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### An Efficiency-Based Explanation for Current Corporate Reorganization Practice

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## REVIEWS

**An Efficiency-Based Explanation for Current  
Corporate Reorganization Practice***Kenneth Ayotte*<sup>†</sup> & *David A. Skeel, Jr.*<sup>††</sup>*Courting Failure*

Lynn M. LoPucki. Michigan, 2005. Pp xii, 322.

## INTRODUCTION

Twenty-two years ago, a young law professor named Lynn LoPucki published an empirical study that offered a startling insight into corporate reorganization practice under the then recently enacted 1978 Bankruptcy Code.<sup>1</sup> The new Code gave corporate debtors and their managers so many protections, LoPucki concluded, that creditors were stymied and debtors were in “full control.”<sup>2</sup> The article became a minor classic—identifying many of the effects that would figure prominently in subsequent debates over whether Chapter 11 of the Bankruptcy Code was too debtor-friendly—and it inaugurated LoPucki’s career as a leading corporate reorganization theorist and empiricist.

During the decade that followed, Professor LoPucki and his colleague Bill Whitford conducted a mammoth empirical examination of, to use the phrase that recurred in the titles of the many articles the study produced, “the bankruptcy reorganization of large, publicly held

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<sup>1</sup> Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure under Chapter 11 of the Bankruptcy Code?: First Installment*, 57 Am Bankr L J 99, 103 (1983) (finding that, after three years of enactment, the Bankruptcy Code of 1978 was severely deficient and left too many large firms to fail again after emerging from Chapter 11 bankruptcy, largely due to the inappropriate amount of control maintained by the debtor during the process), citing Bankruptcy Reform Act of 1978, Pub L No 95-598, 92 Stat 2549 (1978), codified at 11 USC § 101 et seq (2000 & Supp 2005).

<sup>2</sup> LoPucki, 57 Am Bankr L J at 103 (cited in note 1); Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure under Chapter 11 of the Bankruptcy Code?: Second Installment*, 57 Am Bankr L J 247, 272–73 (1983) (continuing the analysis with a focus on the ineffectiveness and underutilization of creditor committees).

companies.”<sup>3</sup> The studies were based on an examination of the records of the largest cases filed in the late 1980s and early 1990s, along with interviews of more than a hundred bankruptcy lawyers, judges, and professionals. The project yielded many important findings, such as the authors’ discovery that managers were frequently replaced before the end of Chapter 11 cases,<sup>4</sup> that managers often focused on creditors’ interests rather than shareholders’,<sup>5</sup> and that most large companies sold a substantial portion of their assets during the case.<sup>6</sup> LoPucki and Whitford also noticed that large companies seemed to engage in venue shopping, with many filing for Chapter 11 in the Southern District of New York, even if those companies had little discernible connection to New York.<sup>7</sup>

In subsequent years, LoPucki has written on a wide variety of issues, many (though by no means all)<sup>8</sup> at least indirectly connected to the corporate reorganization studies for which he is best known, and many drawing on the comprehensive database of large corporate reorganization cases that he has constructed and made available on his website.<sup>9</sup> Particularly as compared to the usual scholarly fare, LoPucki’s

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<sup>3</sup> See, for example, Lynn M. LoPucki and William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 Cornell L Rev 597, 597 (1993) (drawing from an empirical study to describe then-current large firm bankruptcy case outcomes and evaluate the feasibility of alternatives); Lynn M. LoPucki and William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U Pa L Rev 669, 694–715, 742–47 (1993) (describing the relative power of shareholders and creditors and finding that the latter have too much influence over the managers of bankrupt companies); Lynn M. LoPucki and William C. Whitford, *Bargaining over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U Pa L Rev 125, 126 (1990) (reporting the results of an empirical study finding that the absolute priority rule had been abandoned in favor of more individualized decisionmaking).

<sup>4</sup> See LoPucki and Whitford, 78 Cornell L Rev at 612 (cited in note 3).

<sup>5</sup> See LoPucki and Whitford, 141 U Pa L Rev at 745 (cited in note 3).

<sup>6</sup> See LoPucki and Whitford, 78 Cornell L Rev at 601 (cited in note 3).

<sup>7</sup> See Lynn M. LoPucki and William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 Wis L Rev 11, 15 (arguing that forum shopping was corrupting the bankruptcy process, with firms filing in jurisdictions where case law was more favorable to the failing firms or to their attorneys, even in the absence of a meaningful presence there).

<sup>8</sup> In one of the best known articles that does not draw on the reorganization data, though its themes figure briefly in *Courting Failure* (p 55), LoPucki argues that states and offshore havens have made it increasingly easy for wealthy individuals (often doctors who fear malpractice liability) and corporations to put their assets beyond the reach of creditors by passing laws authorizing devices such as asset protection trusts. An individual who sets up an asset protection trust transfers her assets to the trust in the hope that the trust will be deemed off limits to her creditors. See Lynn M. LoPucki, *The Death of Liability*, 106 Yale L J 1, 23–30 (1996).

<sup>9</sup> Lynn M. LoPucki, *Lynn M. LoPucki’s Bankruptcy Research Database* (2002), online at <http://lopucki.law.ucla.edu/index.htm> (visited Jan 17, 2006). It includes data on every large Chapter 11 case (currently defined as cases with assets of at least \$220 million) filed since 1980. By providing both open access to the database, and the specific data used in his projects, LoPucki has been extraordinarily generous. We and many other researchers are greatly in his debt.

articles are colorful, well-written, and often designed to provoke. In the past five years, much of his time and invective have been devoted to a single controversy: the debate over court shopping by large corporate debtors. From a measured observer of the court shopping phenomenon, LoPucki has evolved into an increasingly vocal critic, directing much of his criticism at the bankruptcy court in Delaware, which displaced New York in the 1990s as the venue of choice. Debtors' managers and lawyers look for a court that will favor these "case placers"<sup>10</sup> interests, he argues, so Delaware, eager to garner the accompanying prestige and local revenues, bends the bankruptcy process to the will of the managers and lawyers in order to attract cases.<sup>10</sup>

*Courting Failure* is the crowning achievement of this recent work, combining LoPucki's court shopping data and a seemingly unrelated sequence of articles on international insolvency cases into a single, sustained jeremiad against bankruptcy venue shopping (pp 252–59). Professor LoPucki has shared his outrage with everyone who will listen, and a large number of people have done just that—including many politicians in Washington. During the debates on major bankruptcy legislation in Spring 2005, Texas Senator John Cornyn described venue shopping as

a problem that has been well documented by scholars in the field, most recently in a comprehensive book [just published] by UCLA law professor Lynn M. LoPucki . . . .

The professor has documented instances of forum shopping by corporate debtors that have harmed consumers and workers in virtually all of our [s]tates.<sup>11</sup>

Senator Cornyn was persuaded to withdraw an anti-venue shopping amendment he had proposed, but the proposal continues to linger in Congress.

While there is a great deal to admire in *Courting Failure*, the indictment and proposed reforms are based on two crucially flawed assumptions that cause LoPucki to misdiagnose what works and what doesn't in Chapter 11. First, *Courting Failure* seems to assume that the

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<sup>10</sup> LoPucki's first foray into forum shopping offered cautious praise for the phenomenon and considerable criticism of its abuses. LoPucki and Whitford, 1991 Wis L Rev at 50 (cited in note 7) (arguing that the abuses of forum shopping could be checked without abandoning its positive competitive advantages). His subsequent articles became increasingly critical, although interestingly, none argued that the venue rules should be changed. Only in *Courting Failure* itself has LoPucki argued that corporate debtors should be prevented from filing for bankruptcy in Delaware (pp 252–54) (proposing that the state of incorporation should no longer provide a venue option).

<sup>11</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S 256, 109th Cong, 1st Sess (Mar 2, 2005), in 151 Cong Rec S 1892, 1902 (Supp Mar 2, 2005).

goal of every large Chapter 11 case is, and should be, to rescue the company and thoroughly restructure its operations in order to minimize the likelihood that the company will ever need to return to Chapter 11 again. This assumption is hardwired into the design of LoPucki's empirical analysis, and it drives all of his interpretations of his data. It is also, in our view, mistaken. Drawing on the corporate finance literature, we argue that an intensive, costly restructuring is not always the optimal strategy when a company files for Chapter 11. To the contrary, under a variety of plausible conditions, a quick, low-cost procedure (which we refer to as a "workout") may be more efficient than a costly restructuring. Indeed, we show that a subsequent liquidation or return to Chapter 11 may confirm the efficiency of forgoing an intensive reorganization the first time around, rather than reflect a failure of the system, as LoPucki assumes.

Second, Professor LoPucki's condemnation of corporate debtors' tendency to file in Delaware and New York rather than in other locations ignores several significant checks on the ability of a debtor's managers and attorneys to pick a venue that favors their interests over those of other constituencies. First, and most important in many cases, is the debtor-in-possession (DIP) financier. The rise of the DIP financier—and the phenomenon critics refer to as "creditor-in-possession"—is the single most remarkable omission from *Courting Failure*. DIP financiers exert significant control over the case, and they are unlikely to permit the debtor to choose a bankruptcy venue that undermines the DIP financier's interests. In addition, the debtor's proposed reorganization plan is subjected to a creditor vote, and open auction procedures often can protect creditors' interests in cases that involve a sale of assets.

After critiquing Professor LoPucki's analysis in theoretical terms, we bring our own empirical findings to bear on the venue shopping debate. Our data suggest that the debtors that choose Delaware appear to be drawn by the Delaware court's experience in handling large Chapter 11 cases, and that companies that have substantial secured credit are more likely to file in Delaware.<sup>12</sup> We also reexamine LoPucki's data, and find that the cases he views as smoking guns, demonstrating Delaware's failure, cannot sustain the interpretation he projects on them.

Our analysis proceeds as follows. Part I provides a brief, chapter-by-chapter summary of *Courting Failure*. We begin our critique in Part II, which focuses on LoPucki's evidence that a disproportionate percentage of Delaware debtors wound up back in bankruptcy in the 1990s, that the Delaware firms performed poorly in the interim, and that this

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<sup>12</sup> The statistical analysis is reported and explained in Part III.B.

reflected a failure of the bankruptcy system. In addition to casting doubt on Professor LoPucki's empirical findings, this Part develops a simple model to explore the choice between an intrusive restructuring and a less costly workout under conditions of uncertainty. Part III explores the checks that limit a debtor's managers' and lawyers' ability to choose a bankruptcy venue based solely on their own interests. Together, Parts II and III offer an efficiency explanation for the distinctive qualities of Delaware reorganization and describe several checks on pernicious court shopping that tend to support the efficiency view.

In Part IV, we argue that the real question in current reorganization practice is whether the recent shift to DIP lender control is efficient or problematic. Although the advent of DIP lender control generally seems to have improved Chapter 11, there are several contexts where DIP lenders may divert value from other creditors. Rather than altering the venue rules to prevent troubled debtors from filing for bankruptcy in Delaware, we argue, it makes more sense to focus on the potential distortions created by DIP lender control.

#### I. THE EVER EXPANDING GYRE: LOPUCKI'S INDICTMENT

"Turning and turning in the widening gyre," W.B. Yeats writes at the start of his poem "The Second Coming,"

The falcon cannot hear the falconer;  
Things fall apart; the centre cannot hold;  
Mere anarchy is loosed upon the world,  
The blood-dimmed tide is loosed, and everywhere  
The ceremony of innocence is drowned;  
The best lack all conviction, while the worst  
Are full of passionate intensity.  
Surely some revelation is at hand;  
Surely the Second Coming is at hand.  
The Second Coming!<sup>13</sup>

The vision is apocalyptic: ever-expanding chaos, a world spiraling out of control as the voices of integrity are overtaken by an unstoppable surge of corruption.

The same sense of impending disaster infuses almost every page of *Courting Failure*. LoPucki is convinced that the bankruptcy system is shot through with corruption. The corruption, as he sees it, stems from competition by bankruptcy judges to attract high profile cases, and it has rippled ever outward, poisoning everything in its path.

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<sup>13</sup> W.B. Yeats, *The Second Coming* (1921), in *The Collected Poems of W.B. Yeats* 187 (Collier 6th ed 1989) (Richard J. Finneran, ed).

LoPucki sets the tone at the very outset, by revisiting (in the Prologue) a classic muckraking article by Lincoln Steffens that detailed New Jersey's efforts to entice the nation's largest businesses to incorporate in New Jersey.<sup>14</sup> By giving the corporations whatever they wanted, and aggressively marketing its intent to do so, New Jersey raised so much money through the taxes it charged corporations for the privilege of flying under the New Jersey banner that its governor could proudly report in 1904 that "[o]f the entire income of the government, not a penny was contributed directly by the people" (p 4).<sup>15</sup> In 1913, when then-New Jersey governor (and President-elect) Woodrow Wilson proposed seven bills designed to ratchet up the state's antitrust scrutiny, numerous New Jersey corporations fled in terror to Delaware, which then took over as the leading state of incorporation and has retained that mantle ever since. LoPucki's implicit claims—made explicit in the chapters that follow—are that Delaware has played the same role in bankruptcy, and that the behavior of Delaware's judges has had a cancerous effect on the bankruptcy system.

