Testimony of

Mr. Douglas Baird

July 22, 2003

Testimony Presented By

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Senate Judiciary Committee Hearing
Tuesday, July 22, 2003
SD-226, Dirksen Senate Office Building

"The WorldCom Case: Looking at Bankruptcy and Competition Issues"

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Introduction

I am the Harry A. Bigelow Distinguished Service Professor at the University of Chicago Law School. Since 1980, I have taught commercial law and bankruptcy at the University of Chicago, as well as at Harvard, Stanford, and Yale. I also serve as the Vice Chair of the National Bankruptcy Conference, and it is in that capacity that I appear today.

The National Bankruptcy Conference is a voluntary, non-profit, non-partisan, self-supporting organization of 61 bankruptcy judges, law professors, and lawyers. Its members are recognized experts in bankruptcy law and procedure, and they are committed to the improvement and integrity of the bankruptcy system. The organization came into being when members of Congress urged the country's leading bankruptcy experts to come together and help draft the Chandler Act of 1938, the first comprehensive revision of the Bankruptcy Act of 1898. For over 70 years, the NBC has assisted Congress in crafting this country's bankruptcy laws.

Today, I address the role that Chapter 11 plays when a firm in a troubled industry cannot pay its debts in large part because of the fraud and other crimes committed by its former managers. I make two observations.

? Chapter 11 promotes robust competition in a market economy. It allows assets to be used productively in compliance with all applicable nonbankruptcy laws and regulations even when those assets were previously managed by those engaged in harmful and criminal conduct.

? The proposal embodied in S.1331 on the tax treatment of NOLs on consolidated returns raises a long-standing issue of tax policy. Reforms in this complex environment ought to be undertaken with great care. While I take no issue on the ultimate merits, I believe that the issue deserves

much more serious study than it has received to date.

Chapter 11 Promotes Competition

Chapter 11 ensures that firms that can demonstrate their future viability can sort out their financial affairs while remaining effective competitors in the market. Chapter 11 is especially valuable when a firm's managers have engaged in fraud. Indeed, managers who engage in financial fraud injure most immediately workers, suppliers, unsecured creditors, and public investors. By allowing a viable firm to survive under new management, Chapter 11 minimizes the harm these innocent people suffer.

A firm's assets should not be sold for scrap as punishment for the misdeeds of its former managers. The person who commits a crime with a car must be punished. The car itself should not be. Destroying the car does nothing to help the victims of the crime. The same is true for a firm brought to financial ruin by dishonest managers. We must recognize the rights of the victims, but we do this by putting the assets to productive use and recognizing whatever rights they have as a result of the injuries they have suffered.

None of this, however, is to suggest any leniency towards those involved in wrong-doing. Individuals cannot receive a discharge in bankruptcy for liability for fraud or defalcation in a fiduciary capacity, embezzlement, larceny, or indeed any form of willful and malicious injury. See 11 U.S.C. §523(a)(4), (6). The Sarbanes-Oxley Act of 2002 precludes individuals from obtaining a discharge from debts related to violations of securities law. See Sarbarnes-Oxley Act of 2002, § 803(a), Pub. L. 107-204, 116 Stat. 745, 801 (2002)(adding Section 523(a)(19) to the Bankruptcy Code, precluding the dischargeability of debts arising from the violation of any federal or state securities laws).

Chapter 11 debtors do not get a dispensation from governmental rules and regulations. In fact, they are required to operate in compliance with all regulatory and other laws. See, e.g., 28 U.S.C. §959(b)("a . . . debtor in possession, shall manage and operate the property in his possession . . . according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof"). Therefore, Chapter 11 does not give firms a competitive advantage over others in their industry. Firms in bankruptcy are still subject to the same rules and regulations as everyone else. Antitrust laws and indeed all other regulatory regimes that exist outside of bankruptcy apply with full force inside of bankruptcy. A firm in bankruptcy can no more violate laws against unfair competition than pollute the atmosphere. Chapter 11 merely provides firms with an additional forum in which they can sort out their financial. Firms cannot and do not file for Chapter 11 to profit unfairly at their rivals' expense.

