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Debating Bankruptcy Venue Reform

Law360, New York (September 19, 2011, 11:30 AM ET) -- For years, a debate has percolated within the bankruptcy community over the appropriate judicial fora for Chapter 11 cases and the concentration of cases in the "magnet" jurisdictions of New York and Delaware. That debate is once again coming to a head, with some of the bankruptcy bench's and bar's biggest names weighing in.

In June, U.S. Rep. Lamar Smith, R-Texas, the chairman of the U.S. House Committee on the Judiciary, filed the Chapter 11 Bankruptcy Venue Reform Act of 2011. Similar to other bills previously proposed, the bill would require most companies to file bankruptcy petitions in the state where their principal place of business is or their principal assets are located.

Currently, in addition to those jurisdictions, companies may file for bankruptcy in their state of incorporation, as well as in the state in which any of their affiliates have also filed bankruptcy petitions. Under the proposed bill, companies could no longer file petitions in their state of incorporation unless it was also the location of their principal place of business or assets. Companies could still file in the same district where an affiliate's case is pending, but only if the affiliate directly or indirectly owns, controls or holds more than 50 percent of the outstanding voting securities of such corporation. This would eliminate the possibility of filing in a jurisdiction of a subsidiary or commonly owned sister entity. Companies, therefore, could no longer "bootstrap" onto the bankruptcy case of a small, remote affiliate to get into the forum of choice.

On Sept. 8, 2011, the bill came up for a hearing in front of Rep. Smith's House Committee on the Judiciary, where scholars, judges and practitioners came to testify on both sides of the hotly debated issue.

Testimony Opposed to the Bill

Professor David A. Skeel of the University of Pennsylvania Law School testified in opposition to the legislation and in favor of maintaining the status quo. He argued that "removing the domicile and affiliate options would be an enormous mistake," which would undermine the effectiveness of our corporate bankruptcy system, increase the administrative costs of the system and hurt the very parties it is ostensibly designed to help. He further opined that "the objective of the reform is to make it harder for companies to file for bankruptcy in Delaware or New York."

Skeel noted that "corporations are creatures of the states" and that "removing a corporation's right to file for bankruptcy in a district in its state of incorporation would flip the traditional understanding of corporate regulation on its head."

Skeel also suggested that changing the venue rules would "destroy the expertise that has been developed in [New York and Delaware]" as well as decrease the overall effectiveness of the bankruptcy system. Skeel countered arguments that distantly filed cases are more convenient for large financial institutions and other participants at the expense of local interests by arguing that the "vast majority" of Chapter 11 cases, and the majority of large cases, are filed in the district where the company has its headquarters and principal place of business.

Moreover, he argued that the cases in which local creditors are most likely to wish to participate are the cases which tend to be filed locally. Most of the cases filed in New York or Delaware, on the other hand, are filed by companies for which no single location would be convenient for most of their local creditors.

Skeel offered two possible alternative solutions for the convenience problem, namely utilizing the existing change of venue provisions in 18 U.S.C. §1412 and making it as convenient as possible for creditors and other interested parties to participate in cases even when they cannot realistically appear in person, through use of electronic media and the representation of small creditors by the creditors committee.

The New York City Bar's Committee on Bankruptcy and Reorganization also submitted a letter in opposition to the bill, though it did not present testimony at the hearing. According to the committee, "such a proposal would force courts to ignore the often more important considerations examined under current law, such as (a) the location of the principal operating subsidiaries and whether the parent company itself is a mere holding company with no operations of its own, (b) the interests of justice and convenience of parties who will need to appear during the proceedings to protect their interests and (c) the interests of the state of incorporation."

Like Skeel, the committee argued that Section 1412 already ensures proper venue by allowing transfer to another jurisdiction in the interests of justice or the convenience of the parties. According to the committee, "reform legislation is unnecessary because abuses are routinely counteracted under the current statutory scheme."

The committee also argued that employees and other individuals actually have very little need to appear at a bankruptcy proceeding, whereas the parties that have the most need to appear are in fact the financial creditors and contract counterparties, the vast majority of which are usually located in New York.

The committee also argued that these creditors, in extending credit and engaging in other transactions before and during bankruptcy, rely on the consistency and certainty of the legal standards and practices in experienced jurisdictions such as New York and Delaware.

The proposed bill, on the other hand, would, according to the committee, require companies located in remote jurisdictions to forego the benefits of these sophisticated courts in favor of inexperienced jurisdictions with less predictable and potentially conflicting laws.

