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THE WALL STREET JOURNAL.
WSJ.com

JANUARY 21, 2009

A Kinder Bankruptcy Law Is Sought as Filings Soar

By KRISTINA DOSS

As bankruptcy filings ramp up amid the world-wide financial crisis, companies are finding that changes made to the U.S. Bankruptcy Code three years ago have made it more difficult to restructure. But some experts believe relief could be on the way.

U.S. lawmakers are scrambling to find a way to revive the economy and the businesses that drive it amid the recession. Revamped laws designed to make the restructuring process kinder to struggling companies may be seen as part of the solution, bankruptcy experts say.

Such changes may provide "a mechanism by which people and businesses can begin economic life anew," said Jack Williams, resident scholar at the nonpartisan American Bankruptcy Institute. "Politically, the winds are right for revisiting bankruptcy law."

Changes to the Bankruptcy Code that took effect in late 2005 have made Chapter 11 a less hospitable shelter for struggling companies. Jay Westbrook, a law professor at the University of Texas, said lawmakers focused on changing the consumer provisions and didn't "carefully" work through the business amendments. As a result, provisions were added that gave companies less time and money to reorganize their businesses.

Some argue it is time to roll back those changes as more giant corporations that employ tens of thousands of people, including Lyondell Chemical Co. and Nortel Networks Corp., enter Chapter 11 protection.

Mr. Williams, who teaches bankruptcy law at Georgia State University, said bankruptcy-law changes would be "less drastic" than another bailout like the $700 billion package President George W. Bush signed into law last year.

Barack Obama has vowed to change bankruptcy laws to help struggling Americans stay in their homes, and Mr. Williams says bankruptcy reformists believe the new administration will be receptive to the idea of bankruptcy reform for businesses.

Lawmakers in the House of Representatives have already expressed interest in looking at the business provisions of the Bankruptcy Code. Rep. Linda Sanchez (D., Calif.), chairwoman of the House Judiciary Subcommittee on Commercial and Administrative Law, led a hearing in September examining whether bankruptcy laws were working in light of Lehman Brothers Holdings Inc.'s collapse and the liquidations of retailers such as Sharper Image Corp.

This is good news for bankruptcy experts tired of seeing companies enter bankruptcy only to go out of business. Retailers, in particular, have been hard hit by the changes, which sharply reduce the time they have to scale down their businesses.

Lawrence Gottlieb, chair of Cooley Godward Kronish LLP's bankruptcy practice, said the new 210-day deadline for companies to assume or terminate store leases has put retailers in a bind.

Most retailers make their profits during the holiday shopping season and need to go through at least one to determine which stores to close. But under the new deadline, a retailer that files for bankruptcy protection in the beginning of the year doesn't have that luxury.

The tight deadline, coupled with a downturn in the real-estate market, has also created headaches for retailers that want to make money by assuming and assigning store leases to a third party.

"Retailers don't have time to wait for the market to stabilize and then turn," said Richard Chesley, a partner at law firm Paul Hastings. "If you can't find someone to sell those rights to, you've lost the ability to monetize that asset."

Lenders are also wary of the 210-day deadline. It can take up to 150 days to get permission to conduct the store-closing sales and complete them, leaving only 60 days to figure out a Plan B.

"Banks walk in and say, 'You got to sell your company within 60 days and, if you don't sell it within 60 days, you have to start liquidation,' " Mr. Gottlieb said.

As a result, he said, nearly "every single retailer that has filed since 2005 has either sold their assets or been liquidated." Circuit City Stores Inc., Linens 'n Things, Steve & Barry's and Sharper Image are among the long list of casualties.

A provision added to the Bankruptcy Code in 2005 that requires companies to provide utility providers with adequate assurance of future payment within 20 days of entering Chapter 11 has also hurt retailers and other struggling companies.

Mr. Gottlieb said bankruptcy courts have interpreted this provision as requiring debtor companies to give each utility provider a cash deposit at the beginning of the case for each of its locations to keep the power on. "That is dragging liquidity out of the debtor when they can least afford it," he said.

Trade creditors have also moved to the front of the payment line, which adds to the upfront bankruptcy costs faced by already-cash-strapped businesses. Companies in Chapter 11 protection must pay in full for goods received within 20 days prior to their bankruptcy filing.

Another 2005 change that has come under the microscope is the amendment that put a huge swath of financial contracts outside of the purview of bankruptcy law. In 2005, credit-default swaps, repurchase agreements, mortgage-backed securities and other derivatives were added to the list of financial contracts exempted from the Bankruptcy Code's automatic stay, which blocks creditors from immediately seizing property for the payment of a debt.

Some experts have said the exemption of these contracts can kill reorganization chances and may even increase systemic risk to the financial system.

Mr. Westbrook, of the University of Texas, told lawmakers last fall that they should roll back that change, pointing to the impact it had when Lehman Brothers collapsed in September.

"Much of its asset base no doubt consisted of financial assets exempt from the automatic stay," Mr. Westbrook said. "Thus it is highly likely that many of its assets, probably overvalued to start, walked out the door just before or shortly after its bankruptcy filing, leaving only the dregs, relatively speaking, for the other creditors and stakeholders."

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Printed in The Wall Street Journal, page C3

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