When viable firms can sort out their financial problems while they continue to operate, jobs are saved and markets work more effectively. The world would be a worse and less competitive place if Greyhound Bus or Dow Corning no longer existed. Bloomingdale's and Macy's survived notwithstanding ill-conceived LBOs when they were able to use Chapter 11 to deleverage their capital structures. In general, competitors have little interest in encouraging competition, while the public as a whole does. Hence, we do not give competitors a voice when firms are restructured, whether outside of bankruptcy or in. Chapter 11 does allow firms to reduce debt, but the financial restructurings that take place in bankruptcy are no different in kind from the restructurings that take place outside when a firm is sold or debt is converted into equity. If such de-leveraging makes operational sense, the legal system should facilitate it.

Firms that enter bankruptcy should not be discriminated against on that account alone. Section 525 of the Bankruptcy Code sensibly prohibits discrimination against entities because they are,

or have been, a debtor in bankruptcy. See Federal Communications Comm'n v. NextWave Personal Communications, Inc., 537 U.S. 293 (2003) (FCC could not discriminate against a Chapter 11 debtor simply because it had filed a case under Chapter 11). Workers, suppliers, and public investors should not be put at a special disadvantage merely because their firm is in Chapter 11.

Chapter 11 focuses only on a particular firm and asks whether that firm going forward can succeed, notwithstanding its past financial difficulties. Bankruptcy judges are poorly equipped to implement a regulatory process designed to ensure that an entire industry works better. Chapter 11 does not--and should not--weed out firms merely because of perceived overcapacity in an industry. In our legal and economic system no judge or agency determines who wins and who loses--even when the problem is overcapacity. The natural forces of competition provide the best means of identifying winners and losers in the economy. Chapter 11 is part of that process.

Even if we were to use government regulation to solve problem of overcapacity, the solution should be forward-looking. It should not weed out firms by looking at the bad acts of former managers.

Comments on S.1331

I also comment briefly on S. 1331 entitled "To clarify the treatment of tax attributes under section 108 of the Internal Revenue Code of 1986 for taxpayers which file consolidated returns." As we understand it, S. 1331 is intended to clarify the tax consequences of the following fact pattern:

Example 1. Acme and its wholly owned subsidiary file consolidated returns. Acme borrows $20 million from a bank and contributes the proceeds to its subsidiary. The subsidiary spends the $20 million in a deductible fashion, generating a $20 million net operating loss ("NOL") at the subsidiary level, while Acme itself breaks even. Acme then files itself and its subsidiary for bankruptcy, and upon emergence issues new Acme stock worth $5 million in exchange for the $20 million bank debt. Does Acme's $15 million in cancellation of debt ("COD") income reduce the loss generated by the consolidated group as a whole (here, the $20 million loss generated by the subsidiary)? Or does Acme's COD income reduce only Acme's own attributes (here, its basis in assets, including its stock in its subsidiary)?

If S. 1331 became law, this issue would be resolved in the government's favor by requiring Acme's COD income to be used to reduce the $20 million loss generated by its subsidiary.

I take no position on the merits of S. 1331. I do think, however, that it would be unwise for the Senate Judiciary Committee to take action on S. 1331 in this context and at this time for several reasons.

First, the issue is far more complex than it would appear to be from the simple hypothetical posed above. (The current edition of the standard treatise on consolidated tax returns devotes 11 single-spaced pages (and 19 detailed, substantive footnotes) to the topic. See Dubroff et al., Federal Income Taxation of Corporations Filing Consolidated Returns § 33.06[1] (2002).) This complexity reflects not only the inherent tension that the tax law faces in dealing with consolidated groups that are treated as a single entity for some purposes and as a collection of individual corporations for others, but also the highly interactive nature of the tax attribute system applicable in bankruptcy. We think it unwise to attempt to make rifle-shot changes to this complex tapestry of tax law without a much more broad-based, in-depth review by those with the greatest understanding of the extremely complicated issues raised by discharge of indebtedness in the consolidated return context.

