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They Owe Us

Companies seeking bankruptcy relief should face creditors in their home court.

BY JOHN CORNYN

This spring, President George W. Bush signed into law major legislation to reform our bankruptcy system. I supported the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 because bankruptcy relief should be available to those who are unable to pay—not to those who are simply unwilling to pay. Based on my prior experience as the attorney general of Texas during the Enron bankruptcy, however, I also know there is more that we can and should do to combat corporate abuse of our bankruptcy laws.

Current law still allows corporate debtors to manipulate the U.S. Bankruptcy Court itself to their advantage. Due to a loophole in current law, large companies can effectively choose the particular bankruptcy court in which they would like to file for relief. All that a corporation must do is find—or, if necessary, hastily create—some remote, often minor subsidiary that falls within the jurisdiction of the desired court. And then the parent company can essentially hook its bankruptcy onto the bankruptcy of its junior partner.

Congress must take action to eliminate this kind of blatant forum shopping.

BAD CHOICES

Letting corporations choose the venue for their own bankruptcy filings is troubling for at least two reasons.

First, major corporate debtors should not be able to file their claims in courts thousands of miles from the communities and the workers who have the most at stake, as Houston-based Enron did by filing its bankruptcy claim in the Southern District of New York in 2001. Under these circumstances, it is unfair to force ordinary creditors—including consumers, workers, pensioners, shareholders, and small businesses—to litigate far from home, where the costs and inconveniences associated with travel may prove prohibitive.

Second, current law effectively empowers corporate debtors to pick jurisdictions likely to rule in their favor. This troubling loophole makes it very difficult for ordinary creditors to pursue and receive reasonable compensation. After all, picking the judge isn't far from picking the verdict. What's more, if debtors get to pick the jurisdiction, then bankruptcy courts have a disturbing incentive to compete with each other for major bankruptcy cases, by tilting their rulings in favor of corporate debtors and their attorneys. In the Enron case, for example, creditors expect to receive less than 20 cents on the dollar, while attorneys, accountants, and other advisers may collect more than $1 billion in fees.

ABUSE HAPPENS

Bankruptcy law confers upon bankruptcy judges an enormous amount of discretion—discretion that is largely out of the reach of appellate review. Of course, no one wants to believe that a federal judge would ever distort the law for any reason, let alone in order to improve the court's docket. Yet there is an undeniable temptation to lean a bit, to exercise discretion in ways that will bring the fame and prestige that come with attracting the nation's largest and most newsworthy cases.

Indeed, abuses of the current bankruptcy system have now been well-documented by legal practitioners and academics—

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most recently by UCLA law professor Lynn LoPucki, in a comprehensive book published this year titled *Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts,* as well as by Harvard law professor Elizabeth Warren, who served as the reporter for the National Bankruptcy Review Commission, and University of Texas law professor Jay Westbrook.

As these studies amply demonstrate, consumers, workers, pensioners, and small businesses lose when corporations get to choose who will hear their bankruptcy claims. According to professor LoPucki, approximately half of all recent major bankruptcy reorganizations have failed, requiring repeat bankruptcy filings. The cause? Reorganization plans OK'd by judges that were geared more to please lawyers and corporate executives than to put the companies themselves back into profitable operation and to secure reasonable compensation for ordinary creditors.

DISHONOR ROLL

When I served as Texas state attorney general (from 1999 to 2002), I argued that the Enron bankruptcy should be litigated in Houston, the company's headquarters and home to 7,500 employees and countless others victimized by that corporate scandal. Instead, Enron filed for bankruptcy in New York, where one of its subsidiaries had a mere 57 employees. Over the objection of major creditors, the Bankruptcy Court in New York kept the case.

How did that decision work out for Enron's creditors? The court let the original failed management remain in control long enough to participate in choosing its successors. And, as noted, efforts to recover money wrongfully taken from Enron accounts on behalf of creditors and shareholders have been dramatically crippled.

A similar story can be told about Mississippi-based WorldCom, which perpetrated one of the biggest accounting frauds in history, inflating its income by $9 billion. WorldCom followed Enron into the Bankruptcy Court in New York, where its managers received similarly lenient treatment while creditors lost $20 billion.

Or look at the 2001 bankruptcy of Polaroid. The company is based in Boston, yet the case was adjudicated in Delaware. (Delaware and New York are both favored destinations for corporate managers seeking bankruptcy relief.) Top executives kept their jobs and received millions of dollars in stock. Meanwhile, disabled employees lost their health care coverage.

And just recently, Winn-Dixie, the Florida-based chain with grocery stores across the South, created a New York subsidiary just two weeks before using that subsidiary to file for bankruptcy in New York—to the clear disadvantage and over the loud objections of Southern creditors. After a spate of bad publicity for both Winn-Dixie and the New York court, Winn-Dixie finally backed down and requested a transfer of the case to Jacksonville, Fla. The bankruptcy judge granted the request, but only after specifically noting that the original filing in New York had been conducted in good faith, sending a clear signal that major corporate debtors remain quite welcome to forum-shop.

These are not isolated incidents. To the contrary, more than half of all large public companies filing for bankruptcy in recent years have chosen a court other than the one closest to their headquarters, according to professor LoPucki.

TIME TO ACT

To close this loophole in our bankruptcy laws, I introduced the Fairness in Bankruptcy Litigation Act of 2005 in February. The bill would reform the rules governing venue in bankruptcy cases in order to combat forum shopping by debtors. In doing so, it would implement a major recommendation of the October 1997 report of the National Bankruptcy Review Commission, an independent panel established by the Bankruptcy Reform Act of 1994 to investigate and study issues relating to the U.S. Bankruptcy Code and to suggest needed reforms.

Supporters of the bill include a bipartisan coalition of 24 state attorneys general, led by Texas Attorney General Greg Abbott, and groups representing the interests of consumers, employees, and small businesses—including the Consumer Federation of America, the National Federation of Independent Business, and counsel for the Enron Employees Committee—as well as leading bankruptcy experts and organizations nationwide.

Specifically, the bill would amend 28 U.S.C. §1408, which governs where bankruptcy cases may be filed. Corporate debtors would be allowed to file only in the jurisdiction where their principal place of business in the United States or their principal assets in the United States are located (with just one exception, stated below). Corporate debtors would no longer be permitted to file simply on the basis of their state of incorporation.

In addition, debtors would no longer be permitted to file in another jurisdiction simply because an affiliate of the debtor had filed there. There would be just one exception to this new rule: A subsidiary corporation would be allowed to file in the jurisdiction in which its parent corporation had filed, so long as either (1) the subsidiary corporation and the parent corporation had filed at least one consolidated financial report under the Securities Exchange Act within the previous 730 days, or (2) the subsidiary corporation had been controlled by the parent corporation for at least 365 days.

The bankruptcy reforms passed in April were important and much-needed legislation. But we must not stop there. Congress should now reform the bankruptcy venue law to ensure that workers and creditors are protected against court manipulation by corporate debtors.

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