Following the Introduction, which suggests that competition (in this case by the Southern District of New York) to attract high profile cases enabled Enron's Ken Lay to sidestep significant prosecution,<sup>16</sup> LoPucki briefly recounts the history of bankruptcy venue competition in the first three chapters of the book. Chapter 1 traces the competition to an innocent-looking statutory provision. Under bankruptcy's venue rule, a troubled debtor can file for bankruptcy in any district where: (1) the debtor's headquarters are located, (2) the debtor's principal assets are, (3) an affiliate has filed for bankruptcy, or (4) the debtor is domiciled.<sup>17</sup> In the 1980s, the third option created much of the excitement. Attracted by the sophistication of New York's judges as well as their prodebtor orientation and generous fee awards for the debtor's lawyers, many of the largest corporate debtors wanted to file their cases in New York but didn't have their headquarters, major assets, or domicile in the Big Apple. So long as one of the company's subsidiaries, no matter how small, had already filed for bankruptcy in

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<sup>14</sup> Lincoln Steffens, *New Jersey: A Traitor State, Part II: How She Sold Out the United States*, McClure's 41 (May 1905). Indeed, the innuendo begins before the first page of *Courting Failure*. Facing the Prologue, as an opening epigraph, is the ethical requirement that "A Judge Shall Avoid Impropriety and the Appearance of Impropriety in All of the Judge's Activities" (p xii). The implication is that the nation's bankruptcy judges are behaving in an unethical fashion.

<sup>15</sup> Quoted in Steffens, McClure's at 51 (cited in note 14).

<sup>16</sup> It is perhaps worth noting that this is a dubious claim. Lay has faced an avalanche of litigation, and his criminal trial is scheduled to begin in January 2006. See, for example, *Trial of 2 Enron Executives Is Set for January*, NY Times C12 (Feb 25, 2005); Simon Romero, *Satisfaction and Sadness at the Sight of Handcuffs*, NY Times C4 (July 9, 2004).

<sup>17</sup> 28 USC § 1408 (2000 & Supp 2005).

New York, the whole company could follow its affiliate. LoPucki recounts how Eastern Airlines filed for bankruptcy in New York on the coattails of Ionosphere, Inc., which ran Eastern's hospitality rooms at airports and had less than \$2 million in assets (p 36).<sup>18</sup>

Delaware enters the stage in Chapter 2. After a scathing overview of Delaware's efforts to attract credit card companies and major corporations, LoPucki recounts Delaware's rise to prominence as the premier district for large scale reorganization in the 1990s. Reluctant to file for bankruptcy in New York (because of a recent ruling involving corporate bonds) or Houston (fearing the bankruptcy court might be influenced by local labor unrest in the wake of an earlier bankruptcy), Continental filed in Delaware, whose only bankruptcy judge, Judge Helen Balick, had recently ruled that a company's state of incorporation is its "domicile" for venue purposes.<sup>19</sup> The bankruptcy proceeded smoothly, and Delaware quickly displaced New York as the district of choice for major bankruptcies. LoPucki attributes the shift to prodebtor rulings by Judge Balick and her willingness to "rubber-stamp" prepackaged bankruptcy cases that were prenegotiated and then filed in Delaware.<sup>20</sup> She gave the "case placers"—principally the debtor's managers and attorneys—what they wanted, in LoPucki's view, so corporate America came back for more.

LoPucki completes the brief historical tour in the chapter that follows. Entitled "The Federal Government Strikes Back," Chapter 3 describes the growing hostility to Delaware's dominant share of the largest bankruptcy cases. In 1997, the National Bankruptcy Review Commission proposed, among many other recommendations, that state of incorporation be eliminated as a venue option (p 80). At about the same time, a Judicial Conference report alleging that Judge Balick had engaged in *ex parte* conversations with bankruptcy lawyers further roiled the waters, and is thought to have induced Delaware District Court Judge Joseph Farnan to take control of the assignment of Delaware's bankruptcy cases, by withdrawing the automatic "refer-

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<sup>18</sup> Another company, Tacoma Boatbuilding, rented a small office in New York and declared this to be the company's headquarters (p 32).

<sup>19</sup> From the late 1930s to the 1970s, corporate domicile was excluded as a bankruptcy venue, largely to prevent corporate debtors from bringing their cases to Delaware. In the 1970s, the domicile option was reintroduced, first as a rule change and then in connection with the new Bankruptcy Code. The history is recounted in David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 Del L Rev 1, 5-17 (1998).

<sup>20</sup> In a prepackaged bankruptcy, or prepack, the debtor and its major creditors negotiate the terms of the reorganization before filing for bankruptcy, and submit a proposed reorganization along with or shortly after the initial Chapter 11 petition. See Robert K. Rasmussen and Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 Nw U L Rev 1357, 1374-76 (2000) (suggesting that Delaware's lead in bankruptcies is especially strong in prepackaged bankruptcies, where Delaware's law is far more favorable to debtors).



ence” of the cases to the bankruptcy court (pp 80–87). During this same period, Delaware was a victim of its own success, attracting more major cases than the court—even after the addition of a second judge in 1993—could handle. LoPucki describes Delaware’s decision to bring in outside judges to handle some of the cases and accuses Delaware of yanking cases from one visiting judge—Judge Randall Newsome—when he questioned whether several of the cases really belonged in Delaware (pp 94–95).

For those reading *Courting Failure* as a breathless tale of judicial intrigue, Chapter 4, which shifts from history to data, will come as something of a letdown. But it is the single most important chapter in the book—the chapter that attempts to make LoPucki’s case that bankruptcy judges’ efforts to attract major cases have perverted the bankruptcy system.

Chapter 4 begins by recounting LoPucki’s discovery that many of the large corporate debtors who reorganized in Delaware in the 1990s required a second trip to the bankruptcy court within a few years.<sup>21</sup> For LoPucki, the repeat filings—known in bankruptcy circles as “Chapter 22s”—demonstrate that Delaware’s judges made a deal with the devil: in order to attract big cases, the judges simply confirmed any reorganization plan that was presented to them, without providing any meaningful scrutiny of its terms. To defend this thesis, LoPucki turns to his scholarly critics, rejecting a series of alternative explanations that have been offered to explain the high number of repeat filings in Delaware.<sup>22</sup> One such alternative explanation is that the repeat filings

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<sup>21</sup> The discovery was reported in Lynn M. LoPucki and Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a “Race to the Bottom,”* 54 Vand L Rev 231, 235, 249–50 (2001), which found that nearly one-third (ten of thirty-one overall, and nine of thirty that emerged after 1990) of the large debtors reorganized in Delaware during the period of the study later filed for Chapter 11 a second time. LoPucki refined and further defended the analysis in Lynn M. LoPucki, *Can the Market Evaluate Legal Regimes? A Response to Professors Rasmussen, Thomas, and Skeel*, 54 Vand L Rev 331, 333–38 (2001), and Lynn M. LoPucki and Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 Vand L Rev 1933, 1939 (2002).

<sup>22</sup> Among the articles LoPucki responds to here and elsewhere are several by one of us, see generally David A. Skeel, Jr., *What’s So Bad about Delaware?*, 54 Vand L Rev 309 (2001) (arguing that firms experience a real increase in value upon reincorporating in Delaware and that the high bankruptcy refiling rate there is not an indication of its state’s courts’ failures); David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U Cin L Rev 1243 (2000) (arguing that Delaware venue in bankruptcy offers some (though not all) of the benefits Delaware offers in corporate law); Skeel, 1 Del L Rev 1 (cited in note 19), and several by Bob Rasmussen and Randall Thomas, see generally Robert K. Rasmussen and Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawareization of Corporate Reorganizations*, 54 Vand L Rev 283 (2001) (criticizing earlier critiques of Delaware’s bankruptcy practice, noting a need to consider prepackaged bankruptcies separately from more traditional bankruptcies, a need to assess failure beyond just refiling, and a need to question whether all refilings are negative events); Rasmussen and Thomas, 94 Nw U L Rev 1357 (cited in note 20).

may reflect a decision by the parties that a quick, low-cost restructuring makes more sense than a costly, time-consuming restructuring, despite the higher risk of a subsequent default. In response to this argument, LoPucki marshals data (from a concededly small study) suggesting that companies filing prepackaged bankruptcies and subsequently failing or refiling suffered substantial losses in the interim (pp 108–10). Nor, he argues, are the companies that file for bankruptcy in Delaware more complex or different in other ways from non-Delaware cases: they actually emerge from bankruptcy with fewer classes of creditors, not more, than companies that reorganize elsewhere, and the other variables that LoPucki considers do not reveal further differences between Delaware and non-Delaware cases. The obvious explanation for these findings, LoPucki concludes, is that Delaware debtors reorganize too quickly and not thoroughly enough. Whereas companies reorganizing elsewhere “solved their profitability problems” in bankruptcy, Delaware debtors did not (p 117).

With the four chapters that comprise most of the second half of the book, the breathless tone returns; the gyre starts to spin ever faster, widening from Delaware to encompass the entire U.S. bankruptcy system and then the entire world. In Chapter 5, LoPucki argues that the court competition spread well beyond Delaware and New York in the late 1990s, infecting courts across the nation. The bankruptcy courts in Houston, Dallas, and other cities began to compete by copying many of the attributes that seemed to attract big cases to Delaware: they granted New York rates to bankruptcy professionals and gave debtors much more flexibility with so-called first day orders. Perhaps the biggest winner was Chicago, which, during the corporate scandals, attracted Conesco, Kmart, and United Airlines before several subsequent appellate court rulings seemed to dampen its popularity. In Chapter 6, “Corruption,” LoPucki argues that court competition has corrupted courts’ handling of seven major issues in bankruptcy: (1) professional fees are out of control and are now paid on a monthly basis to keep the professionals happy, (2) failed managers are permitted to keep their jobs, (3) courts’ failure to appoint a trustee—in the Enron case in particular—has helped corporate thieves keep their money, (4) managers are allowed to pay themselves lucrative retention bonuses, (5) courts simply rubberstamp prepackaged bankruptcies, (6) courts permit debtors to give special treatment to favored vendors, and (7) courts close their eyes and permit companies to sell the businesses quickly under § 363 of the Bankruptcy Code, rather

than require the debtor to propose a reorganization plan and submit the sale to a vote of the company's creditors and shareholders.<sup>23</sup>

In Chapter 7, "The Competition Goes Global," LoPucki argues that Delaware and New York reached out to claim jurisdiction in several major international insolvencies involving foreign companies with a small presence in the United States. "The mere fact that so many [of these] cases go forward in the United States without active opposition," he concludes, "does more to prove the effectiveness of U.S. intimidation than the superiority of Chapter 11" (p 189).

By Chapter 8, the gyre is spinning even faster; court competition may now be "Global and Out of Control." LoPucki acknowledges that the forum shopping risk he fears most—that "an international shopper can access an entirely different set of remedies and priorities" if it's not satisfied with its home country's rules—is "held in check" by the ability of the local country's courts "to nullify the attempt by refusing to recognize or enforce the overreaching courts' orders" (p 207). But he argues that scholars have, with increasing success, been pushing international initiatives that would replace the traditional "territorial" approach to international insolvency cases with a more "universalist" approach. Under territorialism, the insolvency laws of any country where a financially troubled company has assets control the disposition of those assets. Under universalism, by contrast, the laws of one country—the location of the debtor's headquarters or principal assets, or a location identified by the company in its charter—would dictate the entire process. Universalism, LoPucki warns, would encourage on an international level the same forum shopping that has corrupted the United States bankruptcy system. Companies could manipulate the choice of forum—moving their headquarters, for instance, if the laws of the country where a debtor is headquartered control—and courts would compete to attract large international insolvencies in the same way United States courts have competed to lure United States debtors.

In Chapter 9 LoPucki shifts back to a somewhat more academic mode, and returns to the question of whether Delaware's competitive success is beneficial or pernicious. The chapter begins by summarizing the longstanding debate whether Delaware's preeminence as a state of incorporation reflects a "race to the top" or a "race to the bottom," and attributes Delaware's popularity to "network effects" (that is,

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<sup>23</sup> For a powerful, issue-by-issue critique of LoPucki's seven examples of ostensible corruption, see Robert K. Rasmussen, *Empirically Bankrupt* (unpublished manuscript 2005) (on file with authors) (pointing out that several of LoPucki's claims are misleading and several of the current bankruptcy practices that LoPucki criticizes are defensible). It is also worth noting that several of the issues here have been affected by the recent bankruptcy reforms. Most importantly, 11 USC § 503(c) (Supp 2005) imposes strict new limits on retention bonuses.

companies choose Delaware because so many other companies have already done so) rather than any superiority of Delaware lawmaking or judicial oversight. But even if Delaware's role in corporate law were beneficial, LoPucki argues, the Delaware bankruptcy courts cannot be defended in the same terms. When corporations move to Delaware, they still must answer to shareholders and other constituencies. If the company is in financial distress, managers "have no reason to concern themselves with the interests or preferences of shareholders in selecting a court," because shareholders cannot interfere with the decision and their interests are likely to be wiped out in bankruptcy (p 241). Managers are therefore free to shop for the court that's best for managers.

Chapter 10, "Conclusions," offers a final set of dire warnings. "If Congress allows the bankruptcy court competition to continue," LoPucki predicts, "the substantive changes already visible in the competing courts' practices will accelerate. To the extent that the courts have placed any limits on incumbent managers' pay, authority, or job security, the courts will remove them" (p 250). The only hope, in LoPucki's view, is to eliminate court competition in one of two ways. First, Congress could remove state of incorporation and filing by an affiliate as bases for venue. A pared down venue provision, which required debtors to look to the location of their headquarters or principal assets, would sharply reduce court shopping (p 252).<sup>24</sup> Alternatively, "Congress might establish specialized bankruptcy courts at three or four locations in the United States to handle only the largest cases," each to cover a separate region (p 253). Unless lawmakers intervene in one of these ways, LoPucki concludes, court competition will spiral even further out of control.

