CHAPTER 2: BUSINESS BANKRUPTCY

INTRODUCTION

Business bankruptcies are only a small fraction of all filings -- about 4% overall -- but the bankruptcy system is a critical part of the cycle of business life and death in the American economy. Principally through Chapter 11, business bankruptcy creates the opportunity to restructure failing businesses, to preserve jobs, to prevent the spread of economic failure to smaller suppliers and other dependent businesses, and to permit communities to retain their tax base. Liquidation is also an important part of the business bankruptcy system, providing an efficient and orderly way to dissolve a business and to distribute its assets equitably among parties who might otherwise see no recovery at all.

The Commission’s recommendations reflect a conclusion that the business bankruptcy system generally works well, at times very well, but that it can be improved. The Recommendations, many passed without dissent, reflect the diversity of issues that arise in business bankruptcy and the possible approaches to improving the system. Four different working groups addressed issues that arise in business cases: the Chapter 11 Working Group, the Small Business, Partnership and Single Asset Working Group, the Transnational Bankruptcy Working Group, and the Mass Tort and Future Claims Working Group. In addition, the Commission as a whole worked to develop proposals on some of the issues that arise most often in a business context, such as the treatment of executory contracts and leases.
The Commission addressed different types of problems in business cases. In some areas, new problems have arisen that were not fully anticipated at the time Congress adopted the 1978 Bankruptcy Code and, as a result, must be resolved with little or no statutory guidance. The unique challenges of mass tort cases have forced courts and parties to struggle in a legal framework not designed for those cases, creating inconsistent approaches in different cases. Partnerships, with their dual partner/partnership liability, also have presented special challenges not recognized in the 1978 Code. The increasing globalization of businesses has intensified the need for transnational cooperation to deal with failing companies. While the 1978 Code reflects Congress’ foresight in including some provisions to deal with transnational bankruptcies, international developments now present both a new need and a new opportunity to improve the bankruptcy system. In these three areas, the Commission developed new structures tailored to significant changes in the business and financial world.

In general, however, most of those who use the system or comment on it agree that the basic structure of business bankruptcy law is sound and needs only fine tuning to clarify ambiguities and reduce cost and delay. The structure of the system has been largely intact since the Great Depression. The major change in the 1978 Code involved the consolidation of three chapters and approaches: separate systems for publicly traded companies, small businesses and single asset cases were fused into a single business reorganization chapter. Chapter 7 liquidation continued to be available for both individuals and businesses of all sizes, but reorganizations for all business entities were combined into a new Chapter 11. It is unsurprising that such an important conceptual change would produce inconsistencies and controversy. Moreover, as more diverse businesses have used the business bankruptcy system, additional areas of the Code have been tested, revealing some ambiguities in the law and some inefficiencies in practice.

From the Commission’s work comes the creation of three new statutory frameworks: mass future claims, transnational bankruptcy, and partnerships. The remainder of the Commission’s recommendations address the existing system, offering recommendations to amend or to clarify current provisions: Chapter 11 generally, small business bankruptcy, and single asset real estate bankruptcy.

Mass Torts

Mass torts present a new challenge to the entire American civil justice system. The present system of case-by-case litigation is not only extraordinarily expensive and wasteful, but it also threatens to deprive claimants at the end of the line of any recovery if the business eventually fails. Those who do not seek immediate legal representation when they are injured and those who discover their injuries only later may find that the first claimants have recovered and the business has disappeared, leaving the latecomers with no compensation. Moreover, huge prospective liabilities
can have an enormous, adverse impact on otherwise sound enterprises that are vital to the American economy; their destruction can cost thousands of jobs and seriously harm the communities that depend on them. A mechanism to deal with prospective liability can give these businesses access to capital markets and permit them to remain contributing members of a community, while it gives them the opportunity to generate the money they will need to compensate those they have injured.

