

As Attorney General of Texas, John Cornyn argued that the Enron bankruptcy should have been filed in or moved to Houston, where the company is located. He may have lost that argument, but now as a current Senator from Texas, Cornyn has now introduced a bill (S. 314) to restrict the debtor's choice of venue to the principal place of business. Relying on support from academics such as Lynn LoPucki and Elizabeth Warren, and the Report of the National Bankruptcy Review Commission, Cornyn's bill would take aim at the forum shopping cited in cases such as Enron, K-Mart, Polaroid, WorldCom and others where the debtors filed in a far-off forum to allegedly escape close scrutiny by workers, retirees, trade creditors and the local press. Cornyn plans to try to attach his controversial bill to the pending bankruptcy bill or other legislative vehicle. Here, ABI Resident Scholar Jeffrey Morris analyzes the bill.

S. 314—Fairness in Bankruptcy Litigation Act of 2005

Restricting Venue Choices for Corporate Debtors

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Sen. John Cornyn (R-Texas) introduced legislation on Feb. 8 to amend 28 U.S.C. §1408 “to combat forum shopping” that the senator in his remarks on the Senate Floor asserted hurts “consumers, creditors, workers, pensioners, shareholders and small businesses.” Conspicuously absent from the list of injured parties are large corporations. They are assumed to be the debtors who are scouring the country for just the right location to file their chapter 11 petition.

The current law gives the potential debtor several venue options. The debtor can file in the district where its principal place of business is located, and it can also choose the district where its principal assets are located. More “exotic” venues are also available under the statute. The corporate debtor can file a petition in which it is domiciled. As noted in the report of the National Bankruptcy Review Commission, “the ‘residence’ and ‘domicile’ of a corporation were treated identically, as the state of incorporation.”¹ Consequently, the state of incorporation offers another venue option for a corporate debtor. The even more “exotic” form of venue selection is available under §1408(2). This provision permits a debtor to file a case wherever an affiliate of the debtor has a case pending. A subsidiary corporation is an affiliate as that term is defined in Bankruptcy Code §101(2). This is the venue provision that allowed Miami-based Eastern Airlines to file its case in the Southern District of New York by joining its affiliate debtor, Ionosphere Inc.² The proposed legislation is intended to combat these acts and restrict the discretion in the selection of the court that will hear the case.

State of Incorporation

Because the statute applies to all debtors, the bill does not delete the reference to residence and domicile as a basis for venue. Instead, it amends §1408 by inserting a new subsection (b)(1) that defines a corporation’s domicile and residence as “where the

debtor's principal place of business is located." This definition would prevent the debtor from filing in a district where the debtor is incorporated unless that district also happens to be the debtor's principal place of business. This is consistent with the reform proposed in the 1997 Report of the National Bankruptcy Review Commission. The Commission noted that when other federal venue provisions allow the filing of cases in the district of the state of incorporation, it is the defendant's state of incorporation that provides the venue option, not the plaintiff's state of incorporation. These provisions effectively recognize that the venue being selected is one that the defendant has already voluntarily used in the past. In a bankruptcy case, on the other hand, it is the debtor who is acting like a plaintiff and is selecting the venue. Thus, the other federal venue provisions do not offer a relevant example to follow.

The Commission also noted that amending §1408 to remove the state of incorporation as a basis for venue of a case returns the law to the practice under the law up to 1979, the effective date of the Bankruptcy Code. From 1973-79, state of incorporation was not a ground for venue of cases.³ The Bankruptcy Code returned that concept to the law beginning in 1979, and the state of incorporation has been a basis for venue of cases ever since.

Employing the state of incorporation as a proper venue might be appropriate in the sense that corporate governance issues can arise in these cases, and the law applicable to those questions would be the law of the state in which the court sits. There would presumably be greater familiarity with that law by the bench, and this would provide a more efficient forum for the resolution of those issues. The problem, however, is that corporate-governance issues typically are not nearly as important in the case as issues relating to the debtor's relationships with its creditors and other parties in interest. Thus, the "extra" expertise regarding the applicable state corporate law gained by the case being filed in the state where it is incorporated is relatively limited. Filing a case in a district in the state where the debtor is incorporated can present significant difficulties for the non-debtor parties who may have no connection to the state. Distance from the courthouse can present problems for these parties. Participation in the case will require hiring local counsel (probably in addition to the attorney who represents the creditor in its locale). If the entity wants to (or must) participate personally in the case, travel expenses and the related costs such as time away from other business make the real cost of participation even greater. Removing the state of incorporation as a ground for the venue of cases does not completely solve this problem because the creditor or other party in interest may not be located where the debtor has its principal place of business. Nevertheless, more creditors are probably located at or near the debtor's principal place of business as compared to its state of incorporation.