Like many muckraking stories, *Courting Failure* is great fun to read—at least if the reader isn't one of the groups, such as bankruptcy judges, who are accused of corruption in its pages.<sup>25</sup> The story is fast-paced and engagingly written, and LoPucki spices up his tour through the arcane world of bankruptcy with colorful examples. As with much classic muckraking, the argument often proceeds by implication and innuendo. The fact that the bankruptcy court did not appoint a trustee

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<sup>24</sup> As LoPucki concedes, companies could still forum shop by moving their headquarters to the desired location. But he concludes (somewhat in tension with his warnings about international forum shopping through headquarters changes) that "such shoppers would not exist in sufficient numbers to corrupt courts that hoped to attract them" (p 252).

<sup>25</sup> LoPucki has continued to sound the corruption theme in commentary written since *Courting Failure* appeared. See, for example, Lynn M. LoPucki, 'Corruption' is the Right Word, 44 Bankr Ct Dec: Weekly News & Comment A7 (July 19, 2005); Lynn M. LoPucki, *Bankruptcy Bingo*, Forbes 44 (July 4, 2005).

in Enron's bankruptcy means that courts compete for cases by letting tainted executives off the hook (no mention that Ken Lay has been a defendant in numerous civil suits and is awaiting a criminal trial). The fact that recent bankruptcy changes in England have made English insolvency slightly more like U.S. law means that England has been forced to compete with the U.S. bankruptcy courts. (In reality, the connection between the English reforms and United States venue competition was, if not wholly imaginary, a tiny factor in the push for reform.<sup>26</sup>)

What made Steffens's muckraking account of early New Jersey corporate law so compelling was an investigative reporting coup: Steffens found a prominent corporate lawyer who claimed to have dreamed up the strategy for attracting giant corporations, and who later had second thoughts about the forces he had unleashed. The power of LoPucki's indictment stems from a very different source: data. The linchpin of LoPucki's court competition story is his finding that a disproportionate percentage of Delaware reorganizations required a second Chapter 11 filing, together with the additional data he marshals in his effort to disprove more favorable interpretations of this finding. We therefore focus first on the empirical claims.

## II. HAS LOPUCKI SHOWN A FAILURE IN DELAWARE?

LoPucki's analysis seems to leave little doubt that the Delaware bankruptcy court must have been inefficient. LoPucki concedes that Delaware reorganizations, particularly the prepackaged cases, are faster than reorganizations in other courts.<sup>27</sup> But his data seem to suggest that this speed comes at a great cost. Firms choosing to file in Delaware are more likely to file for bankruptcy again and to perform worse than other firms after reorganizing, particularly so for shareholders of the reorganized Delaware firms.<sup>28</sup> This leads to the conclusion that judges in Delaware must have been too lax in scrutinizing plans, and that contracting parties themselves must have been unaware of this inefficiency, because such a pattern could not have been chosen voluntarily by rational profit-maximizing actors.

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<sup>26</sup> For an overview of the recent reforms, see, for example, John Armour and Rizwaan Jameel Mokal, *Reforming the Governance of Corporate Rescue: The Enterprise Act 2002*, 32 *Lloyd's Marit & Comm L Q* 28 (2005).

<sup>27</sup> In an earlier article, LoPucki argued that Delaware does not process cases faster than other courts "except by comparison to New York." Theodore Eisenberg and Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 *Cornell L Rev* 967, 989-92 (1999). But other commentators, including us, have found statistically significant differences, and LoPucki's subsequent work reaches a similar conclusion.

<sup>28</sup> LoPucki reviews both the LoPucki and Kalin study (pp 98-102) and the LoPucki and Doherty study (pp 110-17) to support his conclusions. See also note 22 and accompanying text.

In the analysis that follows, we will show that most, if not all, of the patterns documented in the data and described in *Courting Failure* could arise from a model of rational venue choice—made in the interests of maximizing total firm value—in which means of distress resolution differ in their costs and effectiveness.<sup>29</sup> The main contribution of this model is to demonstrate that all of the results ascribed to causal differences among courts (that is, that postbankruptcy outcome differences across courts were caused by deficiencies in the Delaware bankruptcy process) could result from value-maximizing decisions that do not involve a causal role for bankruptcy courts. The choice of courts may well have been efficient, in other words, rather than pernicious.

The model provides support for the notion that all of the patterns we see in the data could have resulted from a pure selection effect, with firms with preexisting differences selecting into distress resolution procedures that are best tailored to their circumstances. In this framework, the Delaware court (and prepackaged bankruptcy, regardless of venue) provides distressed firms with a forum to enact faster, and hence less costly, workout procedures when little would be gained by a long and expensive stay in Chapter 11.<sup>30</sup> The Delaware option is valuable because it provides firms with more flexibility to resolve distress. In our model, this option is strictly welfare-enhancing for the capital providers of distressed firms.<sup>31</sup> Because the model generates many of the seemingly negative outcomes we see in the data, we hope to convince the reader that the conclusions in *Courting Failure* that assign labels of inefficiency to the Delaware bankruptcy process are not justified and may well be wrong.

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<sup>29</sup> The logic of the model developed in this Part draws extensively from the insights of Matthias Kahl. See generally Matthias Kahl, *Economic Distress, Financial Distress, and Dynamic Liquidation*, 57 J Fin 135 (2002).

<sup>30</sup> LoPucki's own research suggests that the direct costs of a Delaware bankruptcy are not less than those of bankruptcies elsewhere. Lynn M. LoPucki and Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J Empirical Leg Stud 111, 131 (2004). Even if this is correct, it is widely agreed (even by LoPucki himself) that direct costs are only a small portion of the costs of bankruptcy. Indirect costs loom much larger. See, for example, Robert H. Mnookin and Robert B. Wilson, *Rational Bargaining and Market Efficiency: Understanding Pennzoil v. Texaco*, 75 Va L Rev 295, 313 (1989).

<sup>31</sup> This is not to say that courts and judges do not differ with respect to their expertise and their ability to handle difficult cases. Nor do we suggest that the judges with the most expertise invariably make good decisions. We set all of these issues aside in the initial model to demonstrate that having a choice of distress resolution procedures is valuable *even if* no differences among courts and judges exist. To the extent that some courts are more skilled than others, then venue choice becomes all the more valuable.

### A. The Model

Consider the following decision problem that a firm in financial (and potentially economic) distress faces.<sup>32</sup> We will take as given for the moment that the firm's decisionmakers (management) will voluntarily choose outcomes that maximize the collective expected payoff to the firm's capital providers. Later, we will turn to the issue of agency problems between management and capital providers to understand how such issues might affect the firm's capital structure decision after distress is resolved. This will introduce the concept of creditor control, which we will later argue is an essential piece of the analysis, one that has been left out thus far in the venue choice debate.<sup>33</sup>

Consider a world with two dates, zero and one. At date zero, the firm is in financial distress and must choose between two forms of distress resolution. Under one option, which we will call "restructuring," the company takes costly actions to improve its operations, in addition to altering its capital structure. This may require selling off unprofitable divisions, replacing poor management, or investing in new capital improvements, all of which will take time and resources to complete successfully. Rather than expend these resources, however, the firm can instead pursue a less costly second option, which we will

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<sup>32</sup> A firm that is in financial distress is unable to pay its debts but may otherwise be viable. A firm in economic distress is not viable and should be shut down.

<sup>33</sup> The role of creditors in corporate governance is familiar to scholars who study governance in European and Asian countries. But it has long been omitted from analysis of American corporate governance. See, for example, John Armour, Brian R. Cheffins, and David A. Skeel, Jr., *Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom*, 55 Vand L Rev 1699, 1720–22, 1763–72 (2002) (discussing the similarities between corporate structure in the United States and in the United Kingdom and the differences in the bankruptcy laws of both—specifically the strong role of British creditors). Exceptions to this neglect include George G. Triantis and Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Cal L Rev 1073, 1080 (1995) (discussing the differing incentives of shareholders and managers and how bankruptcy rules, through creditor actions, can provide shareholders with information about managerial performance), and recent work by Douglas Baird and Bob Rasmussen. See generally Douglas G. Baird and Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, U Pa L Rev (forthcoming 2006) (describing the widening powers of creditors, whose influence exceeds that of shareholders and who exercise great power in and out of bankruptcy); Douglas G. Baird and Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan L Rev 673 (2003) (providing an empirical background to the assertion that modern corporations are not served well by the assumptions underlying arcane bankruptcy law and arguing that creditors have too much power for Chapter 11 to be effective); Douglas G. Baird and Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan L Rev 751 (2002) (arguing that bankruptcy is no longer useful for reorganizations and instead is a vehicle for creditors to force liquidations because the modern corporation has little value as a going concern in comparison with the paradigmatic railroad). One of us has also written in this vein. See, for example, David A. Skeel, Jr., *Corporate Anatomy Lessons*, 113 Yale L J 1519, 1552–62 (2004) (examining creditor protections in corporate law and bankruptcy, and emphasizing the "active role that creditors play in corporate governance and the rules that facilitate this role").

call a “workout.” This involves only a modification of the firm’s capital structure, such as a debt-for-equity swap or an exchange of existing debt for new debt that alleviates the firm’s liquidity shortage but does little to affect operations. To be concrete, suppose a restructuring costs  $R$ , while a workout costs  $W$ , where  $W < R$ .

The difference between the less costly but less thorough “workout” option and the more costly but more thorough “restructuring” option can be thought of in two ways that are relevant to the current debate. The workout can be thought of as a prepackaged Chapter 11, while the restructuring can be thought of as a “full-blown” Chapter 11.<sup>34</sup> To interpret the model differently, within the category of “full-blown” Chapter 11 cases, a Delaware reorganization (which is faster and thus less costly) is likely to resemble the workout option, while cases in other courts resemble the restructuring option.<sup>35</sup>

The firm will face a nontrivial decision between the two options, because the firm’s future prospects, and hence the benefits from restructuring, are uncertain. Suppose there are three possible future states of the world, one of which will be realized at date one. The firm’s owners know only the probability distribution of the future states but do not know exactly which state will arise. We will refer to these states as good, medium, and bad ( $G$ ,  $M$ , and  $B$ ). Let’s first suppose that the firm chooses to save the extra cost of restructuring, and chooses a workout. If the high state (state  $G$ ) arises, which happens with probability  $p_g$ , we suppose that the firm’s prospects improve significantly. From date one forward, the firm will produce cash flows with a present value that, for simplicity, are equal to 1. If state  $M$  arises, with probability  $p_m$ , the firm can return to health, but only if it undertakes the restructuring it passed up at date zero. Since this costs  $R$  (which we assume to be less than 1), the firm’s value in state  $M$  is given by  $1 - R$ . If state  $B$  arises, however, with probability  $p_b$ , the firm’s prospects have deteriorated to the point that a shutdown is efficient.<sup>36</sup> The shutdown will produce a small liquidation value  $L$ , where  $L < 1 - R$ . In addition to the future value of the firm realized at date one, we assume that the decision not to restructure results in losses equal to  $X$  between periods zero and one.

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<sup>34</sup> See, for example, Rasmussen and Thomas, 54 Vand L Rev at 288–90, 295 (cited in note 22) (making this distinction).

<sup>35</sup> Of course, in reality a firm and its creditors could have an extended stay in Chapter 11 in the Delaware courts as well. The important assumption here in tying the model to the data is that the “Other Courts” do not allow for a fast bankruptcy, and will thus be avoided by the firms that would benefit from it. Because these firms are more likely to be economically distressed and will optimally choose higher leverage, the data that would result from a world of this kind might be mistakenly attributed to a faulty Delaware bankruptcy process.

<sup>36</sup> Naturally, because there are only three future states,  $p_g + p_m + p_b = 1$ .



If the firm chooses to spend the extra costs to restructure, on the other hand, three benefits arise. First, the firm improves between dates zero and one, so that the losses  $X$  are not realized.<sup>37</sup> Second, the firm's future cash flows increase in the states of the world in which the firm remains in operation (G and M). We suppose this restructuring benefit has a value of  $d$  in these states. Finally, since the firm already restructured at date zero, it does not need to do so again when state M arises.<sup>38</sup>

With this framework in hand, we can analyze the restructuring/workout decision of a rational, profit-maximizing firm. A firm will choose a workout if and only if the following condition is true:

$$(p_g + p_m)(1 + d) + p_b L - R < p_g + p_m (1 - R) + p_b L - X - W$$

Some simple algebra reduces this inequality to a formula that we can easily interpret. A workout will occur if and only if the following is true:

$$(1 - p_b)d < (R - W) - p_m R - X$$

Qualitatively, this simple model suggests that a less costly workout should occur, compared to a more costly but more thorough restructuring when:

- (a) The cost difference between a restructuring and a workout ( $R - W$ ) is higher. This is intuitive, because it merely suggests that a workout is more likely to be optimal when the extra direct costs of restructuring are high relative to a workout.<sup>39</sup>
- (b) The additional economic losses that follow from choosing a workout ( $X$ ) are low. If, on the other hand, the failure to restructure leads to poor operating performance, then the cost of "buying time" until the state of the world is realized may be too costly. The data presented by LoPucki and Doherty suggest that these interim losses are particularly large following Delaware reorganizations.<sup>40</sup> As we will see below, taking a closer look at the data suggests that there is no evidence that  $X$  is positive.

<sup>37</sup> The model is flexible enough to incorporate the possibility that the workout improves profit between periods; this would mean that  $X$  is negative. We include this parameter because LoPucki interprets his data to imply that  $X$  is positive (due to Delaware's "laissez-faire" approach in failing to require a full restructuring, subsequent profitability suffers).

