1998

Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware

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BANKRUPTCY JUDGES AND BANKRUPTCY VENUE: SOME THOUGHTS ON DELAWARE

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INTRODUCTION

Delaware's recent rise to prominence as the bankruptcy venue of choice for many large debtors has been dogged by increasing controversy. Critics note that firms that file for bankruptcy in Delaware often are domiciled there but have no other significant presence in the state.[1] They also complain that Delaware's bankruptcy judges are so interested in attracting prominent reorganizations to Delaware that they will take only debtors' interests into account.

Interestingly, Delaware's bankruptcy court is not the first to come under fire in recent years. In the late 1980s and early 1990s, numerous publicly held corporations filed their bankruptcy petitions in the Southern District of New York, many managing to do so through a jurisdictional sleight-of-hand.

For much of this time, Delaware was largely off the bankruptcy map. But since the early 1990s, Delaware has rivaled and in some respects surpassed New York as the venue of choice for large debtors. Although many of the complaints about venue-shopping have both Delaware and New York in mind, the most vigorous recent criticism has been directed at Delaware's bankruptcy judges. The criticism is not simply academic. In early 1997, the National Bankruptcy Review Commission proposed that state of incor-

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1. A note on terminology. I will use "domicile" and "state of incorporation" interchangeably throughout the article. As we will see, there has occasionally been some question as to whether a corporation's state of incorporation is its domicile, but courts in recent decades have consistently equated the two.

Under the existing venue provision, 12 U.S.C. § 1408 (1994), a debtor may file for bankruptcy in any district where its principal place of business, principal assets or domicile is, or where an affiliate has filed. It is the third of these options, domicile, that has prompted the recent controversy about Delaware and which is the subject of this article.

poration be eliminated as a basis for venue.[2] If passed, the reform would essentially eliminate Delaware from the corporate bankruptcy picture, since relatively few firms have headquarters or substantial assets in Delaware.

The purpose of this article is to consider both the merits of the Delaware venue controversy — is Delaware venue a good or a bad thing? — and the question whether the reform is likely to succeed. In doing so, I will emphasize two perspectives that are almost entirely lacking in the existing debate. First, both proponents and critics of Delaware venue have failed to fully consider the relationship between Delaware's rise to prominence in bankruptcy and its role in corporate law generally. Commentators sometimes recognize Delaware's preeminence in corporate law, but they almost invariably treat Delaware's recent popularity as a bankruptcy venue choice as raising entirely different issues. In fact, the two are integrally related. Specifically, just as the efforts of Delaware and other states to attract corporations — a process often referred to as "charter competi-

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2. *See, e.g.*, Marvin Krasny & Kevin J. Carey, *Editors Reply to an Anonymous Letter; Why is Delaware the Venue of Choice for Philadelphia-Based Companies?*, The Legal Intelligencer, March 22, 1996, at 9 (proposal agreed to in February, 1997). The National Bankruptcy Review Commission (hereinafter, the "Review Commission" or "Commission") was established by the Bankruptcy Reform Act of 1994 and instructed to conduct an exhaustive investigation of bankruptcy. The Review Commission delivered its reports, together with a long list of proposed reforms, in October, 1997.

Although the Review Commission's discussions attracted widespread attention from practitioners and elicited a lengthy defense of Delaware by the Delaware bar, *see* Report of the Delaware State Bar Association to the National Bankruptcy Review Commission in Support of Maintaining Existing Venue Choices (Sept. 30, 1996) (copy on file with author) (hereinafter *Delaware Report*), the issue first catapulted into the popular media when the Chief Judge of the Federal District Court of Delaware, Judge Farnan, withdrew the standing order referring all bankruptcy reorganization cases to the bankruptcy judges in late January, 1997. *See, e.g.*, Ann Davis, *Bankruptcy's Main Court Faces Limit*, Wall St. J., Jan. 27, 1997, at A3 ("highly unusual" withdrawal of reference "stunned bankruptcy lawyers"); Ann Davis, *Delaware Bankruptcy Court is Target for Alleged Bias Favoring Companies*, Wall St. J., Jan. 28, 1997, at B2 (describing withdrawal order and proposal by Review Commission to eliminate domicile-based venue); *Delaware District Court Withdraws Reference of All Ch. 11 Cases to Bankruptcy Court*, Bankr. L. Rep., Jan. 30, 1997, at 123 (quoting withdrawal order); *Del. District Court Clarifies Order Withdrawing Reference of Ch. 11 Cases*, Bankr. L. Rep., Feb. 6, 1997, at 164 (quoting revised order). The order, and a subsequent order clarifying the first, made clear Judge Farnan's intention to scrutinize Delaware's reorganization cases. I discuss the significance of this action in Part II, *infra*.

tion" — has induced Delaware to regulate corporate law in a generally efficient manner,[3] the same forces will have a beneficial effect on Delaware's bankruptcy judges.[4]

To be sure, the beneficial effects of charter competition are attenuated in the bankruptcy context. I am reminded of a recent Hertz rental car commercial, where a hapless businessman is repeatedly asked if the inferior rental car company he has selected offers the same services as Hertz, and he is forced on each occasion to answer, "not exactly." Because Congress, rather than the states, regulates bankruptcy, and bankruptcy judges are federal, state charter competition in bankruptcy is "not exactly" the same as it is in corporate law generally.[5] Yet, because bankruptcy is so closely linked to other aspects of corporate law, charter competition does influence the Delaware bankruptcy court. Because of this, Delaware venue should be encouraged rather than thwarted.

Second, the article offers a detailed historical perspective on the venue controversy. In contrast to most existing analyses, nearly all of which have considered only the

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3. I should note that this statement is a contentious one. Commentators have long debated whether charter competition has beneficial or perverse effects. Most famously, William Cary argued in 1974 that charter competition produces a "race to the bottom," with states enacting unconscionably manager-friendly laws in order to attract corporations. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974). Ralph Winter rejoined, with a position now described as the "race to the top" view, that market pressures force managers to seek and states to supply efficient regulation. Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977). Most current commentators take an intermediate view. I have described and defended my own perspective, an intermediate view tending toward the race to the top perspective, in David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 Tex. L. Rev. 471 (1994).

4. A recent exception to commentators' neglect of the nexus between bankruptcy venue and corporate law is Robert K. Rasmussen & Randall S. Thomas, Improving Corporate Bankruptcy Law Through Venue Reform (1997) (unpublished manuscript, on file with author). Rasmussen and Thomas address several of the issues noted in this paragraph, agreeing with much of the analysis but critiquing the ultimate proposal I made in *Rethinking the Line*, *supra* note 3. Although their article was completed too recently for me to give it the attention it deserves, I do discuss their conclusions briefly in Part II(F), *infra*.

5. To assure all of the benefits of charter competition, Congress would need to relinquish control over corporate bankruptcy to the states. I have argued elsewhere that Congress should do precisely this, and that there is surprisingly strong historical support for state regulation of corporate bankruptcy. Skeel, *supra* note 3. *See also infra* Part II(A).

recent debate, I show that the current controversy has a long historical pedigree.[6] I focus in particular on a series of debates during the 1930s as to whether firms should be permitted to file bankruptcy petitions in their state of incorporation. Then, as now, everyone knew that the debate was really about Delaware; and the arguments for eliminating domicile-based venue were quite similar to those being made today.

Not only does the historical analysis underscore the connection between Delaware venue and Delaware's role in corporate law generally, but it also provides important insights into the political question of whether venue reform is likely to be adopted. In the 1930s, Delaware initially protected but then lost domicile-based venue. My analysis of these events suggests both that Delaware's role in corporate reorganization was precarious and that the key factor in its initial victory was a well-placed senator. Interestingly, there are striking echoes of both of these factors today, and it seems likely that only a well-placed legislator — which Delaware currently has in Senator Joseph Biden — can preempt reform.

While my analysis focuses on the Delaware venue controversy, it is important to keep a larger picture in mind. At bottom, the venue controversy concerns the quality and efficacy of bankruptcy judges. From this perspective, my defense of Delaware venue is a contention that the desire to attract high-profile debtors will have a desirable effect on Delaware's bankruptcy judges (and on who is selected to serve as a bankruptcy judge in Delaware).

But preserving domicile-based venue is only one way — and a somewhat limited one at that — to enhance judges' performance. I discuss two alternative venue reforms, each of which could improve on the existing regime, at the end of Part II. A different, and still more sweeping, tack might be to alter the judicial selection process. Giving bankruptcy creditors a direct say in the selection process, for instance, might improve judges' incentive to focus on the efficiency of the reorganization process.[7] Fi-

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6. The one commentary that does include a historical analysis is the report prepared by the Delaware State Bar Association. *Delaware Report*, *supra* note 2. Because the report considers only a small piece of bankruptcy venue history — the treatment of venue in the Bankruptcy Act of 1898 — it presents an incomplete and somewhat misleading picture.

7. Professor George Triantis and I are developing and defending just such an approach in a current work-in-progress.

nally, and to take quite a different perspective, it may be that the centrality of bankruptcy judges will decline as the parties make efforts themselves to improve the bankruptcy process.[8]

Nevertheless, even if Delaware venue is only one piece of the puzzle, I hope to show in this article that it is a very promising piece and that it would be a great mistake to thwart bankruptcy filings in Delaware.