Business failures involving mass torts were largely unknown when the Johns-Manville Corporation’s Chapter 11 filing in 1982 required a bankruptcy court to resolve tens of thousands of claims for present and future asbestos injuries. The bankruptcy court and the appellate courts, as well as all of the litigants, had no choice but to create procedures and practices in this uncharted territory. Not surprisingly, the practices were disputed at almost every turn. Although Congress ultimately adopted amendments to deal with asbestos cases, other mass tort cases involving breast implants, toys, plastic pipe, airplanes, medical devices, and boilers have worked their way through the courts without the benefit of a specific statutory structure. The result is excessive cost and litigation, delay, and uncertainty. Too large a fraction of available resources is devoted to attorneys’ fees rather than to compensation for victims and the reorganization of the company to preserve jobs.

When Congress adopted the asbestos amendments in 1994 to address massive personal injury and property damage in a single industry, it took the first step in developing a coherent procedure for dealing with these kinds of claims through bankruptcy. The Commission has built on the experiences of the asbestos cases and other cases involving massive liabilities to make recommendations to deal with mass tort and mass contract claims.

Resolving massive claims is inherently complicated, in part because of the sheer number of claims and in part because the claims themselves involve difficult conceptual issues. Mass tort cases often involve claimants not yet injured or injured but not yet aware of the injury, invoking questions about the fairness of compensation for both present and future victims. The Commission’s Proposal creates a special class for “mass future claims” and establishes procedures in a reorganization to safeguard the rights of the people who hold these claims. Parties may work together with a future claims representative to create a mechanism, such as a trust or private insurance, to provide compensation for people who may not even know of their injuries for years to come. The Proposal establishes guidelines for the appointment of mass future claims representatives, for channeling injunctions and for plan confirmation issues. In addition, it creates other specialized tools to deal with massive liabilities in bankruptcy, without disturbing the basic Chapter 7 and Chapter 11 structure.

The mass future claims issue may have been one of the most conceptually challenging issues addressed by the Commission. At several points, the Commission
was on the verge of concluding that any system designed to deal with these extraordinarily difficult questions would be inadequate in some way. The Commission has made specific and comprehensive recommendations, however, without dissent and with the realization that the only way that all victims in mass liability cases can receive fair compensation, where the mass liability threatens the very existence of the company, would be through a fully developed structure to address the problems. That would maximize the value of the business, enhancing the ultimate return to all victims, from the first to file a claim to the last.

Transnational Bankruptcy

In the 1978 Bankruptcy Code, Congress included, for the first time, provisions to enable courts to deal with the insolvencies of businesses that had assets or creditors across national borders. Since then, the United States has encouraged international cooperation in multi-national business failures, but the tools have been limited and successes have been hard won. As a business fails, the impulse is nearly irresistible in most countries to seize all of the assets located within that jurisdiction for distribution to domestic creditors. This approach essentially destroys the concept of equality of distribution for all creditors. It also eliminates any opportunity to reorganize a failing business. The seizure of foreign assets is an event from which few troubled businesses can recover. While the transnational provisions in the United States’ Bankruptcy Code today are among the world’s strongest in promoting international cooperation, without similar provisions in the laws of other countries, they will remain inadequate to deal with most international business failures.

Since Congress adopted the 1978 Code, the growth of global businesses and the global failures that followed prompted the United Nations Commission on International Trade Law to develop a more comprehensive approach to dealing with insolvent businesses. In September 1997, UNCITRAL adopted a model law to develop a basic structure when bankruptcies involve debtors and creditors that are in more than one country. The United States has taken a leadership role in this work. The Commission, with the able guidance of Professor Jay Westbrook, has had the opportunity to review the model law and to explore the modest changes necessary to bring the United States’ laws into conformance with the model law on transnational insolvency. The Commission unanimously recommends these changes to further the efficient and fair treatment of both debtors and creditors involved in international businesses in liquidation and reorganization.

Partnership and Partner Bankruptcies

Another difficult conceptual issue is partnership and partner bankruptcies. The 1980s saw a sharp rise in the number of businesses operating in partnership form, and they range from informal two-person arrangements to complex structures of general and limited partners whose constituents are all corporate entities. As the
partnership form has grown, both in number and complexity, some have entered bankruptcy either for liquidation or reorganization.

