000 and Flaherty a total of more than $878,000.

OEP claims that Goldman and Flaherty went to work for it at salaries of $165,000 and received annual bonuses of $107,250.[114] Goldman and Flaherty testified that OEP did not discuss continued employment with them at all until after the auction[115] and made no commitment to give them an equity share until months after they began work.[116] Nevertheless, a year after closing each owned stock in OEP probably worth $3 million to $4 million.[117] The evidence indicates that even before the auction, OEP planned to give 10 percent of its stock to its new managers.[118] Financial statements issued by OEP a year later showed management as owning 9.7 percent of its stock, Goldman and Flaherty's 2.6 percent included. In addition, Stanley P. Roth, an influential member of the creditors' committee, also showed up on the other side of the fence as a director of OEP owning 42,440 shares.[119] OEP's disclosure does not explain how he got those shares.

The fact that no other bidder stepped forward even though Polaroid was being sold at a bargain price can be easily explained, even without assuming any wrongdoing. OEP had a deal under which it could not lose. If, as turned out to be the case, OEP was the only bidder at the sale, it could buy Polaroid cheaply and make a lot of money. If someone had outbid OEP, Polaroid had agreed to pay OEP a $5 million "termination payment."[120] (The Delaware bankruptcy court routinely approved such payments and had done so in Polaroid.) The second bidder—the one that did not materialize—would have neither of those advantages. With two bidders at the sale, the likely result was that bidding would have continued until the price reached an amount approximating the true value of Polaroid. If so, the second bidder—the one that never materialized—would have been in a situation in which it could not win. If it won the bidding, it would have paid the full value of what it bought; if it lost the bid it would have spent millions of dollars for which it would not have been compensated. An auction with two bidders might have yielded the full market value of Polaroid. But that is probably the very reason no second bidder was willing to come forward. Far from the panacea Judge Walsh thinks they are, auctions work only in limited circumstances. Polaroid was not one of those circumstances, and the professionals conducting the sale must have been aware of that.

Outside observers—including the *Wall Street Journal,*[121] the *Boston Globe,*[122] *CFO Magazine,*[123] Congressman William D. Delahunt,[124] and Polaroid's stockholders and retirees—all indicated suspicions about the bankruptcy and sale of Polaroid. But because the court allowed Polaroid to use section 363 instead of requiring it to follow plan formalities, the facts that fueled the Polaroid scandal were hidden until after the sale became final. The facts I report here ultimately came to light only because OEP's investors decided to cash in on their newly acquired wealth by selling Polaroid to the public and so had to make public disclosures under the securities laws. Even when this information came out, the response was muted by the realization that whatever might be found after the sale, nothing meaningful could be done about it. Sales under section 363 are final even if accomplished through fraud.

The Ideology That Facilitates Corruption

This chapter described seven bankruptcy court practices that have been corrupted by court competition. There are numerous others. The bankruptcy courts have relaxed their standards for professionals' conflicts of interest. They allow managers and professionals to insert into plans of reorganization provisions releasing themselves from liability for their own negligence or wrongdoing, including, in some cases, even gross negligence. These are just a few of many competition-driven changes have transformed the landscape of American bankruptcy over the period since 1990.

The changes are not yet complete because the interests of the case placers have not yet triumphed completely. There is still more that courts can offer. Some judges have had second thoughts about concessions they have made in order to attract cases, and they have reversed course. But such reversals accomplish nothing. The cases go elsewhere, and the practices continue. Unless Congress intervenes, the process will continue until the managers and the professionals have complete control over case outcomes.

The actions competition forced them to take have made many of the judges uncomfortable. Some alleviate their discomfort by embracing a promarket ideology that assures them that in yielding to the competitive pressure they are doing the right thing. The nature and effect of that ideology are the subject of chapter 9. One of the ideology's teachings is that judges should not interfere with solutions "generated in the marketplace." That exemption could apply to virtually anything on which the major parties to a case are in agreement. Thus the judges approve the parties' reorganization plans, section 363 sales, retention bonuses, fee agreements, and first-day orders as the infallible products of the market's invisible hand. The judges' newfound belief in markets enables many of the judges to do what they have to do to compete for cases: yield their power to those who place the cases.

In relying solely on markets to solve the problems of bankrupt companies, the judges forget that bankruptcy was invented to deal with the illiquidity of failing business. Failing businesses are difficult to sell because the market for such businesses is thin, the records of such businesses are often in disarray, the businesses' circumstances are often changing rapidly, and the businesses lack the working capital needed to continue operations during the negotiations. Bankruptcy addresses the problem of liquidity by protecting a business from its creditors and giving it an alternative to distress sale—reorganization using the assets it already has. That reorganization alternative acts as a sort of competing bid, giving the debtor the leverage to negotiate a fair sale price when only a single outsider is bidding. When managers give up the reorganization alternative—as the managers did in Derby Cycle and Polaroid—they put their company at the mercy of that single outside bidder.