The article proceeds as follows. In Part I, I provide the historical context for the current venue controversy, focusing in particular on legislative debates over domicile-based venue in the early and late 1930s. In Part II, I consider the normative question whether Delaware firms should be entitled to file for bankruptcy in Delaware. In defending Delaware venue, I discuss in some detail the connection between the Delaware bankruptcy court and Delaware's preeminence in corporate law. I then turn in Part III to the political question, which I will consider in "public choice" terms, of whatever venue reform designed to eliminate Delaware venue is likely to succeed.

I. BACK TO THE FUTURE: A BRIEF HISTORY OF BANKRUPTCY VENUE CONCERNS

As if to confirm the old adage that there is nothing new under the sun, the treatment of venue issues in bankruptcy has followed a curious pattern: long periods during which venue concerns remain in the background are periodically interrupted by intense fights about venue. Rather than a new set of issues, the current debate about venue — and in particular, debtors' desire to file for bankruptcy in Delaware — raises many of the same issues that were vigorously debated in connection with the New Deal bankruptcy reforms.

The purpose of this part is to give a brief but thorough history of bankruptcy venue, with a particular emphasis on the current and New Deal concerns about Delaware as the forum of choice for many large debtors. In addition to placing the current debate in historical perspective, the analysis will provide important insights as to both the merits of the debate and the question of whether Delaware can thwart the effort to eliminate state of incorporation as a venue option.

8. The increasing use of "emergence bonuses" in large cases is a fascinating example of such a step. An emergence bonus is a commitment by creditors to pay a debtor's managers a bonus if they confirm a reorganization quickly. Such a bonus cleverly counteracts the incentive managers otherwise have, particularly if they continue to focus on shareholders' interests, to delay the bankruptcy process.

A. Early History: Equity Receiverships and the Bankruptcy Act of 1898

Like American bankruptcy itself, the venue issue has an oddly bifurcated history, due to the fact that large corporate debtors rarely invoked the bankruptcy laws until Congress added a corporate reorganization provision in the 1930s.[9] Rather than bankruptcy, large debtors reorganized through an equity receivership process first used to restructure troubled railroads in the nineteenth century.[10] As a result, there actually were two relevant sources of venue doctrine: the Bankruptcy Act of 1898 and courts' decisions on venue in equity receivership cases.[11]

The Bankruptcy Act's venue provision, section 2a, had provided since the Act's enactment in 1898 that venue was proper wherever a "person" had "their principal place of business, resided, or had their domicile ... for the preceding six months."[12] Because

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9. The Bankruptcy Act of 1898, America's first permanent bankruptcy law, included only two disposition options: liquidation and composition. Although the composition procedure was a simplified form of reorganization, it prohibited a debtor from altering its secured obligations. For this and other reasons, corporate debtors rarely filed for bankruptcy except to liquidate. For a succinct description of the reasons corporate debtors avoided the Bankruptcy Act, see Henry J. Friendly, *Some Comments on the Corporate Reorganizations Act*, 48 Harv. L. Rev. 39, 41-48 (1934).

10. The equity receivership process was developed, largely through the ingenuity of the corporate bar, from traditional state law foreclosure procedures. In the practice that evolved, firms would persuade a friendly out-of-state (in order to establish federal diversity jurisdiction) creditor to invoke the foreclosure process. The firm's managers generally would be appointed as receiver, its underwriters would form "protective committees" to assure the support of its bondholders, and the firm would be "sold" to its existing creditors. For a widely-cited overview of this process see Paul D. Cravath, Reorganization of Corporations, in Some Legal Phases of Corporate Financing, Reorganization and Regulation 153 (1917). I describe the emergence of American corporate reorganization through the equity receiverships in greater detail in David A. Skeel, Jr., An Evolutionary Theory of Corporate Law and Corporate Bankruptcy 40-47 (1997) (unpublished manuscript, on file with author).

11. The principal limitation of the otherwise helpful historical account given in *Delaware Report*, *supra* note 2, is that it considers only the first of these sources, § 2a of the 1898 Act. Much of the debate in the 1930s centered on the treatment of venue issues in equity receiverships, due to the fact that this was how corporations were actually reorganized prior to the codification of reorganization in 1934.

12. 11 U.S.C. § 11a(1) (repealed 1978).

corporations were treated as "persons" and courts construed "domicile" to mean state of incorporation, corporate debtors could file for bankruptcy in their state of incorporation under the 1898 Act.[13] This provision had little significance for corporate debtors until much later,[14] however, because large corporations rarely invoked the Act's liquidation-oriented provisions.

What mattered much more to a corporate debtor was courts' treatment of the venue issue in an equity receivership. As noted above, an equity receivership was simply a state law foreclosure action initiated by a secured creditor when a corporate debtor defaulted on its obligations.[15] Despite the state law basis, many (and in time, most) debtors obtained federal jurisdiction by encouraging a friendly out-of-state creditor to commence the receivership.[16] Not infrequently, questions arose as to where venue could properly lie for these actions.

In time, courts developed several different approaches to the venue issue. Reasoning that a "person" can have only one domicile, and that a firm's domicile is its state of incorporation, some courts concluded that the state of incorporation was the *only* proper venue for a firm's equity receivership.[17] A few courts reached precisely the opposite conclusion, holding that venue should follow a firm's assets or principal place of business, not its state of incorporation.[18] As often is the case, a majority of courts adopted an interme-

13. *See generally* Note, *Venue Under the Chandler Bill in Corporate Bankruptcy and Reorganization Proceedings*, 5 U. Chi. L. Rev. 272 (1938) (describing § 2a of existing Act).

14. As we will see, § 2a became relevant after the 1938 reforms, because large debtors increasingly evaded Chapter X, which was designed to be the principal chapter for regulating the reorganization of publicly held debtors. Section 2a applied to Chapter XI, the chapter these firms sought to invoke.

15. *See supra* note 10.

16. An important exception, as we shall see, is that many firms invoked the state chancery system in Delaware.

17. *See* David M. Wright, Note, *Jurisdiction and Venue in Federal Equity Receivership of Corporations*, 23 Va. L. Rev. 29, 30-31 (1937) (citing Maguire v. The Mortgage Co., 203 F. 858 (2d Cir. 1913)).

18. *Id.* at 34 (citing Primos Chemical Company v. Fulton Street, 24 F. 454 (N.D.N.Y. 1918)).

diate position, and made a fact-based determination whether venue was proper in a particular location. The most frequently stated concern was the convenience of the chosen forum for the parties in the case.[19]

Even in these early years of corporate reorganization, Delaware had a significant and widely known stake in courts' conclusions about venue. By 1920, Delaware had displaced New Jersey as the leading state of incorporation for publicly held corporations. Although most commentators think only of Delaware's role in corporate governance issues, Delaware's primacy also extended to corporate reorganization. Chancellor Wolcott in particular was well-known for his expert handling of equity receivership cases.[20] Then, as now, the question whether venue should lie in the state of incorporation was really a question whether firms should be permitted to reorganize in Delaware.

B. Venue Reform in the New Deal

The New Deal brought a complete transformation of corporate bankruptcy law. The transformation took place in two very different steps. First, Congress codified the equity receivership process, adding a railroad receivership provision to the 1898 Act in 1933 and a similar provision for other corporations in 1934.[21] These initial reforms were

19. *Id.* at 36-42. Convenience to the parties has long been a central concern in bankruptcy, and was seen by many as the principal flaw in the Bankruptcy Act of 1867. *See, e.g.*, Charles Warren, Bankruptcy in United States History 110 (1935). The 1898 Act included several provisions that imposed specific limitations on how many miles a party would be expected to travel. Similar concerns are at the heart of the current venue controversy, but I argue in Part II that the concerns are not well-founded given current technology and demographics.

20. Thus, in the hearings that eventually led to the codification of corporate reorganization, one speaker referred explicitly to the effect that including corporate bankruptcy in the Bankruptcy Act would have on Chancellor Wolcott's chancery court. *Joint Hearings on S. 3866 Before the Subcommittees on the Judiciary*, 72nd Cong., 1st Sess. 570 (1932) (hereinafter *1932 Hearings*) (statement of Max Isaac, Editor, American Bankruptcy Review). *See also* William T. Quillen & Michael Hanrahan, A Short History of the Delaware Court of Chancery, in Court of Chancery of the State of Delaware: 1792-1992, at 21, 37 (1992) (listing decision extending the statutory power to appoint a receiver as one of the eight most important corporate law decisions by Chancellor Wolcott's predecessor, Chancellor Charles M. Curtis).

21. Act of March 3, 1933, 47 Stat. 1474 (1933), 11 U.S.C.A. § 204 (1933) (repealed 1978) (§ 77, providing for railroad reorganization); Act of June 7, 1934, 48 Stat. 912, 11 U.S.C.A. § 207 (1934) (repealed 1938) (§ 77B, providing for corporate reorganization). I discuss the legislative history of Sections 77 and 77B in detail in Skeel, *supra* note 10.

stop-gap measures, enacted in haste in response to the Depression. In 1938 Congress passed a second reform, the Chandler Act, which rewrote both the corporate reorganization provision and much of the rest of the 1898 Bankruptcy Act.[22] The venue question received a surprising amount of attention at each stage of the reform process.