In the 1980s and early 1990s, a number of high profile partnership bankruptcies, including some well-known law firms, highlighted gaps in the Bankruptcy Code for partnership failure. Because both a partnership and its partners are liable for the partnership’s debts, both liquidation and reorganization become very complex. For example, difficult questions arise when a trustee tries to enforce contribution claims against individual partners as the trustee collects the assets of the partnership estate. In addition, the Uniform Partnership Act dissolves a partnership whenever either the partnership or a single partner files for bankruptcy. If this rule is applicable in bankruptcy, the business will dissolve -- calling into question not only whether a partnership can ever reorganize in bankruptcy, but whether a bankruptcy court can administer any of the assets or oversee their pro rata distribution to creditors in liquidation. In this area, the case law is chaotic. With few statutory provisions in place in the 1978 Code, courts have taken diametrically opposing views on a number of important issues.

The difficulties presented by the bankruptcies of individual partners are equally complex. Questions arise about the disposition of the debtor partner’s interest in a partnership if the partnership agreement contains a buyout provision triggered when a partner files for bankruptcy. The enforcement of these provisions could deprive the bankruptcy estate—and the debtor’s creditors—of substantial economic value. State partnership laws determine which assets are used to pay individual debts and which are used for partnership debts, notwithstanding the bankruptcy rules establishing priority of creditors’ payments. As with partnership bankruptcies, courts have had little guidance in this area, and the case law is divided.

The Commission’s task was to develop recommendations to create a new legal framework for the bankruptcies both of partnerships and of individual partners that fit the existing structure in Chapter 7, Chapter 11 and Chapter 13. The Commission was able to build on the work of the National Bankruptcy Conference and an ad hoc committee of the American Bar Association, which collectively addressed many of the issues. The Commission’s recommendations create an efficient, unambiguous mechanism for the complete resolution of the liability of general partners to partnership creditors and the related contribution and indemnity claims of and against general partners. These recommendations would help resolve the conflicting case law that now governs partnership and partner bankruptcies.

The Current System

The Commission’s other business bankruptcy recommendations proceed from a very different perspective, and some of which were the subject of more controversy within the Commission. In these areas, the Commission reviewed the typical business
cases. The Commission working groups studied Chapter 11 generally and small business and single asset real estate cases separately.

Throughout the discussions, the lack of data available to evaluate the Chapter 11 system was particularly troubling. The statistics most frequently cited dealt with the low plan-confirmation rate in Chapter 11, which an Ernst & Whinney study pegged at 17% for cases filed between 1979 and 1986.\textsuperscript{781} The study estimated that 20 to 30% of the confirmations resulted in liquidating plans, leading one government researcher to speculate that perhaps only one in ten companies that enter Chapter 11 successfully confirms a plan to reorganize the business.\textsuperscript{782} As the Chapter 11 Working Group explored these data, however, the Group did not conclude that the numbers were necessarily a cause for dismay. More than 95% of the publicly traded companies in Chapter 11 successfully reorganized,\textsuperscript{783} suggesting that Chapter 11 was a successful vehicle for the largest cases involving the greatest number of creditors, the most significant assets, and the largest number of jobs.

The low confirmation rate also suggests that many businesses use bankruptcy to solve business problems without the need to complete a formal plan of reorganization. Many of the practitioners who testified noted that Chapter 11 cases that were dismissed did not necessarily fail. They explained that once the debtor and its principal creditors reached an agreement, they often would voluntarily dismiss the pending bankruptcy case. Some of the most successful Chapter 11 cases appear in the data under the heading “dismissed.” Of course, since Chapter 11 also attracts some “dead-on-arrival” businesses, one of its principal functions is to identify and to funnel hopeless cases into a speedier, more efficient liquidation than under non-bankruptcy law. Without more complete data, it is impossible to know just how much success and just how much failure are represented in the low Chapter 11 confirmation rates.

\textsuperscript{781} Ernst & Whinney, Report to the Administrative Office of the United States Courts on Bankruptcy Financial Information (May 1989). Under contract to the government to review bankruptcy fees, the firm studied 2,400 Chapter 11 cases filed between 1979 and 1986. The study estimated that 20 to 30% of the confirmations resulted in liquidating plans, leading one government researcher to speculate that perhaps only one in ten companies that enter Chapter 11 successfully confirms a plan to reorganize the business. As the Chapter 11 Working Group explored these data, however, the Group did not conclude that the numbers were necessarily a cause for dismay. More than 95% of the publicly traded companies in Chapter 11 successfully reorganized, suggesting that Chapter 11 was a successful vehicle for the largest cases involving the greatest number of creditors, the most significant assets, and the largest number of jobs.