One example of the sorts of dangers that may be in store if an opposite course is followed can

perhaps be found in S. 1331 itself. While apparently intending to clarify the state of existing law with respect to how COD income offsets NOLs and other consolidated attributes listed in section 108(b)(2) of the Internal Revenue Code, the bill erroneously references section 108(b)(1) (rather than 108(b)(2)), and then appears to require that all items listed in section 108(b)(2) be treated on an aggregate, group-wide basis, even though it could hardly be thought that extending this treatment to asset basis (see section 108(b)(2)(E)) could be thought to "clarify" existing law, since under no reading of that law could asset basis be thought to be subject to group-wide reduction when a member incurs COD income.

Second, I am not convinced that a policy consensus in favor of the result championed by S. 1331 has developed, even though the basic question that it addresses has been understood and debated for many years. For example, in 1990-91, the Section of Taxation of the American Bar Association formed a task force to study the problems involving cancellation of indebtedness in the consolidated return context. After months of work, the task force was unable to reach agreement on the very question addressed by S. 1331, and eventually prepared and submitted to the IRS separate reports favoring and opposing the result currently embodied in S. 1331. Indeed, even the IRS has had difficulty making up its mind on the issue. For a number of years, the IRS seemed to oppose the result suggested by S. 1331. See PLR 9121017 (Feb. 21, 1991). While it is true that more recently the IRS has shown some evidence of having changed its mind, see FSA 19991207 (Dec. 14, 1998); Chief Counsel Advice 200149008 (Aug. 10, 2001), it would appear that the IRS considers this issue to be part of a much broader policy dilemma dealing with consolidated returns that remains unresolved and under study.

This lack of consensus may well reflect the fact that, whatever the strength of the policy arguments in favor of the S. 1331 in circumstances like those in Example 1, those arguments are less compelling, if not unpersuasive, when the circumstances are somewhat different:

Example 2. Acme has two wholly owned subsidiaries, SubA and SubB, and includes both of them in its consolidated return. Acme contributes $20 million of its retained earnings to SubA, which spends the $20 million in a deductible fashion, generating a $20 million NOL at the SubA level. Meanwhile, SubB borrows $10 million from Bank and breaks even. If SubB were to file for bankruptcy and realize $3 million in COD income in the process of restructuring its debt to Bank, S. 1331 would appear to cause the $20 million loss incurred by SubA to be reduced by $3 million as a result of SubB's realization of COD income, even though SubA's loss had nothing do with SubB's debt. Is that an appropriate result?

Finally, the statute that S. 1331 would amend has been on the books for more than twenty years and reflects the many policy compromises--pro-debtor and pro-government--that led to the enactment of the Bankruptcy Tax Act of 1980. As Senator Grassley put it in a colloquy with Senator Santorum on May 15, 2003, "we are talking about tax legislation that has been on the books for an awfully long time." It seems to us that, whatever the merits of S. 1331 may be, it addresses an issue that should not be considered in isolation, apart from its historical context, but only as part of a global effort to revisit the entire framework of bankruptcy taxation. I and other members of the National Bankruptcy Conference would, of course, be delighted to participate actively in such an effort, if Congress were to choose to follow that course.

Conclusion

Congress should not overlook the role of Chapter 11 in fostering a competitive economy. As Thomas Friedman of the New York Times recently noted, a person designing the best economy to compete in the new global era:

would have designed a country with a system of bankruptcy laws and courts that actually

encourages people who fail in a business venture to declare bankruptcy and then try again, perhaps fail again, declare bankruptcy again, and then try again, before succeeding and starting the next Amazon.com--without having to carry the stigma of their initial bankruptcies for the rest of their lives . . . . In Silicon Valley, bankruptcy is viewed as a necessary and inevitable cost of innovation, and this attitude encourages people to take chances. If you can't fail, you won't start . . . .

THOMAS L. FRIEDMAN, THE LEXUS AND THE OLIVE TREE 369-70 (2000) (Updated and expanded Anchor Books edition).