<sup>38</sup> For simplicity, we assume that cash flows are the same in the high and medium state. If we assumed that cash flows in the high state were 2 instead of 1, for example (to further distinguish the high from the medium state), this would have no effect on the decision to restructure, as the simplified inequality above would be identical.

<sup>39</sup> This intuition is one of the principal arguments made by Bob Rasmussen and Randall Thomas in their critique of LoPucki's initial findings. Rasmussen and Thomas, 54 Vand L Rev at 295-99 (cited in note 22).

<sup>40</sup> LoPucki and Doherty, 55 Vand at 1945 (cited in note 21).

(c) The probability of the medium state ( $p_m$ ) is low. The underlying intuition is that restructuring should be undertaken now if it is likely to be required later in any case. When  $p_m$  is low, by contrast, the “option value” of waiting to restructure is higher, since the likelihood of saving on restructuring costs (which are not required in states G and B) is higher. Note that if  $p_m = 1$ , then restructuring is always optimal, since the expression above reduces to  $d > -W - X$ , which is always true.

(d) The probability of the bad state ( $p_b$ ) is high. This result is perhaps the most important to gain an understanding of the firm’s venue choice decision. If the firm’s future prospects are poor ( $p_b$  is high), then a cheaper workout alternative is likely to be preferred, since part of the benefits of a full restructuring (d) accrue only when the firm survives. *The more likely the firm is to fail, the greater are the gains to waiting before attempting a full restructuring of operations.*

It is point (d) that deserves the most attention when attempting to interpret the results of LoPucki and Sara Kalin<sup>41</sup> and of LoPucki and Joseph Doherty.<sup>42</sup> It is apparent from the sketch of the model above that allowing firms the choice of a cheaper and faster workout alternative can increase social surplus, because some firms will benefit from postponing a full restructuring. More importantly, though, the model suggests that comparing postbankruptcy outcomes in firms that choose the cheaper alternative to outcomes in those that select the more costly alternative can be misleading. Firms that are more likely to underperform in the future, all else equal, will rationally select a cheaper, faster bankruptcy procedure, like the procedure offered by Delaware courts (particularly in prepackaged cases) in the 1990s. A higher probability of subsequent failure may result entirely from this selection effect, even if bankruptcy courts have no causal effect whatsoever on postbankruptcy performance.

## B. Capital Structure, Creditor Governance, and Classifying Failure

In this Part, we push the simple framework one step further and consider the possibility of an agency problem that may prevent the firm from taking actions that maximize value. This will allow us to de-

<sup>41</sup> See generally LoPucki and Kalin, 54 Vand L Rev 231 (cited in note 21).

<sup>42</sup> See generally LoPucki and Doherty, 55 Vand L Rev 1933 (cited in note 21).

rive predictions about postdistress capital structure and shed further light on the empirical results we have developed thus far.<sup>43</sup>

To be concrete, suppose management/equity holders are reluctant to pursue a full restructuring or liquidation at date one and will only do so when their hand is forced by an inability to repay debt. In other words, creditor control may be required to force the firm to make value-maximizing decisions. This agency problem might occur for a variety of reasons. Managers might be concerned about their reputation or the likely loss of their jobs, and would not want to risk the stigma of a bankruptcy filing. The equity holders they represent might be similarly reluctant, knowing that a Chapter 11 filing could result in their interests being extinguished. They might prefer to choose risky but inefficient actions that maximize the value of their own interest at the expense of debtholders.<sup>44</sup> To represent this numerically, we assume that if a restructuring or liquidation is required but not undertaken at date one, then the expected value of the firm's future cash flows is zero.

Because the firm is assumed to be insolvent at date zero (thus implying that management must bargain with creditors to a solution), we assume that the capital structure and the workout/restructuring decision will be made to maximize total firm value based on the expectation of the firm's future cash flows. The capital structure will be chosen anticipating future agency problems, namely, that management will avoid restructuring and liquidation whenever possible. Suppose, further, that the firm will be unable to pay its debts whenever these debts,  $D$ , exceed the present value of the firm's future cash flows, which are realized at date one. To avoid unnecessary financial distress, we assume that the firm will choose  $D$  to be the lowest possible value such that management is induced to take the optimal value-maximizing decision in all future states.

With this in mind, consider the firm's optimal capital structure decision when restructuring is preferred (that is, when  $(1 - p_b)d > (R - W) - p_m R - X$ ). If the firm restructures at date zero, then the manager's preferred action is compatible with firm value in all but state B. This is true because no action is required in state G, and restructuring

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<sup>43</sup> For a discussion of how capital structure can be designed to achieve efficient outcomes in bankruptcy when a wider menu of securities are available (including secured debt, leases, and asset-backed securities), see Kenneth Ayotte and Stav Gaon, *Asset-Backed Securities: Costs and Benefits of "Bankruptcy Remoteness"* (unpublished manuscript 2005) (on file with authors).

<sup>44</sup> It is a well-known principle in corporate finance that when firms are in financial distress, managers (representing equity holders) have an incentive to pursue risky projects at the expense of overall firm value. See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J Fin Econ* 305, 334-37 (1976). A bankruptcy filing forces managers to pay more attention to the interests of firm value as a whole, since creditors can reject a debtor's reorganization plan.

is not necessary in state M, since it was already conducted at date zero. This implies that the restructured firm will choose D to be slightly higher than L, so that the firm is forced into liquidation only in that state.

If the converse inequality holds, however, and the firm opts for a workout rather than a restructuring at date zero, the managers' interests diverge with firm value in states M and B at date one, because in state M a restructuring is optimal. This implies that the firm will choose D to be slightly higher than  $1 - R$ , which by our earlier assumption is higher than L.

Thus, the expanded model yields an additional insight, which results from the benefits of creditor governance: a costly restructuring is optimally paired with a lower postdistress leverage ratio, while a cheaper workout is optimally paired with a higher postdistress leverage ratio. This result, like our earlier results, suggests a particular need for caution in interpreting differences in distress resolution as resulting from ineffective court procedures.

### C. Comparing the Two Perspectives

It is important to contrast the perspective in our theoretical model with LoPucki's perspective in *Courting Failure* as it relates to the prominence and efficiency of the Delaware bankruptcy court. In our model, the "depth" of restructuring is a choice made by the firm's owners to maximize its value. A fuller restructuring, despite improving the firm's future prospects, may not always be value-maximizing. The firm might prefer instead to implement a less costly alternative, and save a full restructuring for a later date.

Because the Delaware court (and the prepackaged case more generally) offers the possibility of a faster, and hence less costly procedure, our model predicts that

- (a) it will attract firms that are more likely to fail upon emergence, and
- (b) these firms will emerge with higher leverage than those that undertake a more costly restructuring.

Taking this perspective, the choice of venue merely represents a forum in which the firm implements an expensive or inexpensive plan according to its preferences.<sup>45</sup> The firm's resulting success or failure, then, is determined only by its characteristics upon entering bank-

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<sup>45</sup> One could imagine other analogies that might make the point more creatively that corporate debtors may select Delaware for particular reasons. For instance, though we pour hot coffee into mugs and cold soda into glasses, we rarely assert that glasses "fail to heat the beverage."

ruptcy and the inherent cost of the procedure it chooses, which is not affected by the court itself.

Our approach emphasizes selection and cost as drivers of outcome differences across courts in ways that are consistent with efficiency. Professor LoPucki's interpretation of the facts clearly implies causality by courts and inefficiency. That is, he concludes that outcome differences (such as higher refile rates, higher postbankruptcy leverage, and weaker postbankruptcy performance) must have been caused by differences among courts, judges, or other features of the bankruptcy process that are necessarily inefficient.<sup>46</sup> We strongly dispute this interpretation of the facts. We now turn to a more thorough examination of the existing data to determine whether such strong determinations of causality and inefficiency are warranted.

#### D. Taking a Second Look at the Data

With these insights in hand, we will now reexamine some of the main evidence for Delaware's deficiency, as reported in Professor LoPucki's existing research and summarized in *Courting Failure*. As our model points out, one cost of attempting a faster but (perhaps) less thorough Delaware reorganization is the additional losses that might occur due to the decision to postpone operational changes in the company (represented by the parameter X in our model). These additional losses, if substantial, would lead to the conclusion that the Delaware bankruptcy procedure must have been value-destroying.

As evidence for this conclusion, LoPucki documents the poor postbankruptcy operating performance of the nine Delaware firms that refiled for bankruptcy in the interim periods between the two filings. On average, the cumulative operating losses of these firms averaged 18 percent of asset value. Professor LoPucki interprets these results as strong evidence that the costs of multiple bankruptcies are too costly to be justifiable by rational choice:

Those [Delaware refilers'] operating losses averaged 18 percent of the entire value of the company. . . . Operating losses are generally hard cash, and prepetition financial statements generally overvalue the companies' assets, so the 18 percent figure is a very

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<sup>46</sup> For example, LoPucki and Kalin interpret the data the following way: "The extraordinary high failure rate that resulted from these reorganizations suggests a lack of 'efficiency' in the Delaware process at that time—the very time in which the Delaware court was establishing its dominance." LoPucki and Kalin, 54 Vand L Rev at 264 (cited in note 21). Similarly, with respect to postbankruptcy leverage ratios, "the Delaware bankruptcy court's laissez-faire approach to confirmation may not provide sufficient encouragement for firms to reduce their leverage ratios." Id at 265. In *Courting Failure* itself, LoPucki is characteristically more strident, claiming that Delaware "was actually destroying companies" (p 118).

conservative estimate of the losses that occurred between bankruptcies. . . . To calculate the losses from failed reorganization one would also have to add the cost of the additional bankruptcy. Re-filing was far too expensive to be efficient (p 109).

It is important to recognize the implicit assumptions behind this strong conclusion. In order to interpret these facts as evidence of a faulty Delaware bankruptcy procedure and inefficient decisionmaking, one would have to assume all of the following:

- (a) The accounting measures of losses reflect true economic losses (rather than paper losses);
- (b) These losses occurred after the firm emerged from bankruptcy (rather than merely being recorded after the emergence);
- (c) These losses would not have occurred if a different bankruptcy venue were chosen.

A closer look at the sources of the operating losses in these nine firms, however, reveals that there is reason to doubt each one of these claims. Below, we present a summary of the postbankruptcy performance of the nine Delaware refilers reported by LoPucki. The data reveal a striking pattern. Nearly all of these reported losses are driven by write downs of intangible assets and amortization of postreorganization goodwill.

To explain the importance of this finding, a bit of background is required. Postreorganization firms use a procedure called “fresh start reporting” to create a new set of financial statements after reorganizing. Tangible assets are recorded at their market values, and an intangible asset is created to reflect the firm’s estimate of the difference between the market value of the firm and the liquidation value of its assets. This goodwill “asset” is amortized over a period of years. Operating profits in LoPucki’s work and LoPucki and Doherty’s work are reported after this amortization expense is deducted.<sup>47</sup>

Although this goodwill amortization expense is standard accounting practice, it is hard to attach much economic significance to its value, because the goodwill amount and the amortization schedule are substantially left to the firm’s discretion. Recognizing these defects, both practitioners and academics commonly choose a different measure of profitability called EBITDA, in which depreciation and amortization are added to operating profit to avoid this unnecessary distor-

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<sup>47</sup> LoPucki, 54 Vand L Rev at 331 (cited in note 21); LoPucki and Doherty, 55 Vand L Rev at 1933 (cited in note 21).

tion.<sup>48</sup> EBITDA is sometimes considered a rough proxy for cash flow because it excludes such noncash charges.

In the table below, we present postbankruptcy performance measures from the nine Delaware cases that emerged from bankruptcy between 1991 and 1996 and subsequently were refiled.<sup>49</sup> The notes column describes the reasons behind the large losses that some of the firms reported in a given year.

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<sup>48</sup> EBITDA stands for earnings before interest, taxes, depreciation, and amortization. The operating profit measure used in LoPucki's studies is sometimes called EBIT (earnings before interest and taxes). See Steven N. Kaplan and Richard S. Ruback, *The Valuation of Cash Flow Forecasts: An Empirical Analysis*, 50 J Fin 1059, 1063, 1066-67 (1995). Financial covenants on loans are more commonly based on EBITDA than on EBIT. Other academic studies on post-bankruptcy performance have used this EBITDA measure as well. See, for example, Edith Shwalb Hotchkiss, *Postbankruptcy Performance and Management Turnover*, 50 J Fin 3, 8 (1995).

<sup>49</sup> So that our ratios make sense, we included only annual data from 10-K statements. Data from 10-Q statements were similar. Assets are the "assets before first filing" measure as reported in LoPucki, 54 Vand L Rev at 257-58 (cited in note 21). EBITDA is the operating profit as reported by LoPucki plus depreciation and amortization. Adjusted EBITDA is sales less cost of goods sold and selling, general, and administrative expenses. Where such categories were not explicitly provided in the 10-K, all costs not specifically associated with depreciation, amortization, or write downs of assets were included as a conservative approximation. Amounts are in thousands of dollars.