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\textsuperscript{782} Id. at 10-13. Susan Jensen-Conklin conducted a single-district study of 45 confirmed Chapter 11 cases to determine how many of those cases consummated their plans. She discovered that 10 cases were either liquidated or dismissed. Susan Jensen-Conklin, Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law, 97 COMMERCIAL LAW JOURNAL 297 (1992).

\textsuperscript{783} Lynn M. LoPucki & William C. Whitford, Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies, 1991 WIS. L. REV. 411, 441 n. 105 (finding a confirmation rate of 89-96% among largest cases filed between 1979 and 1988).
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The Commission was aware as well that Chapter 11 serves as a model for out-of-court restructuring. Parties negotiate in the shadow of Chapter 11, restructuring companies without taking them through a formal bankruptcy proceeding. This “non-bankruptcy-bankruptcy” and a related mechanism, the “prepackaged” bankruptcy, demonstrate the advantages of a clear legal structure to identify the rules of business reorganization. America’s thriving work-out business may demonstrate that a functioning bankruptcy system is most valuable to troubled companies that do not formally use it but that rely on its guideposts in debt restructuring negotiations. It also served to remind the Commission that any changes to Chapter 11 will affect business workouts generally.

The difficulties of understanding and making policy recommendations with limited data were magnified for some business cases—especially small business reorganizations and single asset cases. For example, while the Working Group on Small Business, Partnership, and Single Asset cases tried to develop specific data about these cases, the recommendations were ultimately drafted without empirical information on the differences in practices between these cases and Chapter 11 cases generally. The absence of data also made it difficult to estimate how many small business would be swept into particular definitions of “small business cases” and “single asset cases.” The difficulties encountered in developing these Commission Recommendations emphasize the importance of the Commission’s discussion of the need to improve data collection and reporting. The adoption of the data collection and reporting Recommendations, which appear in Chapter 4 of this Report, would be particularly useful in making policy decisions designed to affect only a subset of troubled businesses.

The Chapter 11 Working Group, charged with reviewing the business bankruptcy system generally, began its work with a broad-ranging discussion of the policy objectives in the law. The initial meeting, in June 1996, started with the question of whether Chapter 11 should be sharply modified or abandoned altogether. Judges, lawyers, investment analysts, bankers, accountants, businesspeople, and academics joined the working group in these discussions. Some of the lawyers represented only creditors and others represented debtors, while the academics included critics of the current system. The debates were lively and wide-ranging, but there was widespread agreement about the general goals served by a Chapter 11 system:

- Maximize enterprise value
- Preserve jobs
- Rehabilitate viable businesses
- Encourage out of court restructuring
- Resolve distributive decisions
- Promote efficiency
- Benefit other parties affected by business failure
After the initial meetings, the Chapter 11 Working Group called on the business and legal community to help it develop an agenda for the most pressing problems in reorganization cases. As the issues were identified, the Working Group drew on the expertise of a diverse and ever-changing group of professionals. Ultimately, the Chapter 11 Working Group worked with approximately 200 businesspeople, practicing lawyers, investment analysts, academics, trustees, and judges and with 15 organizations to ensure that it had considered every idea and alternative in dealing with business bankruptcy issues.

In addition, a group of bank representatives formed an Ad Hoc Group of Secured Creditors to review in detail every proposal from the Chapter 11 Working Group. The group offered its well-reasoned thoughts and suggestions at a series of Commission meetings. Notwithstanding the diversity of perspectives represented, there was widespread (although not unanimous) agreement that the Chapter 11 system was generally functioning well and that adjustments to the system, which could have widely-felt implications throughout the economy, should be modest in scope.