Let us begin with the initial codification of railroad and corporate reorganization in 1933 and 1934. As first introduced and passed by the House, Section 77, the railroad provision, provided for venue only in the state of a railroad's principal place of business or principal assets.[23] The initial Senate version of the bill went further and added domicile as another basis for venue. But domicile-based railroad reorganization was not to be. During the Senate deliberations, Senator La Follette proposed that domicile be stricken from the venue options.[24] If reorganization could be based on state of incorporation, he argued, "we may find that a great many of the proceedings ... will occur in ... [states] perhaps thousands of miles away from the territory in which [the railroads] are operating and from the communities in which they have their principal operating offices."[25]

The floor manager — and principal expert — of the bill was Senator Hastings of Delaware.[26] Senator Hastings proposed that the Senate leave domicile in, with the expectation that the conference committee would take a close look at the venue provision

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22. Act of June 22, 1938, 52 Stat. 840, 11 U.S.C. § 1 (1938) (repealed 1978). The Chandler Act was repealed in 1978, when Congress replaced the 1898 Act with the new Bankruptcy Code.

23. *See, e.g.*, 76 Cong. Rec. 5111 (Feb. 27, 1933) (description of the House and Senate provisions on venue by Senator Hastings, floor manager and bill's principal proponent).

24. Senator LaFollette was the son of famous Wisconsin progressive Robert LaFollette, and was an important progressive in his own right. *See, e.g.*, Arthur Schleisinger, The Crisis of the Old Order 225-26 (1955).

25. 76 Cong. Rec. 5111 (Feb. 27, 1933).

26. Throughout the process, legislators frequently noted that the bill was passed so quickly that no one except Hastings fully understood its provisions. *See, e.g.*, 76 Cong. Rec. 4884 (Feb. 24, 1933) (Senator Bratton, another member of the three-member bankruptcy subcommittee of the Senate Judiciary Committee, complaining that even he did not have sufficient time to understand the entire bill).

while reconciling the House and Senate bills.[27] But Senator LaFollette stood his ground, and the Senate approved his amendment deleting domicile from the venue provision.[28]

Congress' treatment of venue followed a strikingly similar pattern in 1934, when it added a corporate reorganization provision to the Bankruptcy Act.[29] As with railroad reorganization, the House version did not include domicile as a basis for venue, but the Senate version did.[30] Once again, a senator, this time Senator Hugo Black of Alabama, argued that domicile-based reorganization would enable corporations to file for bankruptcy in a state far from their principal operations. The bill as written, he contended, "would encourage a continuation of the conditions with reference to the freedom and laxness of corporate laws in certain states."[31]

In response, Senator Hastings defended Delaware's role as a leading state of incorporation, and argued that corporations would file for bankruptcy in their state of incorporation only if there were no obvious location of their principal assets.[32] After further discussion, Senators Black and Hastings agreed to an amendment that would make this policy explicit, authorizing domicile-based filing only if the principal place of busi-

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27. 76 Cong. Rec. 5112 (Feb. 27, 1933).

28. *Id. See also* Max Lowenthal, *The Railroad Reorganization Act*, 47 Harv. L. Rev. 18, 27 n.28 (1933) (describing language as arising from the exchange between Senators Hastings and La Follette).

29. The continued importance of Senator Hastings, a conservative Republican, as chronicled below, is particularly striking given that the Democrats were firmly in control by 1934.

30. *Compare* 77 Cong. Rec. 5009 (June 5, 1933) (House version of bill, not listing domicile) *with* 77 Cong. Rec. 7886 (May 2, 1934) (Senate version, includes domicile). Interestingly, the bill that was proposed as an outgrowth of the 1932 Thacher Report, which in many respects was the wellspring of all of the subsequent reforms, had provided for domicile-based venue, consistent with the Bankruptcy Act's existing venue provision. *See 1932 Hearings*, *supra* note 20, at 60-62 (annotated version of §2(a) of proposed bill). *See also* note 13 and accompanying text, *supra* (discussing § 2(a) of the Bankruptcy Act).

31. 77 Cong. Rec. 7890 (May 2, 1934). Senator Black's comments reflect a deep skepticism of the effects of charter competition, which he analogized to the states' apparent "race" to liberalize divorce laws at that time.

32. *Id.*

ness or assets were "controverted."[33] Interestingly, although the Senate agreed to this amendment, the limitation disappeared while the bill was in conference. As passed, the corporate reorganization provision was more generous on venue than either the House or Senate had been — including state of incorporation as a venue option, with no strings attached.[34]

What are we to make of these developments? At a general level, it is clear that both sides in the venue debate saw domicile-based reorganization as an integral part of the larger controversy about Delaware's success in attracting corporations. There was, and continues to be, a populist (and progressive) disdain for charter competition, since it appears to benefit out-of-state interests at the expense of employees and the communities in which businesses are located.[35] It is therefore not surprising that the two senators who most visibly opposed domicile-based reorganization, Senators Black and La Follette, had populist (or, with La Follette, progressive) inclinations.

Interestingly, the venue debates ran directly counter to the traditional public choice assumption that populist interests play most strongly in the Senate[36] — recall that

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33. The amendment added the following language after principal place of business and principal assets: "Or if the principal place of business or the place where the principal assets are located is controverted, then in the territorial jurisdiction in which it was incorporated: *provided,* that the court may, upon petition, direct a transfer of such proceedings to any territorial jurisdiction where the corporation has a substantial portion of its assets, if satisfied that the interests of all parties would be better subserved." 77 Cong. Rec. 7895 (May 2, 1934).

34. Act of June 7, 1934, 48 Stat. 912, 11 U.S.C.A. §77B(a) (1934) (repealed 1938).

35. The populist disdain for charter competition has not disappeared. It is not accidental that one of the leading proponents of federalizing corporate law in the 1970s was Ralph Nader. *See* Ralph Nader, Mark Green, & Joel Seligman, Taming The Giant Corporation (1976).

36. The rationale for this assumption is that small and less populous states have greater influence in the Senate than the House, due to the fact that every state has the same number of senators. For an analysis of the legislative history of the 1978 Bankruptcy Code that finds evidence confirming this intuition see Eric Posner, *The Political Economy of the Bankruptcy Act of 1978*, 96 Mich. L. Rev. 47 (1997).

on each occasion, the House rather than the Senate passed bills reflecting the populist position that domicile should be excluded. The obvious explanation for this reversal of roles is the effect of a single, well-placed senator, Senator Hastings, whose status as floor leader and principal expert gave him particular influence over the outcome.[37]

One small puzzle remains, however: if Senator Hastings was so influential, why did only the corporate reorganization provision include domicile as a basis for venue? The likely explanation is that Delaware had little at stake in the railroad context. Unlike other corporations, most railroads did not incorporate in Delaware; and even those that did would generally file for bankruptcy in the state where their most important assets were.[38] Thus, it cost Hastings little to concede on railroad reorganization, and the issue may have meant much more to populists, given the importance of railroads to many midwestern and western states.

After the first set of New Deal reforms, then, state of incorporation was preserved as a venue option for corporate debtors. The success was to be short-lived, however. The 1933 and 1934 reforms proved, in a sense, to be simply a pause in ongoing discussions aimed at a more pervasive rethinking of America's bankruptcy laws. In the mid-1930s, with increasing input from New Deal reformers such as William Douglas and the newly formed Securities and Exchange Commission (SEC), Congress considered

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37. Thus, while populist appeals (most visibly, those of Hugo Black) figured prominently in the Senate debate, Senator Hastings managed to preserve domicile-based venue for non-railroad corporations. Hastings' success can be seen as anecdotal confirmation of recent arguments as to the influence legislative committee members have in the legislative process through, among other things, their prominence on the conference committees that resolve differences between House and Senate versions of a bill. *See* Kenneth A. Shepsle & Barry R. Weingast, *The Institutional Foundations of Committee Power*, 81 Am. Pol. Sci. Rev. 85 (1987). I discuss these political issues in more detail in Part III, *infra*.

It is interesting to note that Hastings' constituents were not uniformly thrilled with his role in bankruptcy reform. Many Delaware lawyers would have preferred that things be left as they were — that is, that firms reorganize through the equity receivership process. *See, e.g.*, 77 Cong. Rec. 7891 (May 2, 1934) (statement of Sen. Hastings, noting Delaware lawyers' complaints to him about the reform effort).

38. As Senator Hastings himself pointed out in his debate with Senator Black. *See supra* note 32 and accompanying text.

the proposals that eventually became the Chandler Act.[39] The reformers were adamant throughout the process about excluding state of incorporation from the venue options[40] (and in fact were hopeful of making far deeper inroads on charter competition by enacting a federal incorporation statute).[41] By the time of the principal Chandler Act hearings and legislative debate, Senator Hastings was no longer one of Delaware's senators.[42] With relatively little opposition, the reformers succeeded in limiting venue in Chapter X, the principal reorganization chapter for publicly held corporations, to the state of a firm's principal place of business or assets.[43]

In addition to restricting venue, Chapter X imposed strict governmental oversight on the reorganization process, displacing a debtor's managers with a trustee and giving broad advisory powers to the SEC.[44] The overall effect of the reformers' handiwork was to sever the connections between corporate law and bankruptcy, and to diminish

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39. Under the Securities Exchange Act of 1934, the SEC had been charged with investigating and preparing a report on the use of protective committees in the reorganization process. Securities Exchange Act of 1934, §§ 4, 211, 15 U.S.C. §§ 78d, 78jj (1934). It was this report that landed the SEC squarely in the middle of the reform process. For further discussion, see Skeel, *supra* note 10, at 60-67.