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Firm Name	Year	Operating Profit (EBIT)	EBITDA	Adjusted EBITDA	EBIT/Assets	EBITDA/Assets	Adjusted EBITDA/Assets	Notes
Memorex 1	1993	-80,423	-36,313	-5,025	-4.6%	-2.1%	-0.3%	The amortization of postreorg goodwill totaled 23,460 (29% of operating losses).
Spectravision	1994	-229,386	-178,852	18,567	-37.6%	-29.3%	3.0%	In 1994, the company wrote down the value of hotel contracts by 196,256 (86% of 1994 operating losses).
	1993	3,205	47,308	47,957	0.5%	7.7%	7.9%	
	avg				-18.5%	-10.8%	5.4%	
Cherokee	1994	-17,136	-112	-112	8.0%	-0.1%	-0.1%	
Memorex 2	1996	-207,474	27,557	12,478	-18.2%	2.4%	1.1%	In 1996, amortization of postreorg goodwill was 224,456 (108% of operating losses).
	1995	-84,860	50,311	33,048	-7.5%	4.4%	2.9%	
	avg				-12.8%	3.4%	2.0%	
Westmoreland Coal	1995	-95,960	-81,057	2,403	-36.1%	-30.5%	0.9%	In 1995, the company wrote down the value of assets by 66,623 (69% of operating losses).
	1996	-2,388	-52	-2,312	-0.9%	0.0%	-0.9%	
	avg				-18.5%	-15.3%	0.0%	
Harvard Industries	1993	-9,375	-6,783	-6,783	-1.9%	-1.3%	-1.3%	
	1994	37,619	39,203	39,203	7.5%	7.8%	7.8%	
	1995	38,469	41,455	41,455	7.6%	8.2%	8.2%	
	1996	-9,474	5,838	5,838	-1.9%	1.2%	1.2%	
	avg				2.8%	4.0%	4.0%	
TWA	1994	-279,494	-96,211	42,638	-10.4%	-3.6%	1.6%	Recorded 175,100 in write downs and other one-time charges (63% of operating losses).
United Merchants	1992	-16,896	-10,147	-10,147	-7.5%	4.5%	4.5%	
	1993	-11,160	-9,369	-9,369	-5.0%	4.2%	4.2%	
	1994	-11,314	-9,591	-9,591	-5.0%	4.3%	4.3%	
	1995	-6,663	-5,195	-5,195	-3.0%	2.3%	2.3%	
	avg				-5.1%	3.8%	3.8%	
Grand Union	1998	-132,500	70,600	70,600	-9.5%	5.1%	5.1%	Cumulative amortization of excess reorg value was 290,300 between 1996 and 1998 (129% of cumulative operating losses).
	1997	-65,300	122,800	122,800	-4.7%	8.8%	8.8%	
	1996	-27,600	116,200	116,200	-2.0%	8.3%	8.3%	
	avg				-5.4%	7.4%	7.4%	
Average of averages					-9.0%	2.3%	1.8%	

We report two new measures of profitability that avoid the distortion caused by noncash charges. The first, EBITDA, is operating profit plus depreciation and amortization. As noted, this measure corrects for the distortions caused by the arbitrary choice of postreorganization goodwill. As these data show, several of the largest reported losses were driven entirely by amortization of postreorganization goodwill. In two of the cases, Memorex 2 and Grand Union, these goodwill amortization expenses were more than 100 percent of the reported operating losses. Using EBITDA as a measure of profitabil-



ity, these firms actually earned a positive profit between refilings. Overall, when EBITDA is used as a measure of profit, the average Delaware refiling firm lost an average of only 2.3 percent of its pre-bankruptcy asset value per year.

The second measure, which we call adjusted EBITDA, adds back the value of asset write downs in addition to depreciation and amortization. This measure allows us to further understand the true drivers of the reported postbankruptcy performance of these nine firms. Although asset write downs are certainly more likely to represent true economic losses than amortization of reorganization goodwill, it is highly unlikely that large abnormal write downs of asset values resulted from value-destroying activity that occurred entirely in the period in which the losses are recorded. More likely, large write downs would recognize economic losses resulting from decisions made in past periods.

As our adjusted EBITDA-to-total assets ratio demonstrates, all of the large single-period losses (periods in which operating losses were more than 10 percent of asset value) resulted from either amortization or large write downs of assets. When these losses are excluded, only three of the nine firms suffered losses in the period between bankruptcies, and only one of the firms (United Merchants) lost more than 1 percent of asset value in an average year. On average, the adjusted EBITDA-to-total assets ratio for the Delaware refilers is a positive 1.8 percent of prebankruptcy assets per year.<sup>50</sup>

Our analysis of the nine Delaware failures suggests several conclusions. First, the operating loss measure (EBIT) reported by LoPucki<sup>51</sup> and by LoPucki and Doherty<sup>52</sup> is an extreme overstatement of any value loss attributable to the Delaware bankruptcy process. Even if the postbankruptcy performance of these nine firms were perfectly foreseeable in advance, we could not conclude that the decision to emerge from bankruptcy was economically inefficient. Attributing any postbankruptcy underperformance to causality by some feature of the Delaware bankruptcy process is even more speculative.<sup>53</sup>

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<sup>50</sup> In interpreting these figures, we do not mean to suggest that any of these nine firms were “good” performers. Naturally, because all of these firms filed a second time for Chapter 11, it is likely that any profitability measure would be below average if compared to industry peers. Considering, however, that these nine firms were the worst performers of the group emerging from Delaware in the 1991–1996 period, the losses are surprisingly moderate.

<sup>51</sup> LoPucki, 54 Vand L Rev at 336–38 (cited in note 21).

<sup>52</sup> LoPucki and Doherty, 55 Vand L Rev at 1942–44 (cited in note 21).

<sup>53</sup> Rasmussen reaches a very similar conclusion by conducting careful anecdotal case studies of each of the bankruptcies in question. See generally Rasmussen, *Empirically Bankrupt* (cited in note 23).

Second, the results directly contradict Professor LoPucki's claim that these losses "are generally hard cash." Instead, nearly all of the reported losses are driven by noncash charges whose economic significance is dubious. In addition, the fact that many of the large reported operating losses were driven by asset write downs, not post-bankruptcy operations, supports the notion that preexisting conditions of Delaware filers (and of prepackaged cases) are as important a driver of refiling patterns as decisions made after the filing.

#### E. Is There a Bias against Delaware?

The above analysis and examples suggest that the economic losses of companies emerging from Delaware are both overstated and wrongly attributed to the Delaware bankruptcy process. But LoPucki's performance measure also is likely to overstate the losses in cases from other bankruptcy courts. It might therefore seem that LoPucki still can claim that Delaware firms perform substantially worse than firms emerging from other courts. Is there a reason why a comparison of postbankruptcy performance is likely to be biased toward finding that the Delaware bankruptcy process was inefficient?

For several reasons, the answer is yes. As our theoretical model suggests, firms choosing a faster, cheaper means of resolving distress are more likely to be candidates for a later liquidation. Owners might rationally choose to forsake an expensive restructuring, which would be wasted if the firm is later liquidated. This selection effect can be an important driver of postbankruptcy performance.<sup>54</sup> Second, if creditor governance is valuable, it is rational for more troubled firms to choose higher postbankruptcy leverage ratios—distressed firms might be optimally kept "on a short leash" to shut down overspending on projects that are later determined to be unprofitable.<sup>55</sup>

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<sup>54</sup> Professor LoPucki has attempted to refute these points in prior work by comparing Delaware and non-Delaware filers along observable measures such as size and leverage. Although such simple observable measures might identify an obvious selection effect, the failure to find obvious observable differences driving both the filing decision and refiling does not rule out the presence of selection. In most empirical studies of this kind, researchers recognize the possibility of unobservable differences and use econometric techniques (such as instrumental variables) to eliminate them. In our own research, we have found such an approach to be difficult, in part due to the small sample size and the lack of plausible instruments. Given the inherent difficulty involved, we believe it is sensible to acknowledge the possibility that unobservable selection could be driving the results, especially because we have identified a plausible explanation for it in our theoretical model, and anecdotal evidence from practitioners indicates that the "tougher" cases often go to Delaware to take advantage of the expertise of its judges.

<sup>55</sup> The Spectravision case (one of the Delaware refilers) illustrates this point. The company provided pay-per-view movie services to hotel chains through an outdated technology. After its first prepackaged filing, Spectravision converted to a newer, more modern technology that used satellites to deliver movies to hotel rooms. This new technology turned out to be a failure, run-

Consistent with our model, LoPucki and Doherty find that Delaware firms do emerge with higher leverage than non-Delaware firms. This insight is important. As our data below will demonstrate, all of the metrics used by LoPucki and Doherty to argue that Delaware bankruptcies cause poor postbankruptcy performance are distorted by leverage.

### 1. Measures based on a second bankruptcy filing.

When firms emerge from bankruptcy or complete workouts, they rarely, if ever, choose an all-equity capital structure, despite the fact that this choice would minimize the likelihood of refailure.<sup>56</sup> Instead, firms often choose high levels of debt that make a second bankruptcy a distinct possibility. Our simple model points out one reason why firms might choose high leverage after resolving distress—this choice may be required to prevent the future overspending, risk-seeking tendency of management and equity. This benefit-of-creditor governance has so far been ignored in the venue choice debate. Because firms reorganizing in Delaware emerge with higher leverage, a second bankruptcy is certainly more likely, controlling for the firm's postbankruptcy profitability. To see this as a failure, however, would be a mistake. The logic behind our model suggests that if firms were forced to emerge from bankruptcy with no debt and to remain all-equity-financed after bankruptcy, they would certainly refile with lower probability. Importantly, however, significant firm value might be lost because the potential for effective creditor governance would be lost.<sup>57</sup> This governance lever should be

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ning over budget and behind schedule, and many hotels were reluctant to make the conversion. Though it sought to restructure its bonds to avoid a second filing, it was unsuccessful, and a cash shortage forced the company into Chapter 11 again in 1995. In its second bankruptcy, it was acquired by On Command, one of its competitors. On Command converted hotels with Spectravision technology to its own more cost-effective technology. Had leverage been lower, Spectravision might have continued to pursue the risky technology indefinitely, particularly given equity-holders' tendency to pursue risky projects at the expense of firm value. Spectravision is also discussed in Douglas Baird and Robert Rasmussen's critique of *Courting Failure*. See generally Douglas G. Baird and Robert K. Rasmussen, *Beyond Recidivism* (unpublished manuscript 2005) (on file with authors).

<sup>56</sup> For a thoughtful discussion of this point, see Barry E. Adler, *A World Without Debt*, 72 Wash U L Q 811, 815–17 (1994).

<sup>57</sup> One justification for the leveraged buyout (LBO) wave in the late 1980s was that debt helps solve a firm's "free cash flow" problem. Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy*, 2 J Applied Corp Fin 35, 44 (Spring 1989) (describing the potential benefits and pitfalls of leveraged buyouts and the strategy behind them). By committing cash for debt repayment, overspending can be curbed significantly. Though the LBO wave resulted in numerous bankruptcies in the early 1990s, a study by Gregor Andrade and Steven Kaplan finds that the costs of purely financial distress are moderate and that the LBO wave overall created value. See Gregor Andrade and Steven N. Kaplan, *How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J Fin 1443, 1444 (1998).

particularly important in firms that have filed for bankruptcy once, because the future prospects of these firms are likely to be in doubt. In short, refile is not a useful measure of the effectiveness of a bankruptcy procedure. Moreover, using this measure to compare across courts is biased against Delaware, whose process allows firms to emerge with higher leverage.<sup>58</sup>

## 2. Measures based on net income.

As taught in most corporate finance textbooks, net income is a measure of firm performance that is skewed downward by leverage.<sup>59</sup> Because net income is reported after interest expense, higher debt will lead to lower net income for a given quality of the firm's performance. The main measure LoPucki and Doherty use to argue for Delaware firms' "astonishingly poor" performance is net income divided by assets.

Similarly, LoPucki and Doherty report that Delaware reorganizations are significantly more likely to be classified as "failures." A reorganization is classified as a failure if (a) a second Chapter 11 is filed, or (b) the firm merges or is acquired after negative earnings are recorded. Because firms reorganizing in Delaware chose to emerge with higher leverage, their mergers are more likely to be classified as failures according to this metric, since net income is more likely to be negative for a given operating performance.

## 3. Measures based on operating profit (EBIT).

Though less obviously so, operating profit (EBIT) is also biased against firms that seek to emerge from bankruptcy with higher leverage. As our earlier discussion highlights, amortization of postreorganization goodwill is an important driver of operating profit of reorganized firms. A study by Reuven Leuhavy finds evidence suggesting that firms with higher postbankruptcy leverage are significantly more likely to overstate their fresh start equity values.<sup>60</sup> This, in turn, increases amortization expense and reduces reported operating profit. Leuhavy suggests that the rationale for this bias may be the incentive to achieve confirmation of a plan by overstating the firm's solvency.<sup>61</sup>

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<sup>58</sup> To the extent that other courts have begun to replicate Delaware practices, these differences may diminish somewhat over time.

<sup>59</sup> See, for example, Robert C. Higgins, *Analysis for Financial Management* 9 (Irwin/McGraw-Hill 6th ed 2001).

<sup>60</sup> See Reuven Leuhavy, *Reporting Discretion and the Choice of Fresh Start Values in Companies Emerging from Chapter 11 Bankruptcy*, 7 *Rev Accounting Stud* 53, 54–55 (2002).

<sup>61</sup> *Id* at 69.