One challenging task undertaken by the full Commission was a review of the chaotic case law involving executory contracts under 11 U.S.C. § 365. This section of the Code governs the treatment of all of the debtor’s contracts in force at the time of the filing, based on a determination that a contract is “executory” at the time of filing. The Commission proposes a more direct analysis, dropping the concept of “executoriness” in favor of straightforward rules regarding the breach or performance of a contract. While the Commission’s Recommendations will not solve all the difficulties that have arisen in section 365, they will provide a more solid conceptual foundation and eliminate a large portion of the current litigation. The Recommendations also would grant compensation to nondebtor parties for injuries they suffer from the trustee’s delay in the decision to breach or perform a contract, thus assuring balance between the interests of the estate in reorganization and fairness to the nondebtor party who may or may not be called on to perform under the contract.

Prepackaged bankruptcy plans are cost-saving, time-saving innovations that have become a significant part of the business bankruptcy system in the last 20 years. The Commission developed a number of proposals to permit the efficient resolution of these cases, such as elimination of mandatory waiting periods for plan voting and expansion of the opportunities for prepetition solicitation of support for a plan. In cases that are appropriate for a prepackaged treatment, the Commission’s Recommendations should facilitate their use.

The actual operation of business cases received significant attention. The Commission recommends simplification and clarification of the asset sale process during a bankruptcy, freeing assets more quickly for distribution to creditors. Pre-
bankruptcy waivers have been increasingly included in loan documents as one creditor attempts to limit the rights of other creditors in bankruptcy and to tie the hands of the debtor in a reorganization effort. The Commission recommends invalidation of these clauses that potentially permit one party to opt out of a collective bankruptcy proceeding.

The Commission recommends several changes to the plan confirmation process that are designed to settle disputes or uncertainties in the law that have led to expensive, time-consuming delays. Not without dissent, the Commission explicitly endorses the new value exception to the absolute priority rule, as articulated by the U.S. Court of Appeals for the Ninth Circuit in *Bonner Mall* and, more recently, by the Seventh Circuit in *203 North LaSalle Street Partnership*. That support, however, carries an important qualification: the Commission recommends that any debtor in possession that attempts to “cram down” a new value plan should lose the exclusive right to propose a plan of reorganization. This caveat will give other parties the right to propose their own plans of reorganization and, in effect, to make their own bids for the business. This proposal is more favorable to creditor interests than the current case law in the area and thus adjusts the Chapter 11 balance slightly, but the Commission believed that it was beneficial to permit the market, rather than the court, to value a business in reorganization.

The rules governing classification of creditors are also clarified in the Commission’s proposals. The appellate courts have used some variation of the “rational business justification” test adopted by the Commission, but litigation continues as other standards also have been used. The Commission’s Recommendation would settle the litigation by focusing on the business reasons for classification—the standard that best embraces the business-oriented approach that should guide most decisions in any reorganization.

The Chapter 11 proposals also include amendments to facilitate mediation, to strengthen the investigatory powers of examiners, and to govern postconfirmation modification. Some small, but persistent, injustices in Chapter 11 are also addressed. The Commission recommends, for example, that when a company files for bankruptcy, the money it holds for its employees, such as deductions to pay for medical insurance or savings bonds, be treated as the employees’ funds, not assets of the debtor company. That will free those funds from the grip of the law’s automatic stay, making them immediately available to the employees. Overall, the Chapter 11 proposals make changes that should reduce litigation and enhance the procedures of most Chapter 11 cases.

Perhaps the most substantial changes recommended in the Chapter 11 process address small business bankruptcies. The Working Group on Small Businesses, Partnerships and Single Asset Cases dealt with some of the practical effects of the decision by Congress to bring all business reorganization cases into a single chapter
in 1978. While there were many points of view on the subject of small businesses that file for bankruptcy, the Small Business Working Group focused on evidence that small cases are not flourishing in the general Chapter 11 structure. The Bankruptcy Reform Act of 1994 enabled businesses to elect small business treatment that shorten deadlines for plan confirmation, but the work of the Small Business Working Group has gone further.

The Recommendations separate the treatment of small businesses and large businesses in both their access to Chapter 11 and the rules by which they may try to confirm plans of reorganization. With some dissent, the Commission adopted a series of proposals to make Chapter 11 less hospitable for some small businesses, intended to force the dead or dying small businesses into liquidation more quickly. Unlike the 1994 Amendments, the proposed small business Recommendations would be mandatory for all small businesses, and they would increase rather than decrease some reporting requirements, heighten supervision, and shorten other deadlines.