Testimony in Favor of the Bill

The Commercial Law League of America (CLLA) and its bankruptcy section offered testimony in favor of the bill, stating that "it constructively attempts to rebalance the interests of all parties in bankruptcy by making sure that the bankruptcy reorganization process remains within the regions and communities that have the most significant vested interest in the outcome." According to the CLLA, "bankruptcy is local" and involves a multitude of local issues including not only employment and the local economy, but also municipal services and even health care. Therefore, requiring that a corporate bankruptcy take place locally allows the participation, input and information that local parties provide and "ensures that the distinct needs of the community are not overlooked, or worse, ignored."

Frank J. Bailey, chief judge for the U.S. Bankruptcy Court for the District of Massachusetts, testifying on his own behalf, also testified in favor of the bill, arguing that the focus of forum selection should be on the convenience and best interests of the creditors and other nondebtor parties in interest, not just the debtor and its professionals. According to Judge Bailey, "The driving force in venue decisions in bankruptcy filings has become what is best for the lawyers and other turnaround and workout professionals that advise corporate management … this means the banks, bondholders, and hedge funds can, together with the debtor, select a venue that is convenient for them, and the employees, local governments, landlords and smaller vendors will be stuck with that choice."

Businesses where people work and invest their futures, Judge Bailey testified, are woven into the fabric of the community and often become iconic representations of the communities themselves. Locally filed cases would be far more convenient to, and allow much greater participation of, local creditors, the community and other interested parties. Allowing such distant filings, on the other hand, takes cases away from the employees who hope for a successful outcome to save their jobs and pensions, as well as the vendors who had come to expect that they would deal with the company locally.

As part of his testimony, Judge Bailey offered case studies of several large Massachusetts companies, including Polaroid Corporation and Evergreen Solar Inc. In each case, the company was founded and headquartered in Massachusetts, utilized many Massachusetts vendors and employed thousands of Massachusetts residents. Evergreen Solar was of particular local concern, according to Judge Bailey, because the company had received $58 million in state incentives to locate a plant in Massachusetts, the largest corporate incentive in state history. Yet each company filed for bankruptcy in Delaware, far from their primary bases of operations and far from many of the constituencies to which those companies were accountable.

Judge Bailey responded to the argument of Skeel and others that the current venue rules adequately provide for venue transfers where appropriate. According to Judge Bailey, these provisions are largely ineffective because the expense and difficulty of litigating a change of venue motion remotely, the strong presumption in favor of the debtor's choice, and the reluctance of creditors to file such motions (based on the fact that the same court that decides the motion will handle the case in the likely event that the motion is denied) make change of venue a near impossibility.

Judge Bailey concluded his testimony by stating that "at the very heart of the concept of venue is the idea that those affected by a court proceeding should have access to the proceeding."

Professor Melissa Jacoby of the University of North Carolina at Chapel Hill also offered testimony in favor of the bill. According to studies cited by Jacoby, since 2005, nearly 70 percent of the more than 200 large public companies that have filed for Chapter 11 bankruptcy did so in Delaware or the Southern District of New York.

Many of Jacoby's arguments in favor of the bill were based on the comparisons to other federal venue laws, which are far more restrictive than the current bankruptcy venue law, and which focus more on persons involuntarily brought before the court, such as defendants, rather than filers. According to Jacoby, the current bankruptcy venue law is an anomaly among venue laws that should be brought into line with other federal standards.

Jacoby also countered Skeel's contention that technology can be a substitute for local participation. She noted that video conferences can be costly and complicated, that telephonic appearances can be awkward, and that it is difficult for a judge to assess a witness' credibility over the phone.

Although it did not appear at the hearing, the National Association of Credit Management (NACM) has also offered its support to the bill. The NACM is an association comprised primarily of unsecured trade creditors. While it supports the bill as is, it has also recommended that the text be changed in order to ensure that it applies to both limited liability companies and corporations. As currently drafted, the bill would apply only to corporations.

Going Forward

Now that the hearing is complete, the House Committee on the Judiciary's Subcommittee on Courts, Commercial and Administrative Law will likely consider the bill in a "markup session." After that session the subcommittee may decide to report the bill favorably to the full committee, with or without amendment, report it unfavorably, or report it without recommendation. The subcommittee may also table the bill by postponing consideration indefinitely, thereby effectively killing the bill. The current status of the bill can be found anytime on "Thomas," the Library of Congress' bill tracking system, at http://thomas.loc.gov.

Whether or not the bill survives the subcommittee, its proposal illustrates the longstanding and ongoing concern within the bankruptcy community about the prevalence of magnet jurisdictions for Chapter 11 cases.

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