## F. Do Delaware Reorganized Firms Really Underperform after Bankruptcy?

The following table presents postbankruptcy performance data from firms emerging from Chapter 11 between 1991 and 1996, drawn from LoPucki's Bankruptcy Research Database.<sup>62</sup>

Court	Net Income/ Assets		Operating Profits/ Assets		EBITDA/Assets		Adjusted EBITDA/Assets	
	Average of Averages	N	Average of Averages	N	Average of Averages	N	Average of Averages	N
Delaware	-11.5%	13	-3.8%	13	10.9%	13	11.6%	11
SD NY	-2.8%	10	4.0%	10	11.0%	10	9.8%	9
Other Courts	-3.5%	37	6.1%	37	11.9%	37	12.3%	26

Although the data is not an identical match to the data used in LoPucki and Doherty, the common statistics are substantially similar. The difference between Delaware and "Other Courts" is most pronounced for the net income measure and the operating profit measure, which are distorted by leverage and goodwill amortization. Notice, however, when we calculate performance measures that are independent of these biases, the differences between Delaware and Other Courts becomes negligible (no more than 1 percent of total assets). A statistical test of the performance data reveals that such a small difference in means could easily be driven by random chance.<sup>63</sup>

## G. Conclusion

Based on a simple theoretical model and a second look at the existing empirical evidence from Chapter 11 filings, we find no evidence to support the conclusion that the Delaware bankruptcy process is inefficient, or that competition for bankruptcy cases is socially destructive, as Professor LoPucki asserts in *Courting Failure*. All of the available evidence reported in the existing empirical research, after more careful scrutiny, is completely consistent with the hypothesis that

<sup>62</sup> We selected all firms emerging from bankruptcy between 1991 and 1996 with confirmed plans and matched them to data from COMPUSTAT for up to five years following their emergence from bankruptcy. Although the original list of firms was larger, COMPUSTAT data was only available for sixty of the firms, which generated a total of 287 observations. Adjusted EBITDA is calculated as: sales less cost of goods sold and selling, general, and administrative expenses.

<sup>63</sup> When we tested for differences in means of the EBITDA measures between Delaware and Other Courts, the p-values are above 0.8. This suggests that a difference of such small magnitude could easily be generated by chance if in fact there is no intrinsic difference between the postbankruptcy performance of firms emerging from Delaware and those emerging from Other Courts.

venue choice in bankruptcy has been welfare-enhancing and made in the interests of overall firm value-maximization. The Delaware bankruptcy courts, due to their faster handling of cases and lack of interference in the firm's decisionmaking process, offer firms a valuable option that is not available in other venues. To the extent that Delaware judges have particular expertise in handling large, complicated reorganizations, as anecdotal evidence suggests, such gains from venue choice are even larger. Similarly, prepackaged cases offer firms an opportunity for a quick, low-cost debt restructuring that avoids the direct and indirect costs of a needlessly extended stay in bankruptcy. These cost-saving options, however, are most valuable to firms whose future viability is most uncertain. Moreover, it is exactly these firms that benefit the most from creditor governance, the exercise of which may require a second trip to bankruptcy.

Our analysis suggests the importance of finding better metrics to measure whether bankruptcy outcomes can be legitimately labeled as "failures" or "successes." In addition, given that venue choice is anything but a random process, caution should be exercised in attributing causality of outcomes to bankruptcy courts rather than to the conditions of the companies that choose them. Future empirical research related to the issues raised in *Courting Failure* should focus squarely on the amount of firm value that is either created or destroyed during the bankruptcy process, with an eye on establishing causality in a more convincing way. Given the difficulty in establishing accurate measures of firm value when firms are highly distressed, and the inherent small sample size problems associated with large Chapter 11 bankruptcies, this is by no means an easy task.

### III. IS (DELAWARE) VENUE SHOPPING PERNICIOUS?

The analysis thus far shows that the data LoPucki offers as evidence of a breakdown in the Delaware courts may actually demonstrate precisely the opposite. If a thoroughgoing restructuring is not the optimal strategy for every financially troubled firm—and, we have argued, it isn't—postbankruptcy losses and a subsequent liquidation or refiling may reflect an effective bankruptcy process rather than a failure.

To further assess which view of the data is more plausible—LoPucki's skeptical account or our more optimistic alternative—we turn in this Part to LoPucki's theoretical explanation for the alleged breakdown in the bankruptcy courts. In his theoretical account, the behavior of Delaware and now other U.S. bankruptcy courts is best

explained as an example of pernicious forum shopping, a claim he supports by identifying seven issues that reflect corruption in the bankruptcy courts.<sup>64</sup> In the first section of this Part, we investigate LoPucki's forum-shopping claims and suggest several reasons why it is unlikely that Delaware and other courts focus almost exclusively on the interests of the debtor's managers and attorneys. In the section that follows, we offer evidence suggesting, among other things, that experience rather than insidious forum shopping was a major factor in Delaware's popularity in the 1990s.

#### A. Pernicious versus Beneficial Venue Shopping

LoPucki introduces his brief against Delaware by describing Delaware's efforts to attract business in other areas. "Despite its on-shore location," he writes, "the state of Delaware is a haven, engaged in many of the same businesses pursued by offshore havens such as Bermuda, the Cayman Islands [etc]. Havens are states or countries that turn lawmaking into a business and prey on their neighbors" (p 51).<sup>65</sup> As examples of Delaware's "exploitation" of other states, he cites its status as the most popular state of incorporation, its efforts to attract credit card issuers, its legislation authorizing "asset protection trusts," and finally its prominence as a venue for large scale corporate reorganizations (pp 53–56).

In classic muckraking fashion, LoPucki lumps the examples together, and in doing so suggests that they are equally troubling. But in reality (as LoPucki implicitly acknowledges much later in the book, by offering a slightly less breathless analysis of Delaware's role in bankruptcy) (pp 240–43), not all forum shopping is created equal. While forum shopping can have undeniably deleterious effects in some contexts, it produces radically better results in others. The standard illustration of worrisome court shopping is tobacco and other nationwide tort litigation.<sup>66</sup> If the alleged victims are located throughout the country, lawyers can sue in almost any courthouse they choose. Judges or juries that wish to punish giant corporations, or simply to bring business (in the form of lawyers and parties patronizing local hotels and restaurants) to their community, can put their courthouse on the map

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<sup>64</sup> See text accompanying note 23.

<sup>65</sup> For a recent attack on Delaware written in much the same spirit as *Courting Failure*, see Jonathan Chait, *Rogue State: The Case against Delaware*, New Republic 20 (Aug 19, 2002) (criticizing, in addition to Delaware's efforts to attract corporations and credit card banks, the tolls on I-95).

<sup>66</sup> Todd Zywicki provides a detailed exploration of the mass tort example and other current and historical examples of court shopping in a forthcoming review of *Courting Failure*. Todd J. Zywicki, *Is Forum-Shopping Corrupting America's Bankruptcy Courts?*, 94 Georgetown L J (forthcoming 2006).

by returning a few large damages awards. Unlike the benefits, which flow directly to the judge or jury and their community, the costs are borne by consumers across the nation. It is this externalization of costs, without an effective check, that makes for inefficient forum shopping.<sup>67</sup>

In corporate law, the comparison that LoPucki and other participants in the bankruptcy venue debate dwell on at greatest length, commentators have debated for more than thirty years whether the states' efforts to attract corporations ("charter competition") have produced a race to the bottom (pernicious forum shopping) or a race to the top (beneficial forum shopping) in state regulation. There is no need to rehearse the debate yet again here.<sup>68</sup> For present purposes, it suffices to note that race to the bottom scholars traditionally have argued that managers are the ones who choose a company's state of incorporation; states therefore adopt laws that are designed to keep managers happy, and these laws divert value from shareholders, who are the ones who bear the costs of inefficiently manager-friendly laws. Race to the top theorists, by contrast, point out that there are two potential checks on managers' ability to seek, and states' incentives to provide, manager-centered laws: (1) a proposal by managers to reincorporate is subject to a shareholder vote, so shareholders have a direct say in the decision to shift the company's domicile to Delaware; and (2) the takeover market, the market for capital, and other market forces will punish companies that incorporate in states with inefficiently lax regulation. For several decades, much of the charter competition debate focused on the question whether these checks are robust enough to prevent managers and the states that love them from diverting value from shareholders. Most recently, several scholars have questioned whether there really is any meaningful competition, because Delaware seems to have a near monopoly and Congress seems to be a more serious regulatory competitor for Delaware than the other states.<sup>69</sup>

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<sup>67</sup> *Id.* (contrasting forum shopping in contemporary mass tort cases with the more beneficial court shopping in England that predated the emergence of the common law).

<sup>68</sup> LoPucki provides his own summary of the debate (pp 236–40). Further discussion can be found in David A. Skeel, Jr., *Rethinking the Line between Corporate Law and Corporate Bankruptcy*, 72 *Tex L Rev* 471 (1994), and in many other places. The leading advocate of Delaware is Roberta Romano, and the principal critic has been Lucian Bebchuk. See, for example, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv L Rev* 1435 (1992) (examining how states can be led to adopt undesirable corporate policies and how federal regulation should be introduced to curtail this problem); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 *J L Econ & Org* 225 (1985) (arguing that competition among the states has produced efficiency and exploring why Delaware is dominant).

<sup>69</sup> See, for example, Mark J. Roe, *Delaware's Competition*, 117 *Harv L Rev* 588, 600 (2003) (arguing that federal intervention rather than competition from other states is the principal threat to Delaware); Marcel Kahan and Ehud Kamar, *The Myth of State Competition in Corpo-*



Market skeptic that he is, Professor LoPucki sides squarely with the race to the bottom theorists in the corporate law debate. But the more important question is how the general venue shopping analysis plays out in the related but different bankruptcy context. Whatever one thinks of the corporate competition debate, LoPucki argues, the checks identified by corporate scholars do not come into play in the bankruptcy context.<sup>70</sup> If a debtor's managers wish to file for bankruptcy, shareholders and creditors have no say in the matter; the debtor's directors can unilaterally choose whether and where to file. Nor do the capital markets serve as a restraint. When managers file for bankruptcy, the company is at the end of the line. All of the capital raising has already been done. As a result, the managers and bankruptcy lawyers have nearly unbridled discretion to look for the bankruptcy court that best—or most outrageously—serves their own interests. As always, LoPucki puts the point with a bit more verve, writing:

The lawyers and executives who choose venues for large public companies—the case placers—are hard-nosed businesspeople. They know they have something valuable to offer: tens or hundreds of millions of dollars of business for local bankruptcy practitioners. They expect something in return: advantages their bankruptcy courts at home would not give them (p 133).

In our view, LoPucki's forum-shopping analysis ignores (or seriously underplays) several critical checks on the ability of managers and their attorneys to seek a venue that promotes their interests at the expense of creditors and other constituencies of a troubled company. First, and most important, although his argument that managers do not face capital constraints when they file for bankruptcy may have been accurate in the 1980s, it has been anything but accurate for the past decade. Since the mid 1990s, most large corporate debtors have been dependent on extensive bank financing during the period immediately before bankruptcy and throughout the bankruptcy case. DIP

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*rate Law*, 55 *Stan L Rev* 679, 748 (2002) (asserting that Delaware is the only state that stands to benefit from chartering corporations and the only state that significantly attempts to attract them); *id* at 743–47 (asserting that Congress could compete with Delaware by creating a federal corporation law); Lucian Bebchuk and Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 *Yale L J* 553, 555–57 (2002) (arguing that Delaware has a monopoly on out-of-state incorporations and that this is unlikely to change).

<sup>70</sup> This argument is borrowed from Rasmussen and Thomas, who develop the point in detail. Rasmussen and Thomas, 54 *Vand L Rev* at 290 (cited in note 22). Unlike LoPucki, Rasmussen and Thomas exempt prepacks from the analysis, based on the fact that a debtor's managers negotiate the terms of the prepack in advance with creditors, whose support is necessary for the prepack to be approved. For a critique of the distinction, see Skeel, 54 *Vand L Rev* at 326–28 (cited in note 22). As suggested below, we suspect that there actually is a very significant check on the venue choice in many cases: the DIP financier.

financing is now the most important corporate governance lever in Chapter 11.<sup>71</sup> DIP financiers seem to influence the decision where to file for bankruptcy, and, more importantly, they use the DIP financing agreement to exert significant control over the direction of the Chapter 11 case. This influence takes a wide range of forms, including, among other things, insisting that the company bring in a chief restructuring officer, including explicit directives to sell assets or restructure quickly, and metering the company's access to capital in order keep the debtor on a tight leash.<sup>72</sup>

The banks that serve as DIP financiers aren't in the habit of simply throwing money away. It is therefore unlikely that they would sit idly by while a debtor's managers and their attorneys directed the case to a venue that let managers stick around when they should be ousted and paid the debtor's bankruptcy lawyers and other professionals exorbitantly large amounts of money. In cases where the company depends on a DIP lender for financing, one suspects that managers will be permitted to remain in place only if there is a good reason for their presence and that the debtor's attorneys and other professionals receive New York rates because the lender is persuaded that the rates (and retaining the attorneys who insist on them) are justified.

The second check is creditor voting. Each of the reorganizations that later refiled was approved by a vote of the debtor's creditors. Creditor voting is not a perfect check against potential bankruptcy abuses, of course. Because creditors do not vote until the debtor proposes a reorganization plan, the vote does not protect them from decisions that favor the debtor's managers or attorneys at their expense earlier in the case. During the 1980s, many commentators believed that courts' willingness to repeatedly extend the debtor's exclusive right to propose a reorganization plan not only enabled debtors to divert value from creditors, but also may have distorted the creditors' vote. A debtor's implicit threat to drag the case out, on this view, may have pressured creditors to approve plans they might otherwise have rejected.<sup>73</sup> One of the most striking qualities of the Delaware cases, by contrast, as we have seen, is that they are significantly faster than cases elsewhere, which suggests that the creditors' vote is not distorted

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<sup>71</sup> See, for example, David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U Pa L Rev 917, 919 (2003) (describing DIP financing and performance-based compensation as the two most important governance levers in many cases).