The Commission’s proposal on small businesses applies to all businesses with unsecured debts less than $5 million at the time of filing and to all single asset real estate cases, regardless of size. Debtors would have increased reporting responsibilities. A small business debtor would be required, for example, to file within three days after filing bankruptcy a balance sheet, statement of operations, and cash-flow statement and the debtor’s most recent tax return or a statement made under penalty of perjury that no such financial statements had been prepared or that no tax return had been filed. Small business debtors would then be required to attend meetings for initial debtor interviews and court-ordered scheduling conferences—in addition to the meetings of creditors that all debtors, large and small, must attend.

Small business debtors also would have to permit on-site inspection of their premises and of their books and records. They would have 10 days to establish separate deposit and tax accounts, and they would be limited to 30 days to file all schedules and statements of financial affairs. These businesses would face dismissal from Chapter 11 if they failed to comply with obligations to file their tax returns, maintain current insurance, or pay all non-contested post-petition tax claims in a timely manner. Small businesses, unlike their larger counterparts, would not receive an automatic stay if they made a second trip to bankruptcy within a two year period.

The Commission’s Proposal would impose on small businesses new and uniform reporting requirements on the debtor’s profitability, projected cash receipts and cash disbursements, including comparisons with actual cash receipts from prior reports. Small business debtors also would be required to report on “such other matters” as “may be called for in the best interests of debtors and creditors and the public interest.” The Commission’s Recommendations would simplify plan disclosure statements, but they also would shorten the time available to confirm a plan of reorganization. Extending the time to confirm a plan would be more difficult for small
businesses than for large ones. Even if no creditor objected to the extension, the U.S. Trustee would be required to be involved in any decision to extend the time to confirm a plan of reorganization to “defend the public interest.”

Not all of the Recommendations from the Small Business Working Group were limited to small businesses. The Commission adopted the Recommendation of the Small Business Working Group to modify the Code for all debtors to expand the grounds for which any debtor—not just a small business debtor—could be dismissed from bankruptcy. The Commission recommends 12 new grounds for the dismissal of a Chapter 11 case, as well as additional grounds for the appointment of a trustee to replace the manager of the business. One important feature of the Commission’s proposals is the enhanced role the U.S. trustee would play in intervening in small business bankruptcies.

The Small Business Working Group also proposed a set of Recommendations to deal with single asset real estate cases. These cases typically involve a single apartment house or office building, although the proposed Recommendations would expand the definition. Since their inclusion in Chapter 11 in 1978, these single asset businesses have been the source of a great deal of litigation, significantly influencing the development of the law governing reorganizations. In 1994, Congress added a provision to the Bankruptcy Code to move small single asset real estate cases through the system more quickly. Here, the Commission offers a group of proposals to change further the treatment of such cases. The single asset real estate proposals were not fully developed until after the final meeting of the Commission. In a divided vote, the Commissioners voted by mail ballot to approve them. An alternative approach, prepared by Professor Kenneth Klee, which the full Commission did not have the opportunity to consider, also appears in the final section of this chapter. Five Commissioners expressed their support for the alternative approach.

Two principles guided the Commission in developing its business bankruptcy recommendations: reducing cost and inefficiency in business reorganizations and liquidations and enhancing the effectiveness of the Bankruptcy Code to deal with business failures. The number of Recommendations in this section—more than 70 were adopted—suggests that there are many ways in which these principles found expression. Some recommendations, such as those dealing with mass tort and partnership cases, would replace cumbersome and uncertain procedures developed in the absence of clear statutory guidance. In other cases, such as prepackaged bankruptcies, new rules proactively would facilitate the reorganization or liquidation process. Other types of recommendations would resolve disputes in the courts over ambiguous statutory language. And all of these recommendations should reduce delay, attorneys’ fees, and court time in developing a workable plan of reorganization, leaving more money on the table for the creditors. Collectively, the business bankruptcy proposals are designed to improve a system that generally works well and
to create and sharpen the tools needed to deal with business failures for the next 20 years.