40. *See, e.g., Hearing on H.R. 6439 Before the Committee on the Judiciary, House of Representatives,* 75th Cong., 1st Sess. 183 (1937) (statement of William O. Douglas, SEC Chairman). Interestingly, the early versions of the Chandler Act, which predated the SEC's involvement and were drafted largely by the National Bankruptcy Conference, also omitted state of incorporation from the venue options. *See, e.g.,* John Gerdes, *Section 77B, The Chandler Bill and Other Proposed Revisions,* 35 Mich. L. Rev. 361, 379 (1937)(citing and describing 1936 version of bill).

41. Joel Seligman provides a useful discussion of the unsuccessful efforts to propose and pass a federal incorporation statute in Joel Seligman, The Transformation of Wall Street 205-10 (1982).

42. Senator Hastings lost his reelection bid in 1936 — a loss attributed by many to his adamant opposition to the New Deal reforms. *See, e.g.,* Charles J. Durante, Kingmakers, Not Kings: 1900-1939, The Delaware Bar in The Twentieth Century 527, 534 (Helen L. Winslow, et al., eds., 1994) (hereinafter *Delaware Bar*). Delaware did have a Senator on the Senate Judiciary Committee during the late 1930s, Senator James Hughes, but he, unlike Senator Hastings, was not on the bankruptcy subcommittee and does not appear to have played a significant role.

43. 52 Stat. 840, 886, 11 U.S.C.A. § 128 (1938) (repealed 1978).

44. 52 Stat. 840, 888, 11 U.S.C.A. § 156 (1938) (repealed 1978). *See also* Skeel, *supra* note 10, at 64-65 (discussing mandatory trustee provision and the controversy it inspired).

managers' incentives to invoke the reorganization process. States like Delaware could no longer attract corporate reorganizations, since domicile was not a permissible basis for venue, and after the 1930s, there were relatively few large-scale reorganizations in any event. The change in Delaware's role was quickly apparent in the Delaware chancery court. Whereas the chancery court previously had been well-known for its role both in corporate law and with receiverships, the court's expertise centered on corporate law alone after the 1930s.

C. Venue in the Post-New Deal Era

As I have described in detail elsewhere, the post New Deal era was in many respects a transition period for bankruptcy.[45] The New Deal reforms crippled the elite bankruptcy bar, and corporations viewed Chapter X as an absolute last resort due to its draconian effect on managers. But the New Deal reforms contained the seeds of the developments that eventually led both to the bankruptcy process we now have in Chapter 11, and to renewed concerns about venue shopping.

Crucial to subsequent developments was the fact that, although everyone knew Chapter X was designed for publicly held corporations, nothing in the Chandler Act *required* that public firms choose this chapter rather than Chapter XI, which contained a somewhat expanded version of the traditional composition procedure.[46] An increasing number of firms with outstanding issuances of public securities began filing under Chapter XI, a strategy the Supreme Court vindicated in the mid-1950s.[47] In time, Chapter XI became the chapter of choice for publicly held corporations.

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45. The analysis of the next three paragraphs is drawn from the more detailed discussion in Skeel, *supra* note 10.

46. For a thoughtful discussion, see Eugene R. Rostow & Lloyd N. Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 Yale L.J. 1334 (1949). In contrast to Chapter X, which was almost entirely the SEC's handiwork, the SEC played little role with Chapter XI or the remainder of the Chandler Act. The National Bankruptcy Conference, which was comprised of bankruptcy lawyers and lawyers' organizations such as the ABA, was the driving force behind the changes in these other areas.

47. General Stores Corp. v. Shlensky, 350 U.S. 462 (1956) (holding that the choice between chapters depended on the "needs to be met"). For further discussion, see David A. Skeel, Jr., *supra* note 10, at 71-73.

In addition to providing much more flexibility — most importantly, by permitting a firm's existing managers to remain in control — Chapter XI also altered a firm's venue options. Rather than Chapter X's restrictive standard, firms that filed their petition under Chapter XI were subject to the Bankruptcy Act's general venue provision.[48] Since the general standard listed domicile as a basis for venue, just as it had prior to the New Deal reforms, a firm that invoked Chapter XI could file in its state of incorporation if its managers so chose.

In 1973, the Bankruptcy Act's venue rules were consolidated in Rule 116(a), which provided separate standards for individuals, partnerships, and corporations. The new rule, which was superseded with the enactment of the Bankruptcy Code in 1978, included only principal place of business and principal assets as venue options.

Given Delaware's status as the state of choice for publicly held corporations, one might expect that when firms began to invoke Chapter XI, Delaware quickly became the filing location of choice. Yet even as of 1973, few firms made a special effort to file in Delaware based on their status as a Delaware corporation. Why was this?

Several factors seem to explain the relative lack of Delaware filings. First, many of the firms that initially steered away from Chapter X and into Chapter XI were medium-sized rather than truly "publicly held" firms.[49] Medium-sized firms often are centered in a single state and incorporated in that state.[50] At least early on, then, relatively few of the firms using Chapter XI were likely to have been Delaware firms. By the 1960s and early 1970s this pattern had changed, however, as even the largest firms looked to Chapter XI — which suggests that other factors must also have been at work.

Second, and perhaps more importantly, bankruptcy lawyers simply did not think to file in Delaware. Few bankruptcy lawyers were likely to have remembered Delaware's former status as an important reorganization venue, particularly given the near complete

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48. Bankruptcy Act § 2a(1), 11 U.S.C. § 11a(10) (repealed 1978).

49. As Benjamin Weintraub and Harris Levin chronicled in a series of articles in the 1950s and early 1960s. *See, e.g.*, Benjamin Weintraub & Harris Levin, *A Sequel to Chapter X or Chapter XI: Coexistence for the Middle-Sized Corporations*, 26 Ford. L. Rev. 292 (1957).

50. Delaware's preeminence in corporate law is a preeminence with respect to publicly held corporations — 40% of which are incorporated in Delaware. For smaller corporations, it generally is cheaper and more convenient to incorporate in the state where the firm is located. *See, e.g.*, William L. Cary & Melvin A. Eisenberg, Cases and Materials on Corporations 125 (7th ed. 1995).

separation between the practice of corporate law and bankruptcy practice.[51] The law firms that encouraged their large corporate clients to incorporate in Delaware were no longer the same firms that steered troubled firms through bankruptcy. Moreover, Delaware's judges themselves could no longer claim any particular expertise in reorganization law. Firms did engage in varying degrees of forum shopping, of course, but they generally did not view Delaware as an important option.[52]

Together, these factors seem to have kept Delaware out of the limelight. Each was to change in important respects after the Bankruptcy Code was enacted in 1978.

D. The 1978 Bankruptcy Code and Thereafter

The 1978 Bankruptcy Code brought sweeping changes to bankruptcy law, several of which made reorganization much more palatable to the managers of troubled firms. In addition to combining Chapters X and XI of the old Act into a single reorganization chapter, Chapter 11, the Code adopted a presumption that a debtor's managers would remain in charge during bankruptcy,[53] and all but eliminated SEC oversight. The drafters were quite clear that they intended for Chapter 11 to encourage rather than discourage reorganization, based on their view that troubled firms often are worth more as going concerns than in piecemeal liquidation.

In connection with their pervasive revision of the bankruptcy laws, the drafters also adopted a new venue provision. The new provision once again included state of incorporation as a permissible basis for venue, and also stated that a firm may file in any

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51. For further discussion of the separation, see Skeel, *supra* note 10, at 66.

52. Notice that this offers a striking illustration of the effect institutions have on actors' (here, managers' and their lawyers') perception of available options. The most prominent exponent of this institutional perspective on economic history has been Douglass North. *See* Douglass C. North, Institutions, Institutional Change and Economic Performance (1991). My own view, as will become clear, is that these limitations play an important role, but the adaptive process generally tends toward efficiency in a context such as American corporate law and corporate bankruptcy.

53. The presumption of managerial control arises from Bankruptcy Code § 1101, which defines the "debtor-in-possession," and Bankruptcy Code § 1107, which gives the debtor-in-possession all of the powers of a trustee (and in doing so, implies that existing managers will not be replaced by a trustee under ordinary circumstances).

jurisdiction where an affiliate has filed.[54] The provision was enacted with relatively little fanfare,[55] but its terms lie at the heart of the recent firestorm of protest about venue shopping in bankruptcy.