<sup>72</sup> See, for example, David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 Cardozo L Rev 1905, 1906–07 (2004). For a detailed list of the provisions DIP lenders use to exert control, see Harvey R. Miller, et al, *Debtor Dispossessed: The Rise of the "Creditor-in-Possession" and Chapter 11 Asset Sales: Does Chapter 11 Have a Future for Debtors?* 13–16 (unpublished manuscript 2005) (on file with authors).

<sup>73</sup> See generally Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 Wis L Rev 729.

in this fashion in Delaware. This and the fact that creditors approved the reorganization plans in the cases LoPucki examined suggest that the creditors, like the debtor and its attorneys, concluded that the plan was the best way forward.

Elsewhere in *Courting Failure*, LoPucki argues that Delaware permits a debtor's managers to sell assets at inefficiently low prices, and that the managers arrange side payments such as continued employment or consulting agreements with the purchasers of the assets.<sup>74</sup> Even if LoPucki were correct that Delaware permits excessively quick sales, the asset sale cases would not speak to LoPucki's findings about repeat Chapter 11 filings, since the § 363 sales do not lead to a traditional reorganization.<sup>75</sup> These are different cases, in other words, than the cases in LoPucki's original analysis. More importantly, we have significant doubts about LoPucki's characterization of § 363 sales practices. So long as the managers themselves (or the DIP financiers, as discussed in the next Part) are not the buyers of the assets, open auction procedures seem likely to ensure that the assets are bought by the highest valuing bidder. In effect, an open auction is a substitute for a direct vote by creditors. Although one can quibble with the sales conducted in a few cases, courts have developed auction procedures that seem defined to balance the need for a prompt sale before the value of the assets deteriorates, on the one hand, with the need to conduct a thorough, open auction, on the other.<sup>76</sup>

The checks we have just described are not perfect. But the existence of these correctives raises serious doubts about the suggestion that a debtor's managers and lawyers can use the venue choice to benefit themselves and destroy otherwise healthy companies.

## B. Another Explanation for Delaware: Judicial Expertise

Drawing on theory and recent developments in Chapter 11 practice, the last section argued that a debtor's managers and lawyers have far less wiggle room than *Courting Failure* suggests. This raises an obvious question: if large corporate debtors' fondness for Delaware in

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<sup>74</sup> LoPucki contends that managers "announce their attention to sell only at the last minute," in order to "deliver a company to themselves or their accomplices at a bargain price" (p 169). He goes on to suggest that the managers do not usually purchase the companies themselves; rather, the "debtor's managers get some kind of publicly announced payoff—in the form of employment or consulting contracts—from the buyer" (p 174).

<sup>75</sup> For a general discussion of § 363, see Douglas G. Baird, *Elements of Bankruptcy* 182–87 (Foundation 3d ed 2001).

<sup>76</sup> The Bankruptcy Court for the Southern District of New York, for instance, has developed detailed guidelines for making the property available for inspection, conducting the auction and other matters related to the § 363 sale, in addition to the general notice and reporting requirements set forth in Bankr R 6004 (2005).

the 1990s cannot be explained as a simple power grab by managers and lawyers, what is driving the venue choice? This section briefly reports the results of our own empirical investigation into the determinants of the Delaware filing decision. As we shall see, our findings offer a significantly different perspective on the Delaware filing decision, a perspective more consistent with the analysis of the previous section.<sup>77</sup>

1. The sample.

Our sample of corporate debtors was collected from the Bankruptcy DataSource, which has records of all Chapter 11 bankruptcies of firms with assets of at least \$50 million.<sup>78</sup> The DataSource provides monthly updates on major developments in the Chapter 11 proceeding, including summaries of proposed plans of reorganization, whether the case was prepackaged, and the dates on which plans are confirmed or converted to Chapter 7 liquidations. It also lists summary information about the firm, from which we recorded the state of the firm's headquarters, and the court and the judge presiding over the Chapter 11 case. The original sample for this study consists of all such firms filing for Chapter 11 between 1990 and 1999 with at least \$50 million in assets. Firms filing twice within the sample period were classified as separate observations.

The Bankruptcy DataSource records were supplemented with firm characteristics from COMPUSTAT, using the data closest to but not after the date the firm filed for Chapter 11.<sup>79</sup> In order for the firm's data to be considered valid, the firm must have filed a 10-K statement within twenty-four months of the bankruptcy date. Because it is common for firms to forsake their SEC filings in the wake of bankruptcy, several observations were lost at this stage. Finally, as measures of bankruptcy case experience by state, we used the average number of

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<sup>77</sup> The sample and findings outlined in this section are described in more detail in a companion paper. See Kenneth M. Ayotte and David A. Skeel, Jr., *Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy* 6–8 (unpublished manuscript 2004) (on file with authors).

<sup>78</sup> The \$50 million cutoff thus gives our sample both more and marginally smaller firms than Professor LoPucki's sample (whose cutoff is \$220 million). The Bankruptcy DataSource is available online at <http://www.bankruptcydata.com> (visited Jan 17, 2006), through a subscription service.

<sup>79</sup> Although the Bankruptcy DataSource provides balance sheet data, we used alternative sources for this and for management characteristics because the Bankruptcy DataSource often did not report the most recent data available prior to filing.

business Chapter 11 cases filed in 1997 per court for each state, as listed on the federal judiciary's website.<sup>80</sup>

Based on information from the DataSource, which was supplemented through newspaper searches where necessary, the outcome of a firm's bankruptcy was classified as a reorganization or a liquidation/sale. A reorganization was coded if the firm emerged from bankruptcy as a going concern with at least part of its original operations intact, without being acquired by or merged with an already existing firm. Identifying a distinction between a liquidation and a sale was more subtle and required more judgment calls. Because the descriptive statistics of sold and liquidated firms are similar, and since both sales and liquidations are quite different from the firms that successfully reorganize, we chose a bivariate classification system to identify the outcomes of cases as reorganized or not.

Using this sample, we attempted to determine which firms are most likely to file for bankruptcy in Delaware and why.<sup>81</sup> We compared the experience of the "home court" (based on the location of the company's headquarters) of companies that filed in Delaware to that of the non-Delaware filers. We also considered various other attributes of the companies that did or did not file in Delaware, as well as the duration and outcome of the Chapter 11 cases.

## 2. What steered debtors to Delaware? The findings.

For present purposes, three of our findings are especially noteworthy. The first is that the companies that file for bankruptcy in Delaware have significantly more secured debt than companies that file elsewhere. Indeed, the fraction of the debtor's assets that are financed with secured debt is the single strongest firm-level determinant of a company's decision to file in Delaware.<sup>82</sup> This does not prove that bank lenders influenced the decision whether to file in Delaware or elsewhere, but the fact that the overall amount of secured debt is an

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<sup>80</sup> We used the average Chapter 11 cases per state, rather than per district, because the numbers for many districts are too small to generate meaningful comparisons. Because Delaware is a single district, combining districts in other states actually exaggerates the experience of other filing locations.

<sup>81</sup> Because Professor LoPucki and others have argued that managers seek a manager-friendly venue, we also considered managerial variables such as the size of the CEO's stake in the company and the CEO's tenure in an earlier version of the paper. See note 77. The coefficients on these variables were consistently near zero and statistically insignificant. Overall, we found no evidence that proxies for managerial influence had any effect on the Delaware filing decision.

<sup>82</sup> See Ayotte and Skeel, *Why Do Distressed Companies Choose Delaware?* at 9 (cited in note 77).

important predictor of filing location strongly suggests that they may have.<sup>83</sup>

The second finding concerns the relationship between court experience and the bankruptcy venue decision.<sup>84</sup> The firms that filed for bankruptcy in Delaware came from states whose bankruptcy courts handled an average of 176 business Chapter 11 cases in 1997. The average experience for the companies that stayed home and filed in their local district, by contrast, was 205 cases. This distinction, which is statistically significant, suggests that corporate debtors from districts with an experienced court were far more likely to stay home than companies from districts that have not handled as many Chapter 11 cases. To put the finding in more concrete terms, the coefficient of the experience variable in our regression analysis implies that a firm headquartered in a state that is twice as experienced would be 11.9 percent less likely to file its case in Delaware, all else equal. In corporate law, the experience and expertise of Delaware's state court judges is often cited as one of the most important factors in Delaware's success in attracting corporations to the state. Our analysis strongly suggests that these same factors played an important role in Delaware's popularity as a bankruptcy venue for large corporate debtors in the 1990s.

Finally, our analysis confirms the general perception and other researchers' findings that the Delaware bankruptcy judges handled cases appreciably faster than the judges in other districts. Replicating the estimation presented in Eisenberg and LoPucki's original article, but using our broader sample of Chapter 11 cases, we find that Delaware cases are 168 days faster than cases elsewhere, a speed effect that is statistically significant.<sup>85</sup> We also find some evidence to support the drivers of venue choice that our model incorporates, which is consistent with the Delaware speed effect. Controlling for other factors, the companies that file in Delaware have a lower ratio of EBITDA to Assets (though the effect is not statistically significant). We also find that firms with higher prebankruptcy EBITDA to Assets ratios take significantly longer to reorganize. While this may seem surprising at first, this result is completely consistent with the logic in our model: the firms with better postbankruptcy prospects should rationally choose a

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<sup>83</sup> Similarly suggestive is the fact that Delaware firms appear to be more likely to have a CEO who is a professional restructuring expert. (Our earlier analysis found a differential of 0.15 versus 0.06.) Because bank lenders are often instrumental in replacing (or supplementing) existing managers with a restructuring consultant, this too suggests that bank lenders influence the decision to file in Delaware.

<sup>84</sup> See Ayotte and Skeel, *Why Do Distressed Companies Choose Delaware?* at 7-8, 10 (cited in note 77).

<sup>85</sup> The p value of the test statistic is 0.052.

longer, and hence more thorough, restructuring. Firms with weaker prospects should rationally choose a faster reorganization, which the Delaware court provided.<sup>86</sup>

Overall, these findings suggest that companies may have filed for bankruptcy in Delaware in order to benefit from the Delaware judges' experience, the speed of the Delaware process, or both. The findings also suggest that secured creditors may have played a role in the decision to file in Delaware. But the findings cast doubt on Professor LoPucki's suggestion that the venue choice is best explained in terms of managers' and bankruptcy attorneys' pursuit of their own interests.

#### IV. MEET THE NEW BOSS: THE DIP LENDER IN FULL CONTROL

The most puzzling omission from *Courting Failure* is its near silence on the most important development in Chapter 11 practice over the past decade: the increasing influence of the debtor's postpetition financier over the Chapter 11 process. As discussed in Part III.A, the debtor's lenders are a crucial check on the managers' and lawyers' choice of bankruptcy court; and, as we saw in Part III.B, our empirical evidence strongly suggests a link between secured creditors and the decision to file for bankruptcy in Delaware.

Professor LoPucki doesn't ignore the role of DIP lenders entirely. "Case placers" are defined early in the book to include the "lawyers, corporate executives, banks, and investment bankers" who choose the company's bankruptcy court (p 17).<sup>87</sup> But the bank lenders are at most an afterthought. They disappear almost entirely from the analysis, and the occasional, cameo references tend to assume that the lenders' interests are congruent with those of the managers and bankruptcy attorneys who are *Courting Failure's* focus (p 242). Both the much-discussed rise of DIP financier control and the evidence that companies with more secured debt have tended to file in Delaware suggest that the most important issue in bankruptcy is the implications of the new creditor governance.

In this Part, we consider in more detail the new role of DIP lenders, and their influence on the venue decision. This Part focuses in particular on the question whether DIP lender control has tended to improve Chapter 11 practice, or whether DIP lenders divert value from other interested parties. As we shall see, our conclusions are mixed:

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<sup>86</sup> Ayotte and Skeel, *Why Do Distressed Companies Choose Delaware?* at 13–14 (cited in note 77). Like Eisenberg and LoPucki, we excluded prepacks and controlled for the book value of the companies in the sample.

<sup>87</sup> LoPucki further explains that "[t]he beneficiaries of competition are the case placers—the debtor's executives, professionals, and DIP lenders" (p 138).

overall, the rise of DIP lender control has significantly improved Chapter 11, but it also seems to have perverse effects in some contexts.

The large companies that entered Chapter 11 in the decade after the Bankruptcy Code was enacted (including many of the early leveraged buyouts that failed) often had a large amount of unsecured debt and comparatively little secured debt. As a result, when they filed for bankruptcy, the cash generated by the business was not all spoken for, and the debtor could use this cash to finance the reorganization effort. The large companies that have filed for bankruptcy more recently, by contrast, have often relied heavily on secured debt prior to bankruptcy, and thus have less cash to work with.<sup>88</sup> Lenders now place tight restrictions on debtors prior to bankruptcy as a condition of providing working capital, and they use the debtor-in-possession financing agreement to dictate the course of the Chapter 11 case.<sup>89</sup> By setting strict cash flow requirements as a prerequisite for future disbursement, bank lenders can force the debtor to cut costs (as in the United Airlines bankruptcy) or sell assets. In some cases, they have imposed explicit restrictions on the case, as when lenders required that F.A.O. Schwarz reorganize within two months or be liquidated.<sup>90</sup>

The empirical studies that have appeared thus far have offered encouraging conclusions about the influence of DIP financing on the Chapter 11 process. Several studies have shown that debtors with DIP financing are more likely to reorganize than those without, and one study finds an increase in the value of a debtor's stock and public debt when DIP financing is approved.<sup>91</sup> By themselves, these early studies do not show that DIP financing is efficient—that it improves overall outcomes in Chapter 11.<sup>92</sup> But they certainly do not seem to contradict

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<sup>88</sup> See, for example, Harvey R. Miller and Shai Y. Waisman, *Whither Goest Chapter 11?* 86 (unpublished manuscript 2005) (on file with authors) (“Increasingly, more debtors that file under [C]hapter 11 have balance sheets that are encumbered by large amounts of secured debt.”).