The "Affiliate" Rule

The more controversial venue provision is the rule that allows a debtor to file a case in any district in which there is already pending a case commenced by or against an affiliate. This venue provision, set out in current §1408(2), is intended to allow connected entities to proceed in the same court to avoid inconsistent rulings and to improve the prospects for providing full relief for the related parties. While well intentioned, the rule has been used in the past to create a right to venue for a troubled company by initiating a case by a subsidiary (or other type of affiliate) and then following the first filing with a

filing by the larger company that is facing financial difficulties and that could not have filed a petition in the particular jurisdiction other than by means of the affiliate venue rule. As noted above, Eastern Airlines took advantage of this provision. More recently, Enron Corp. followed this path when its subsidiary, EMC, a commodities trading firm, properly filed its chapter 11 petition in the Southern District of New York. Enron Corp. then followed its subsidiary and commenced its chapter 11 case in the Southern District.⁴ As Sen. Cornyn noted in his floor remarks when introducing the bill, "Houston was where the majority of employees and others who were victimized by that corporate scandal called home." Yet the affiliate venue rule permitted Enron to file in New York.

The amendment would not entirely reject affiliate filings, but it would substantially curtail the practice and probably effectively put an end to it. Under the amendment, a corporate debtor can file its case in the same district where a case is pending for a corporation that is in control of the entity that now wants to be a bankruptcy debtor. Control is defined in the amendment by cross reference to the definition of control in §2 of the Bank Holding Company Act of 1956. Therefore, under the amendment, a corporate debtor may file a case in a district in which it does not maintain its principal place of business if there is already pending in that court a case of a corporation that is in control of that debtor. In other words, the subsidiary can follow the parent into a particular bankruptcy court, but the parent cannot follow the subsidiary. In "biblical" terms, the amendment says "Thou shalt not allow the tail to wag the dog."

The senator cited several other examples of forum shopping that he asserts demonstrate the need for enactment of the bill. Among the cases listed as examples of blatant forum shopping are Polaroid (Boston company filed in Delaware), K-Mart (Michigan company filed in Chicago) and WorldCom (Mississippi company filed in S.D.N.Y.). The venues selected in these cases would be improper under the proposed amendment to §1408. Sen. Cornyn also appended to his remarks correspondence he has received in support of the proposal from a number of bankruptcy professors and practitioners who believe that the current venue provision is fatally flawed.

A message that one can derive from the bill and the Senator's remarks is that debtors forum shop to obtain improper advantage over other parties. The advantages can result simply from the court being in a location distant from significant constituencies in the case, to a veiled suggestion that some courts will not sufficiently protect the legitimate interests of victims of corporate scandals because the "remote" court will not be sensitive to the interests of the "local" harms being suffered.

Venue should be irrelevant to these matters. Venue does not change the uniform federal law that is applicable to the pending case, it simply involves the physical location of the court in which the disputes will be heard. Nonetheless, as the Bankruptcy Commission recognized, the reality is that venue selection can have a significant impact not just on the specific case before the court, but on the development of the bankruptcy law generally. As more and more decisions are rendered by just a few courts, those courts arguably take on a greater significance than is appropriate in a national, uniform bankruptcy system as contemplated by the Constitution.

One thing that can safely be said about the bill is that it will not go unchallenged in Congress. When the Commission engaged in its study of the problem, the State Bar of Delaware presented a substantial report to the Commission in support of the affiliate and

state of incorporation venue provisions. Such groups have strong advocates in the Senate and on the Judiciary Committee in particular, such as Sen. Biden of Delaware.

It might be interesting to keep an eye on Sen. Cornyn's positions in the debate. He has staked out a position that chastises the perpetrators of corporate fraud who take advantage of a "troubling loophole" in the venue provisions to evade their financial commitments to the detriment of their creditors. Amendments will be offered to restrict the use of state homestead exemptions on the grounds that some state exemptions are really just "troubling loopholes" that protect debtors in palatial residences who live in luxury while leaving their creditors high and dry. Texas is prominent on the list of states with unlimited homestead exemptions. Will Sen. Biden remind Sen. Cornyn of that fact during the debates on the bill to restrict the venue of bankruptcy cases?⁵

Footnotes

1 *Report of the Nat'l. Bankr. Rev. Comm.* at 772 (Oct. 27, 1997) (citations omitted).

2 *Id.* at 775. The Commission Report also noted that "there was no indication that Ionosphere was in need of bankruptcy protection or a financial restructuring." *Id.*

3 *Id.* at 772.

4 See *In re Enron Corp.*, 274 B.R. 327, 341 (Bankr. S.D.N.Y. 2002).

5 See the full text of the bill at thomas.loc.gov/cgi-bin/bdquery/z?d109:s.314.