As increasing numbers of publicly held corporations filed Chapter 11 petitions in the 1980s, choice of forum began to play a prominent role in the bankruptcy decision. The clear venue of choice for these corporations was the Southern District of New York.[56] Although some of the firms had a substantial presence in New York, others made use of the broad flexibility built into the venue provision; Eastern Airlines, for instance, used the filing of a relatively minor affiliate to establish venue for the much larger core firm.[57] Skeptics of these tactics argued that managers headed to New York to take advantage of its manager-friendly posture on issues such as extending the so-called "exclusivity period,"[58] while defenders emphasized the value of the judges' sophistication in particularly complex reorganizations.

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54. The new, and current, provision permits a case to be filed in the district:

> (1) in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in the United States, or principal assets in the United States, of such person were located in any other district; or
>
> (2) in which there is a pending case under title 11 concerning such person's affiliate, general partner, or partnership.

28 U.S.C. § 1408 (1994).

55. This is not to say the venue provision passed without comment. During the hearings, a few speakers worried that the provision gave debtors too many venue options, and as a result would permit venue shopping.

56. *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 Wisc. L. Rev. 11, 15 (1991).

57. *Id.* at 22. *See also id.* at 27 (Johns Manville filed for bankruptcy in New York despite having no substantial assets there).

58. *See* Bankruptcy Code § 1121 (debtor-in-possession has exclusive right to propose reorganization plan for first 120 days of case, and longer if extended).

Interestingly, Delaware played little role in managers' thinking during the 1980s, and it was something of an accident that first brought Delaware to prominence. The firm that put Delaware back on the map was Continental. According to widely repeated rumor, when Continental was considering its second bankruptcy filing in 1990, its managers wanted to file either in New York or Atlanta. Because neither of these locations was viable, the managers debated other possible choices on the eastern seaboard, and through a process of elimination settled on Delaware. In the wake of Continental's remarkably smooth reorganization, other publicly held corporations followed suit.[59] And the rest, as they say, is history.

Even more than with the Southern District of New York, Delaware's emergence as a venue of choice has provoked loud criticism, with striking echoes of the criticisms made by Senator La Follette, Senator Black, and other reformers in the 1930s. Earlier this year, the National Bankruptcy Review Commission, which has just completed an extensive new study of the bankruptcy system, made the criticism of Delaware (and to a lesser extent, New York) concrete by proposing that the Code's venue provision be amended to eliminate both state of incorporation and affiliate filing as bases for venue.[60] In effect, the new proposal, which was formally approved by the Commission, advocates a return to the New Deal reformers' approach in Chapter X of the Bankruptcy Act.

Shortly after the Commission approved the proposed amendment, in a move that many commentators saw as connected in some way to the venue debate, Judge Farnan, the chief judge of the District Court in Delaware, withdrew the standing order that automatically refers bankruptcy cases to Delaware's two bankruptcy judges.[61] Consistent with his announced concerns about the burgeoning bankruptcy caseload in Delaware, Judge

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59. For a general discussion of the Continental filing and its role in Delaware's rise to prominence, *see* Mark D. Collins, *Why Delaware?*, Del. Law., Fall, 1997, at 38.

60. In doing so, the Commission adopted the recommendations of a memo prepared by Larry King and Elizabeth Holland. Memorandum from Larry P. King & Elizabeth I. Holland to National Bankruptcy Review Commission (Nov. 19, 1996) (on file with author).

61. *See supra* note 2 (describing the orders). The standing order is an artifact of the awkward relationship between bankruptcy judges and the district court. Because bankruptcy judges do not have Article III status, the federal district court technically oversees bankruptcy cases. Each district's standing order delegates this authority, for the most part, to the bankruptcy judges in a district. By withdrawing the order for chapter 11 cases, Delaware's district court thus took the unusual step of asserting in practice the oversight authority it holds in theory.

Farnan began assigning some of the new Chapter 11 cases to Delaware district court judges.

To appreciate the significance of Judge Farnan's order, we must first consider the more general question of whether Delaware's rise to prominence is in fact malignant, as the Commission's proposal assumes, or whether its effects should be seen in a more positive light. Drawing on both our historical discussion and the academic debate over charter competition, I turn to this question in the part that follows.

II. BANKRUPTCY IN DELAWARE: FOR BETTER OR WORSE?

Critics of firms' efforts to file for bankruptcy in Delaware (or New York) tend to emphasize two kinds of objections: 1) the favored judges are too sympathetic to debtors' interests; and 2) the favored forum unfairly inconveniences a substantial portion of a debtor's creditors.

We will focus most extensively on the effect of venue shopping on judges, both because it goes to the heart of the bankruptcy process and because the existing debate has missed some of the most important implications of Delaware's recent rise to prominence. I will emphasize in particular the relationship between Delaware's bankruptcy judges and Delaware's general preeminence in corporate law. Although charter competition functions less effectively in bankruptcy — most obviously, due to the federal nature of bankruptcy legislation — Delaware judges still will regulate bankruptcy more efficiently than their peers in other districts. The analysis thus suggests that the widespread criticism of Delaware is mistaken.

After exploring the relationship between venue shopping and Delaware's bankruptcy judges, I consider the concern that a firm's decision to file for bankruptcy in Delaware will make it too costly for most creditors to participate in the bankruptcy case, and argue that this concern also does not weigh against domicile-based venue. I conclude by considering two alternative venue reform possibilities.

Before I dive into the analysis, however, I should first give a more specific description of the practices that critics of Delaware's bankruptcy judges find objectionable.

A. What "Debtor-Friendly" Means in Delaware

As I have noted, the standard complaint about both Delaware's and New York's bankruptcy judges is that they are too "debtor-friendly." Critics trace this bias in debtors' favor to venue shopping, reasoning that judges establish a reputation as debtor havens in order to attract the largest, most prominent bankruptcies to their courthouse.

Although critics often suggest that judges in Delaware and New York are debtor-friendly in the same way, the two districts actually have established quite different reputations among practitioners — reputations that are amply borne out by their track records in large cases. The New York judges are known for their willingness to repeatedly extend the exclusivity period during which the managers of a large debtor are the only ones who can propose a reorganization plan.[62] Because extended exclusivity reduces the pressure for a debtor's managers to act quickly, it can encourage long, drawn-out, costly bankruptcy cases.

Delaware's judges, on the other hand, have established precisely the opposite reputation. Rather than lengthy cases, Delaware is known for its speedy confirmation of reorganization plans.[63] Many of the large firms that file in Delaware seek to confirm prepackaged bankruptcy plans,[64] and more traditional cases also tend to reach confirmation quite quickly.[65]

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62. LoPucki and Whitford described this aspect of New York's reputation six years ago; LoPucki & Whitford, *supra* note 56, and many commentators have noted it since. *See, e.g.*, Federal Judicial Center, *Report to The Committee on The Administration of The Bankruptcy System, Chapter 11 Venue Choice By Large Public Companies* at III-7 (Jan. 9-10, 1997) (hereinafter *Federal Judicial Center Report*).

63. *See Federal Judicial Center Report, supra* note 62, at III-6; *see also Delaware Report, supra* note 2 at 15-17.

64. In a prepackaged bankruptcy, a debtor's managers attempt to negotiate the terms of a reorganization plan prior to filing for bankruptcy. To minimize the length of the case, the managers generally include the reorganization plan with their petition. Although the New Deal reformers repeatedly criticized pre-bankruptcy negotiations in the hearings that led to the Chandler Act, the 1978 Code explicitly contemplates the use of prepackaged plans. *See* Bankruptcy Code § 1126(b) (defining the parameters of prebankruptcy acceptance or rejection of plans). For a more detailed description of prepackaged bankruptcy, and an argument that it should be permitted in the bank insolvency context, *see* David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, Tex. L. Rev. (forthcoming 1998).

65. For specific figures on this, *see Delaware Report, supra* note 2, at 16-17 (average time to reorganize publicly held firm in Delaware from 1991-1995 was 11.7 months, as compared to 15.7 months nationally).

Complaints about debtor-friendliness in Delaware focus not on extensions of exclusivity, but on several Delaware practices that smooth the way for a debtor. Most prominent is the judges' treatment of "first day orders" — the requests for use of cash collateral and for permission to pay employees, among other things, that a debtor often files along with its bankruptcy petition.[66] While most bankruptcy judges delay their approval until they can hold a hearing and give creditors an opportunity to respond, Delaware judges often approve the orders almost immediately. One judge also is known for fielding calls from Delaware attorneys *before* a firm files for bankruptcy, and indicating, among other things, which of the two Delaware judges a case would be assigned to.[67]

One factor the Delaware judges do have in common with their colleagues in New York is their treatment of debtors' attorneys' fees. Both courts have a reputation for generosity in granting attorneys' fees, a factor that obviously would sit well with an attorney who is helping a firm decide where to file for bankruptcy.[68]

The question, then, is how alarming are these tendencies? Are critics correct that Delaware's (and New York's) efforts to attract debtors are having, and will have, ruinous effects on the bankruptcy process?

B. Racing to the Bottom or Top in Corporate Law

As discussed in the last part, complaints about Delaware as a bankruptcy venue are not new; similar complaints were made in the 1930s. In the 1930s, the complaints were integrally connected to a larger debate about whether Congress should displace the states as the principal regulator of corporate law. It is only by understanding the larger,

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66. The orders presented for approval at the commencement of the case — that is, first day orders — typically include, among others, orders approving the retention of debtor's counsel, approving the use of cash collateral, authorizing the payment of payroll, and authorizing the payment of various other prepetition expenses. For a list of first day orders approved in the Today's Man bankruptcy, *see* Krasny & Carey, *supra* note 2.