<sup>89</sup> The principal Bankruptcy Code provision governing DIP financing is § 364, which, among other things, authorizes the bankruptcy court to give priority status to new lending. 11 USC § 364 (2000 & Supp 2005).

<sup>90</sup> For a detailed list of the provisions used by DIP financiers to assert control in Chapter 11, see Harvey R. Miller, et al, *Debtor Dispossessed: The Rise of the “Creditor-in-Possession” and Chapter 11 Asset Sales: Does Chapter 11 Have a Future for Debtors?* 13–16 (unpublished manuscript 2005) (on file with authors).

<sup>91</sup> See, for example, Sandeep Dahiya, et al, *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J Fin Econ 259, 270–76 (2003) (arguing that DIP financing increases the likelihood of successful emergence from Chapter 11); Sris Chatterjee, et al, *Debtor-in-Possession Financing* 15–16 (unpublished manuscript 2001) (on file with authors) (citing evidence that debtor-in-possession firms successfully emerge from bankruptcy significantly more often than firms without financing).

<sup>92</sup> The apparent success of cases with DIP financiers may be a selection effect, for instance. DIP financiers may pick the best cases, rather than produce them through their performance in Chapter 11. In addition, simply emerging from Chapter 11 is a very imperfect measure of the



the impression that DIP lenders have reined in debtors' managers and their attorneys.

Our own view is that the emergence of DIP financier control is generally a welcome development. To the extent they limit managers' ability to entrench themselves or to dissipate assets, DIP financiers are in effect protecting the interests of all of the company's creditors. Similarly, after a debtor is reorganized and emerges from bankruptcy, the DIP lender is well positioned to keep the company and its managers on a short leash.

Because they enjoy both priority and control, however, there is also a risk that bank lenders will expropriate value for themselves at the expense of the debtor's other creditors in some cases. Two kinds of potential expropriation are of particular note. The first stems from the fact that the debtor's DIP financing is often provided by banks who had already served as the debtor's lenders prior to bankruptcy. If the new lenders are the same as the old, and the old loan is undercollateralized, the lenders may try to use the new loan to ensure that even the uncollateralized portion of the old loan is repaid in full.<sup>93</sup> The most explicit strategy for propping up the old loan, and thus diverting value from other unsecured creditors, is to insist that the collateral for the new loan secure the old loan as well—a technique referred to as “cross-collateralization.”<sup>94</sup> But there are a variety of other provisions, some much more subtle, that can also be used to improve the status of the earlier loan.<sup>95</sup> The second form of expropriation comes in cases where the DIP financier also intends to purchase the debtor's assets in connection with a § 363 sale prior to confirmation of a reorganization plan. In this case, the DIP financier has an incentive to pay as little as possible for the debtor's assets.<sup>96</sup> If the lender can use its control to drive down the sale price, the effect is to take money straight out of

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success or failure of a Chapter 11 case—on this point, as should be clear, we agree with Professor LoPucki, though we reach this conclusion for very different reasons.

<sup>93</sup> This problem is discussed in more detail in Skeel, 25 *Cardozo L Rev* at 1926–29 (cited in note 72) (noting that prepetition lenders also serve as the DIP financier nearly 60 percent of the time).

<sup>94</sup> For a description and criticism of cross-collateralization, see generally Charles J. Tabb, *A Critical Reappraisal of Cross-Collateralization in Bankruptcy*, 60 *S Cal L Rev* 109 (1986).

<sup>95</sup> The most common strategy is to structure the DIP as a “roll-up,” pursuant to which amounts owed under the earlier loan are paid first while the debtor is in bankruptcy. If the earlier loan is undercollateralized, the roll-up can effectively convert the unsecured portions into secured obligations. Although the lender argues that the prepetition loan was fully collateralized, and thus that the roll-up does not entail bootstrapping, whether the earlier loan truly was fully protected is not always clear. For further discussion, see, for example, Skeel, 25 *Cardozo L Rev* at 1926 & n 62 (cited in note 72).

<sup>96</sup> Perhaps the most high profile recent example of a DIP financier acquisition was the purchase of TWA by American, which was planned prior to TWA's Chapter 11 filing and carried out in bankruptcy.

the pockets of the debtor's other creditors, because a lower price means there is less money for the creditors.

Courts have long been aware of the first problem: the DIP lender's very understandable but troublesome desire to use its new loan to shore up the priority of its prepetition financing. A bankruptcy judge who is asked to approve a DIP lending agreement that includes problematic provisions is in a delicate position. The debtor invariably needs the financing right away, and the DIP lender threatens to walk if the proposed agreement is not accepted as is. Despite these pressures, bankruptcy judges have resisted many of the most blatant forms of bootstrapping. Although cross-collateralization is not explicitly prohibited by the Bankruptcy Code, for instance, courts rarely permit it.<sup>97</sup> Bankruptcy judges also have been skeptical of provisions that purport to waive the debtor's right to recover preferential transfers that were made to the DIP lender prior to bankruptcy.<sup>98</sup>

The threat of loan-and-control transactions is both more subtle and more intractable. The problem, as noted above, is that the DIP lender has an interest in paying as little as possible for the debtor's assets. It might appear that the obvious solution is to hold an open auction, and thus subject the DIP lender's bid to a market test. But the postpetition financier is likely to have better information than any outside bidder, because the bank will have thoroughly investigated the debtor as a precondition to making its loan, and will be monitoring the company's financial condition on a continuous basis.<sup>99</sup> The information asymmetry between the bank and other potential bidders creates a classic winner's curse dilemma: other bidders know that, if they outbid the better informed bank, this probably means that they bid too much.<sup>100</sup> Conducting a fully advertised auction with transparent auction procedures isn't likely to level the playing field. As a result, outside bidders will either underbid or stay home, and the DIP lender may walk away with the assets at a bargain price.

Notice the contrast to the complaints lodged against § 363 sales in *Courting Failure*. As noted earlier, LoPucki contends that Delaware enables managers to conduct quick sales that enable managers to "deliver a company to . . . their accomplices at a bargain price," in return for which the managers get a consulting contract or job (p 169). If this

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<sup>97</sup> *In re Saybrook Mfg Co*, 963 F2d 1490 (11th Cir 1992), is often viewed as having tolled the death knell on explicit cross-collateralization provisions.

<sup>98</sup> See, for example, *In re The Colad Group, Inc.*, 324 BR 208 (Bankr WD NY 2005) (refusing to approve various terms in a DIP financing agreement).

<sup>99</sup> See, for example, Skeel, 25 Cardozo L Rev at 1930 n 74 (cited in note 72).

<sup>100</sup> The winner's curse dilemma is described in detail in Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 Stan L Rev 597, 624-25 (1989).

were a problem, it could plausibly be addressed with open auction procedures.<sup>101</sup> So long as the court ensures a level playing field, higher bidders are likely to emerge if the proposed sale is based on a lowball bid. Bias in favor of a DIP financier, on the other hand, is a far more difficult problem to correct, because the DIP financier has a structural advantage over possible competing bidders.<sup>102</sup>

Shifting the market test back in time and requiring that the debtor seek competitive bids for its DIP financing also would not solve the loan-and-control problem. Anticipating the handsome profits it will make from acquiring the debtor's assets at a below-market price, the loan-and-control financier can underbid other potential lenders by offering attractive terms for the DIP financing.<sup>103</sup> In effect, the loan-and-control financier can treat the DIP financing as a loss leader, and make its real money from its subsequent acquisition of the debtor's assets. This gives the loan-and-control lender a leg up against other potential lenders, and makes it unlikely that another lender will offer a superior financing package. Thus, even if the bankruptcy judge requires competitive bidding both for the debtor's DIP financing and for the purchase of the assets, the loan-and-control lender is likely to profit at the expense of the debtor's other creditors.

It is important to keep in mind that in many cases, DIP financier control does not implicate either form of expropriation. This suggests that the most sensible strategy for correcting the distortions is simply to focus on the particular problem. Perhaps we should take a cue from Professor LoPucki and head to Washington with this Review in hand. Amending the Bankruptcy Code to prohibit a lender from serving both as DIP financier and as purchaser would sharply reduce a DIP lender's ability to divert value from other creditors. But we are cautiously optimistic that bankruptcy judges will themselves solve the loan-and-control problem without the need for congressional intervention. We have already seen courts responding to the bootstrapping problem by prohibiting loan provisions that would give preferential treatment to a lender's prepetition loan. As courts begin to focus on the distortions created by loan-and-control transactions, we expect to see efforts to protect the debtor's other creditors from the risk of arti-

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<sup>101</sup> Recall that the curative effect of an open auction was discussed in Part III.A.

<sup>102</sup> If the managers were actively collaborating with the bidder on the bid, or participating directly, their inside information could distort the bidding process much as a loan-and-control financier's superior information does. But in most of the cases, the managers do not participate in the bid.

<sup>103</sup> For a somewhat similar point, see Barry E. Adler, *Bankruptcy Primitives*, 12 Am Bankr Inst L Rev 219, 227-29 (2004) (suggesting that a secured creditor might use its control to obtain returns that violate absolute priority).

ficially low sale prices. At the least, this might include a reluctance to approve § 363 sales that are opposed by the creditors committee; ideally, bankruptcy judges will go further and move toward a blanket or near-blanket prohibition against purchase of the debtor's assets by the debtor's postpetition financier.

## CONCLUSION

*Courting Failure* is a remarkable book on many different levels. Rarely does a corporate bankruptcy scholar figure so prominently in the debates over bankruptcy reform as did Lynn LoPucki in early 2005. The venue reform proposal offered by Senator Cornyn was inspired by *Courting Failure*, and Senator Joseph Biden of Delaware found the threat to Delaware serious enough to warrant a verbal duel with Cornyn and LoPucki in the pages of *Legal Times*.<sup>104</sup> In the academic arena, the book is required reading for anyone who teaches, writes, or even thinks in any serious way about American corporate bankruptcy. And for those who are neither politicians nor scholars, *Courting Failure* is a colorful, muckraking tour through the hugely important world of Chapter 11.

In our analysis of *Courting Failure*, we have focused primarily on the heart of the book—Professor LoPucki's claims that the Delaware bankruptcy court was a disastrous failure in the 1990s, that it warped the bankruptcy process to favor the debtor's managers and their lawyers over everyone else, and that Delaware's tactics spread throughout the U.S. bankruptcy system. LoPucki's claim that there is now an international dimension to the competition is far more speculative and is plausible, if at all, only if he has correctly diagnosed the U.S. system.

LoPucki's data are impressive, and in recent years he has raised many of the most important questions that have been asked about the corporate restructuring process. Why did so many Delaware cases lead to subsequent Chapter 11 filings in the 1990s? Are Delaware cases different from cases filed in other courts?

We have argued in this Review that, although *Courting Failure* raises the right questions and offers valuable data, LoPucki's interpretation of the data is flawed in fundamental respects. *Courting Failure*

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<sup>104</sup> See John Cornyn, *They Owe Us: Companies Seeking Bankruptcy Relief Should Face Creditors in Their Home Court*, *Legal Times* 67 (June 6, 2005) (citing LoPucki as authority for the argument that bankruptcy's venue rules should be changed); Joseph Biden, *Give Credit to Good Courts*, *Legal Times* 67 (June 20, 2005) (noting that "the real political momentum behind Sen. Cornyn's argument is the advocacy" of Professor LoPucki, and describing critiques of LoPucki's findings); Lynn M. LoPucki, *Courting the Big Bankrupts*, *Legal Times* 58 (July 18, 2005) (responding to Senator Biden's column and arguing that the "option to forum shop is undermining the courts' integrity").

analyzes the venue choice issue through the lens of an interpretative framework that is a throwback to an earlier era—a time when a debtor’s managers and their lawyers seemed to fully control the Chapter 11 practice, and when most observers assumed that the goal of the Chapter 11 process was to rescue a company and reorganize it into something like its prebankruptcy form. We have argued that this picture no longer corresponds to corporate restructuring practice, and that it is impossible to understand the venue choice issue or Chapter 11 generally without appreciating how the practice has changed.

In addition to critiquing Professor LoPucki’s empirical findings, our analysis made three basic points. First, a full-blown restructuring is not likely to be the optimal strategy for every financially troubled company. A quicker, less costly restructuring may be preferable under a variety of very plausible conditions, and for these firms, a repeat filing may not reflect a failure of the earlier Chapter 11. This insight provides a possible efficiency-based explanation for the performance of the Delaware court. Second, we pointed out that a company’s venue choice is subject to crucial checks, which raises further questions about LoPucki’s contention that the debtor’s managers and lawyers have unbridled discretion to search for the court that best serves their own interests. Finally, we argued that the most important recent development in Chapter 11 is the rise of DIP financier control. Although DIP lenders generally seem to improve the Chapter 11 process, under some circumstances they may divert value from other creditors. Rather than eliminating venue choice, the solution to this problem is to address it directly.

Our own empirical analysis appears to support our conclusions that corporate debtors tended to choose Delaware because of the court’s experience, and that DIP lenders are now the most important decisionmakers in many cases, but we and other scholars are just beginning to make sense of the dramatic changes in contemporary Chapter 11 practice. There is a great deal of work to be done. Both for Professor LoPucki’s followers and for his critics, *Courting Failure* is the place where much of the next generation of corporate bankruptcy scholarship should begin.