67. *See, e.g.*, *Federal Judicial Center Report*, *supra* note 62, at III-9 & III-10; Ann Davis, *Too Much Bustle in Bankruptcy Court?*, Wall St. J., Feb. 5, 1997, at B1. As I discuss below, many practitioners suspect that Judge Farnan's orders withdrawing the bankruptcy reference were prompted in large part by these ex parte contacts.

68. *See, e.g.*, *Federal Judicial Center Report*, *supra* note 62, at III-7 (New York reputation for high fees).

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68. *See, e.g.*, *Federal Judicial Center Report*, *supra* note 62, at III-7 (New York reputation for high fees).

recurrent debate in corporate law that we can fully appreciate the significance of Delaware's renewed importance in bankruptcy.

In its current incarnation, the debate traces back to a 1974 article by William Cary (who, not coincidentally, had previously been chairman of the SEC).[69] Cary argued that the competition among states to attract corporate charters leads to a "race to the bottom." Because managers are the ones who choose a firm's state of incorporation, states have an incentive to tailor their laws to the desires of corporate managers. Corporate managers are happiest if they have little accountability, and can run their firm however they see fit. In their effort to attract corporations, Cary reasoned, states therefore will enact laws that are laxer and laxer on managers, and worse and worse for shareholders — hence, the "race to the bottom." The worst offender is the biggest winner: Delaware.

While Cary's pessimistic assessment of charter competition has proven enormously influential, it neglected to consider a single, crucial factor: the role of markets. Although states do have an incentive to cater to managers, managers cannot afford to incorporate in states with wildly inefficient laws; not only would a firm that did so suffer in the product and capital markets, but its stock price also would fall, thus making the firm an attractive takeover target.[70] In view of this, charter competition may actually produce a race to the top, with managers seeking and states providing relatively efficient laws, rather than the dismal ones Cary expected.[71]

This perspective suggests that Delaware lawmaking is more likely to be praiseworthy than lamentable. Much of the structure of Delaware corporate law appears to confirm this benign view. Delaware's dependance on franchise tax revenues assures that it will remain responsive to the needs of the corporations domiciled in the state. Delaware

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69. *See* Cary, *supra* note 3.

70. This was Ralph Winter's principal insight in his critique of the race to the bottom view. Winter, *supra* note 3. Here, as in my discussion of the debate in the introduction, I have offered a somewhat contentious account of the debate. Other commentators are much less optimistic about the curative influence of markets in this context. For an important recent example, *see* Lucian A. Bebchuk, *Federalism and the Corporation: Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435 (1992).

71. Even on this view, however, state corporate law is likely to be only *relatively* efficient, as I discuss below.

also has a small, efficient court system and judges who are more expert in corporate law than the judges of any other court in the country.[72]

This is not to say that Delaware lawmaking is optimal in every respect. Because markets are imperfect, and because it is relatively costly for Delaware firms to switch to another state, Delaware can permit at least some inefficiencies in its regulation of corporate law. The most obvious illustration of this is that several aspects of Delaware doctrine seem to benefit a particular interest group, the Delaware bar, at the expense of a more fully efficient corporate law.[73] Delaware is notably generous in granting attorneys' fees in shareholder suits, for instance, and has adopted a litigation-intensive approach to the question of when such a suit can be dismissed.[74]

Despite these imperfections, however, state charter competition in general, and Delaware lawmaking in particular, seems far superior to federalizing corporate law as race-to-the-bottom theorists have proposed from time to time. In fact, there is a strong argument that the states also should be given authority over corporate bankruptcy. Because bankruptcy is an important component of corporate law, the same pressures that impel states toward efficiency in corporate law almost certainly would cause them to regulate corporate bankruptcy more effectively than Congress has done.[75]

What does all of this say about Delaware's recent visibility in the bankruptcy context? There are obvious differences between existing bankruptcy law and a regime that left bankruptcy regulation to the states. The question, then, is whether Delaware judges are likely to act *as if* bankruptcy were truly a part of Delaware corporate law, or whether venue shopping will create some other kind of incentives for Delaware judges.

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72. Roberta Romano has made each of the points in this paragraph in a recent book (and in the articles that presaged it). Roberta Romano, The Genius of American Corporate Law (1993).

73. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 Tex L. Rev. 469 (1987).

74. *Id.* It is worth noting the connection between Delaware's reputation for generosity on fees in corporate law and the similar reputation its bankruptcy judges have in the bankruptcy context.

75. I have made this argument in considerable detail and considered the objections and obstacles to state regulation of corporate bankruptcy, elsewhere. See David A. Skeel, Jr., *supra* note 3.

C. Delaware and the Bankruptcy Race

To understand the relationship between the Delaware bankruptcy judges and charter competition, we need to consider more explicitly the factors that must be present for charter competition to take place. Two in particular stand out for our purposes. First, states cannot act as competing sources of regulation unless the area in question is regulated in some way by the states. Second, it must be clear that the law of the state of incorporation, rather than that of some other state, will apply when a dispute arises. Because the states have long regulated corporate law, and the "internal affairs" doctrine assures that courts will look to the law of the state of incorporation in resolving corporate governance issues,[76] corporate law satisfies both of these prerequisites — hence the well-developed charter competition in corporate law.

In the analysis that follows, we will consider whether these factors apply to Delaware's success in attracting bankruptcy filings. Although bankruptcy seems at first to be an unlikely context for effective charter competition, we will see on inspection that both prerequisites are at least partially met.

1. The applicability of Delaware law

The most obvious impediment to charter competition in bankruptcy is that bankruptcy, unlike other aspects of corporate law, is federal in nature.[77] Congress sets the standard for recovering preferential payments or confirming a reorganization, not the states. With Congress supplying a single framework that applies in every case, the states cannot easily provide competing sets of bankruptcy laws.

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76. For a recent, ringing affirmation of this approach by the Supreme Court, see *Delaware v. New York*, 507 U.S. 490 (1993). By contrast, if ordinary conflicts of laws principles applied to corporate law issues, and as a result the laws of states other than a firm's state of incorporation were frequently applied, charter competition would be seriously undermined.

77. In the discussion that follows, I focus on variation within the federal component portion of bankruptcy law. On issues not covered by the bankruptcy framework, courts have long deferred to state law. See *Butner v. United States*, 440 U.S. 48, 55 (1979), which underscores the local role in bankruptcy negotiations.

While the federal nature of bankruptcy law clearly interferes with charter competition, it would be a mistake to conclude there is no room for local variation. Quite to the contrary, commentators have long noted that bankruptcy practice varies significantly from jurisdiction to jurisdiction.[78] The differences can be either procedural or substantive in nature, or both. Examples of procedural variation include courts' different approaches to hearings or first day orders.[79] Substantively, courts have adopted different approaches (sometimes by reference to state law) to issues ranging from the breadth of the preference provisions to whether secured creditors have a security interest in rents received during the pendency of a case.[80] A wide range of issues that fall somewhere between substantive and procedural, such as the decision whether to approve a postpetition financing arrangement or to extend exclusivity, are similarly flexible in nature.

Thus, it quickly becomes clear that bankruptcy judges could develop a jurisdiction-specific approach to bankruptcy — one which distinguishes themselves from their peers in other locations. The federal nature of bankruptcy law limits but does not wholly remove local control over the bankruptcy process, as evidenced by the distinct reputations that Delaware and New York bankruptcy judges have developed in recent years.

2. The question whether the "Delaware" approach will apply

The existence of a "Delaware" approach would not by itself lay the groundwork for bringing charter competition into the bankruptcy context. In addition to making the laws (or, as in bankruptcy, applying them in a distinct fashion), Delaware must also be able to assure that the laws will in fact apply to a Delaware firm that files for bankruptcy.

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78. Much of the recent literature has considered dramatic variations among jurisdictions with respect to personal bankruptcy cases. *See, e.g.*, Jean Braucher, *Lawyers and Consumer Bankruptcy: One Code, Many Cultures*, 67 Am. Bankr. L.J. 501 (1993).

79. *See supra* note 66.

80. Congress attempted to reduce the variations among the districts on each of these issues with the Bankruptcy Reform Amendments of 1994. Thus, the revision Bankruptcy Code § 550 is designed to reverse the Seventh Circuit decision in Levitt v. Ingersoll Rand, 874 F.2d 1186 (7th Cir. 1989) and to limit the parties from whom the trustee can recover; and the revision of Bankruptcy Code § 552 is intended to assure that security interests generally do extend to postpetition rents.

Outside of bankruptcy, this prerequisite is supplied by the internal affairs doctrine, which assures that Delaware law will apply to Delaware corporations even if the dispute arises elsewhere. Delaware is better off if the parties litigate in Delaware — local litigation enhances Delaware's precedent base, for instance, and benefits the local bar. But investors know that Delaware law also will be applied by non-Delaware courts, which enables them to take the contours of Delaware law into account in valuing the firm.

The "Delaware" approach to bankruptcy, by contrast, does not offer the same degree of portability. Because Delaware's approach stems from the way the Delaware judges handle actual bankruptcy cases, Delaware has little influence on cases filed elsewhere. There is no analogue to the internal affairs doctrine to instruct non-Delaware judges to mimic the Delaware judges' approach. As a result, the effects of charter competition will only extend to bankruptcy if Delaware firms that file for bankruptcy routinely bring their petitions in Delaware.

The analysis thus suggests mixed conclusions as to the connection between charter competition and Delaware's recent prominence in bankruptcy law. On the one hand, Delaware's judges are subject to the same federal bankruptcy laws as everyone else, and Delaware can only leave its stamp on bankruptcies involving Delaware corporations if the corporations decide to bring their cases in Delaware. On the other hand, the bankruptcy laws leave sufficient flexibility for the judges to develop a Delaware-specific approach, and Delaware corporations do increasingly file in Delaware.

My own inclination is to view the glass as half full, rather than half empty. Even imperfect charter competition seems preferable to its absence. Moreover, the seriousness and sophistication of Delaware's corporate legal culture should, at least over time, manifest itself in the bankruptcy context.[81] In the analysis that follows, I suggest that strong evidence supporting this optimistic view already exists.[82]

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81. Roberta Romano has frequently emphasized the importance of Delaware's judicial expertise. *See, e.g.*, Romano, *supra* note 72, at 38 & n.20. For a detailed description of the process by which Delaware chancery and supreme court judges are selected, *see* David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 Va. L. Rev. 127 (1997).

82. This is not to say the Delaware bankruptcy court is ideal. As I have suggested, some of the recent concerns, particularly those about judges' ex parte contacts with the Delaware bar, clearly are legitimate.

D. The Evidence So Far: Assessing the Delaware Approach

Thus far, I have argued in relatively abstract terms that the benefits of charter competition should also have at least some effect on the Delaware bankruptcy court. Over time, at least, the efficiency or inefficiency of Delaware's bankruptcy process should be reflected in the value of Delaware corporations.

In this section, I take a closer look at several aspects of the Delaware approach, in order to determine whether Delaware appears to be improving or undermining bankruptcy law. I also offer several predictions as to the future direction of the Delaware court if Congress retains domicile as a venue option.

1. The Delaware specialty: prepacks and speed

As suggested earlier, Delaware's bankruptcy judges have established a reputation for speed.[83] In striking contrast to New York, which has tended to specialize in unusual and complex cases, Delaware has become the leading destination of prepackaged bankruptcy filings. Delaware's judges also tend to confirm traditional Chapter 11 cases much more quickly than judges in other districts.

Venue shopping in bankruptcy has thus produced a clientele effect, with Delaware attracting firms that seek to reorganize quickly. Interestingly, several commentators have argued that charter competition is characterized by a similar dynamic outside of bankruptcy. Professors Baysinger and Butler, for instance, contend that different states specialize in attracting different kinds of corporations.[84] While the theory has only limited explanatory power in the general corporate context, the process of specialization is quite evident in bankruptcy. An obvious explanation for Delaware's striking specialization is that Delaware is only one of several venue options, and managers have strong practical reasons to file where their offices are located.[85] By holding out the prospect of a

83. *See supra* notes 63-67 and accompanying text.

84. Barry D. Baysinger and Henry Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & Econ. 179 (1985).

85. Recall that Senator Hastings made precisely this argument in defense of Delaware venue in the 1930s. *See supra* note 32 and accompanying text. For evidence that managers do in fact tend to file for bankruptcy in the district of the firms' headquarters, *see* LoPucki & Whitford, *supra* note 56, at 26-29, (suggesting that 36 of the 43 cases studied were filed in the district where the firms' headquarters were).

prompt reorganization, Delaware counteracts managers' concerns as to the disruptiveness of an out-of-town filing.

What, then, are we to make of these developments? Is Delaware's penchant for speed desirable, or cause for concern? The obvious answer is that the Delaware approach has a great deal to commend it. To be sure, some of the criticisms of Delaware's judges are well-founded — most obviously, the complaints about ex parte contacts with members of the Delaware bar.[86] But Delaware has successfully addressed the single biggest problem with Chapter 11 in recent years — the inordinate time and expense of the reorganization process.[87]

One final note on prepackaged bankruptcies. Recent empirical evidence suggests that prepackaged bankruptcies are quicker, less expensive, and entail smaller deviations from absolute priority than traditional Chapter 11 reorganizations.[88] Yet one still might debate whether routine confirmation of prepackaged plans is a welcome development. It is conceivable, for instance, that some prepackaged plans effect a redistribution from scattered, general creditors to large creditors such as the institutional investors that often hold publicly issued and privately placed bonds. Despite this and other concerns, prepackaged plans seem on balance to offer an attractive balance between the benefits of an out-of-bankruptcy workout and of Chapter 11. For the firms most amenable to a prepackaged plan — publicly held firms with relatively uncomplicated capital structures — the benefits of avoiding a full-blown Chapter 11 process may be substantial.

In sum, Delaware's bankruptcy judges have responded to venue shopping by establishing a reputation for speedy reorganization. Although one could quibble as to whether prepackaged bankruptcy plans are desirable, the fact remains that Delaware's

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86. These complaints apparently were magnified by Delaware lawyers' word-of-mouth advertisement that they could get things done in the Delaware bankruptcy courts that would not be possible elsewhere.

87. The cost and delay of chapter 11 has been widely criticized in recent years. For a description of its sources, *see* David A. Skeel, Jr., *Markets, Courts and the Brave New World of Bankruptcy Theory*, 1993 Wisc. L. Rev. 471 (1993).

88. Elizabeth Tashjian, Ronald C. Lease, & John J. McConnell, *An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. Fin. Econ. 135 (1996). Note that prepackaged bankruptcies ideally might bridge the differences between out-of-bankruptcy workouts and full-blown chapter 11 cases. *See* Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. Fin. 161 (1997) (finding that firms reduce their leverage more in chapter 11 than through out-of-bankruptcy workouts).

judges have counteracted the single most pervasive problem with Chapter 11 — the time and expense the process entails.

2. Substantive effects — fiduciary duties and directorial elections

Less obvious than the relative duration of Delaware bankruptcy cases is whether and how venue shopping will affect the court's decisions on substantive issues. If I am correct that nonbankruptcy corporate charter competition will influence Delaware decisionmaking in bankruptcy, the effect should extend to specific substantive issues. One set of issues jumps out as a particularly promising candidate for doctrinal development: the nature of directors' fiduciary duties when a firm is insolvent and the related question of whether shareholders are entitled to elect directors in bankruptcy. To show this, I will briefly describe the recent case law on each of these issues, then speculate as to how venue shopping may influence future developments.

In a series of cases in recent years, bankruptcy judges in New York and the chancery court in Delaware have faced the question of whether shareholders can call a shareholders' meeting during the bankruptcy case for the purpose of displacing the current directors.[89] The request almost invariably comes when shareholders fear the directors will support an unfavorable reorganization plan, and the practical issue is whether to allow shareholders to use their nonbankruptcy voting rights as a source of bargaining leverage. The existing case law concludes that shareholders can invoke these rights absent "extraordinary circumstances," just as they could outside of bankruptcy, although courts have denied the request on several occasions.[90]

Elsewhere, I have argued that courts' general sympathy for the shareholders' position may be a perverse effect of the separation between state-regulated corporate law and federal bankruptcy law — an effect I refer to as vestigialization.[91] Because sharehold-

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89. Prominent recent cases include Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.), 801 F.2d 60 (2d Cir. 1986) (enjoining meeting because it would constitute a "clear abuse"); Lionel Corp. v. Committee of Equity Sec. Holders (In re Lionel Corp.), 30 Bankr. 327 (Bankr. S.D.N.Y. 1983) (permitting shareholders committee to ask Delaware chancery court to authorize shareholders' meeting). I have commented critically on these cases in David A. Skeel, Jr., *supra* note 3, at 506-09; David A. Skeel, Jr., *The Nature and Effect of Corporate Voting in Chapter 11 Reorganization Cases*, 78 Va. L. Rev. 461, 485-86 (1992).

90. *Id.*

91. Skeel, *supra* note 3.

ers are no longer the residual owners of an insolvent firm, they have poor decision-making incentives and thus should lose their authority over the board of directors if the firm files for bankruptcy. If anyone votes, it should be the firm's unsecured creditors. Yet, because bankruptcy courts look to state law for guidance on this issue, and state decision-makers regulate with healthy corporations in mind, courts have concluded that shareholders should have the same powers in bankruptcy that they have while the corporation is solvent.

Interestingly, on the issue of directors' fiduciary duties, several nonbankruptcy courts have recently suggested that directors' duties change when a firm becomes insolvent. Most prominently, Chancellor Allen stated in *Credit Lyonnais Bank Nederland, Nv. v. Pathe Communications Corp.*[92] that corporate directors must consider creditors' interests as well as shareholders' in the event of insolvency.

My analysis of venue shopping predicts that the return of bankruptcy cases to Delaware will counteract the effects of vestigialization, and that Delaware's chancery and bankruptcy courts will develop an increasingly consistent, coherent approach to these issues. Most obviously, I would expect the courts to develop a strong presumption *against* permitting shareholders to elect new directors in bankruptcy, at least in the contexts where the issue has tended to arise.[93]

At first glance, a recent decision in the Marvel reorganization might appear to belie my prediction. In *Marvel*, the district court upheld a shareholders' meeting request that was quite explicitly designed to displace Marvel's current board of directors.[94] Al-

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92. No. Civ. A. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

93. As suggested in the text, the issue arises well after the bankruptcy filing, in the context of negotiations on a particular reorganization plan. By contrast, one can imagine Delaware judges permitting a shareholder vote earlier in a case if, for instance, a group of shareholders wishes to challenge the filing.

In fairness, I should note that, even if my predictions were to prove prescient, it might not provide conclusive evidence that venue shopping has benign effects. One could also interpret the developments in other ways. Removing shareholders' right to replace directors, for instance, could be viewed as a means of insulating directors from scrutiny — particularly if the right to replace directors were simply eliminated rather than given to creditors.

94. Official Bondholders Committee v. Marvel Entertainment Group, Inc. (In re Marvel), C.A. No. 97-146-RRM, slip op. at 12 (D. Del. May 14, 1997) ("[i]t is well settled that the right of shareholders to compel a shareholders' meeting ... subsists during reorganization proceedings.").

though the opinion carries ringing endorsements of shareholders' right to invoke their voting rights in bankruptcy, the context in which the decision arose puts it in a somewhat different light. The "shareholders" in the case were a group of bondholders, led by Carl Icahn, who became shareholders when the bankruptcy court permitted them to foreclose on stock that Ronald Perelman of Marvel had pledged to secure the bonds.[95] Thus, the effect of the decision is to permit a group of creditors to replace Marvel's directors, a result much more in line with the position I have argued for than the language of the opinion might suggest.

It is still too early to state with any certainty how venue shopping will affect Delaware decision-making on substantive issues. But my analysis suggests both that it will have an effect, and that the effect is likely to be a generally desirable one.

3. Judicial expertise and judicial culture

Thus far, I have offered evidence and a bit of speculation in support of my contention that charter competition will beneficially influence Delaware bankruptcy cases. The fact that Congress rather than the states regulates bankruptcy seriously dilutes the effect, but Delaware still has enough flexibility to leave its stamp on bankruptcy law. In this subsection, we turn more directly to the judges themselves. Once again, we will see both that federal regulation interferes with state decision-making, and that Delaware's influence nevertheless shines through.

An important part of Delaware's success in corporate law lies in its remarkable judiciary. As befits Delaware's longstanding preeminence in corporate law, Delaware's judges as a group offer more expertise and sophistication than those of any other court in

95. Moreover, some observers suspect that Judge Farnan's order withdrawing the bankruptcy court's reference may have influenced the sequence of events that shifted authority to the Marvel bondholders. *See, e.g.* Ann Davis, *Delaware Court's Actions in Marvel Case Viewed as Message to Corporate Debtors*, Wall St. J., June 30, 1997, at B12.

the country.[96] Moreover, the state's careful selection process, in which the corporate bar plays a prominent role, is carefully designed to assure that things stay this way.[97]

Because bankruptcy judgeships are federal, Delaware's bankruptcy judges are chosen through an entirely different process. Bankruptcy judges are appointed by the federal court of appeals.[98] Thus, the federal judges of the Third Circuit, rather than Delaware, determine who will fill Delaware's bankruptcy court.

Yet this is not the end of the story. Although Delaware does not have formal authority over the selection of bankruptcy judges, as a practical matter its bar is likely to be the principal source of nominees. And in fact this has proven to be the case. The practice that has developed in the Third Circuit, as in other circuits, is to assemble a list of nominations — generally provided by the local bar — which is forwarded to the Third Circuit. Bankruptcy judgeships are then filled from the list of nominees.[99]

Given the obvious value of a vigorous corporate bankruptcy practice to the Delaware bar, the bar can be expected to exercise some of the same care in nominating bankruptcy judges that it does with Delaware chancery and supreme court judges. It is too early to tell for sure, but the selection of Delaware's two current bankruptcy judges seems to confirm this prediction. When Delaware's senior bankruptcy judge, Judge Helen Balick,

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96. *See supra* note 81 and accompanying text. For an exploration of the way in which the Delaware courts establish standards of corporate behavior, often through opinions that distinguish in quasi-moral terms between appropriate and inappropriate directorial performance, see Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 U.C.L.A. L. Rev. 1009 (1997). *See also* Skeel, *supra* note 81, at 163-72 (describing "moral dimension" in Delaware decision making).

97. For a detailed discussion of Delaware's judicial selection process, *see* David A. Skeel, Jr., *supra* note 81.

98. *See* 28 U.S.C. § 152(a)(1) (court of appeals to make appointments "after considering the recommendations of the Judicial Conference").

99. More precisely, the judicial council of each court of appeals is responsible for making recommendations to the circuit court. The Judicial Conference recommends that the judicial councils appoint a merit selection panel with at least three members to assist them in assembling nominations. The merit selection panel is expected to submit five to ten names to the judicial council, which then submits at least three nominees to the court of appeals. For a detailed description of the selection process, see Administrative Office of The United States Courts, The Selection and Appointment of United States Bankruptcy Judges, at 9-10 (1994) (merit selection panels); *id.* at 18-21 (submission of names).

was selected in 1984, Delaware's bankruptcy court had no particular prominence; and the selection process drew little of the attention that chancery and state supreme court judgeships receive.[100]

By 1991, when Delaware added a second bankruptcy judge, Peter Walsh, things were just beginning to change. The Continental case had put Delaware on the map, and the connection to Delaware's role in corporate law was becoming more clear. The Delaware bar took a more active interest in the selection process; it almost certainly will take an even greater interest in future appointment decisions, and will exercise the same kind of care as it does with the chancery and supreme court nominations. Moreover, once they are selected, Delaware's judges become part of the same corporate culture that has played so prominent a role in corporate law generally.

It is important to emphasize that the selection of bankruptcy judges is "not exactly" (to return to the commercial I described in the Introduction to this article) like Delaware's selection of chancery and supreme court judges. The Third Circuit can, if it wishes, completely circumvent the Delaware bar in its selection of bankruptcy judges for the District of Delaware. Nevertheless, under ordinary circumstances, the Delaware bar will play an important role and will select for many of the same qualities we see in Delaware's regulation of corporate law.

4. Delaware's dance with Congress

In order to further underscore the connection between Delaware's roles in corporate law and bankruptcy, I conclude this discussion of "evidence" by returning to the recent orders withdrawing the bankruptcy court's reference.

As noted earlier, in February, 1997, after the controversy over Delaware venue had spurred the National Bankruptcy Review Commission to adopt its proposal to eliminate domicile-based venue, Chief Judge Farnan of the District Court reversed the automatic reference of Chapter 11 cases to the bankruptcy judges.[101] His order, as clarified in a subsequent order, announced that the district court judges would begin overseeing some of Delaware's bankruptcy cases.

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100. This is not intended to be a comment on Judge Balick, who is rightly perceived to be a talented bankruptcy judge. Rather, my focus is on the nature and competitiveness of the selection process.

101. *See supra* note 2.

Observers were quick to suspect a connection between Judge Farnan's order and the precarious status of Delaware venue. What no one seems to have noticed, however, is that the sequence of events finds a fascinating echo in Delaware's regulation of corporate law. In the late 1970s, as Ralph Nader and others pressed Congress to enact a federal incorporation statute, the Delaware Supreme Court engaged in a startling shift in direction in its treatment of a controversial issue: freezeout mergers used by firms to eliminate their minority shareholders.[102] The principal effect was to subject the transactions to much greater scrutiny, and as a result to defuse critics' claims that Delaware was too lax on managers and other insiders.[103] Some commentators have drawn a similar connection between the court's 1989 decision in *Time-Warner*,[104] which made it more difficult to effectuate hostile takeovers, and prior efforts to prod Congress to enact federal antitakeover legislation. In each case, the Delaware Supreme Court cleverly preempted federal legislation by, in effect, saying "we get the message."

It is important not to overstate the case that Judge Farnan's order was similarly designed to dissuade Congress from eliminating domicile-based venue. The order itself pointed to Delaware's overcrowded docket as the reason for asserting district court control over the bankruptcy docket; and several members of the Delaware bar have suggested to me that Judge Farnan was simply angry at reports of ex parte contact between Dela-

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102. The principal shift came in Singer v. Magnavox, 380 A.2d 969 (Del. 1977). The Delaware Supreme Court quickly retreated from *Singer; see* Tanzer v. Internodal Gen. Incus., 379 A.2d 1121 (Del. 1977); and subsequently abandoned it. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

103. A member of the Delaware bar offers a nicely understated account of the dance between Delaware and Congress: "The [debate over whether to enact a federal incorporation statute] was conducted in law journals and on the seminar circuit for several years but eventually subsided without congressional intervention after the Delaware Supreme Court rendered a series of decisions upholding minority challenges to corporate actions. Whether the decisions represented a shift in approach ... became a moot point when the critics chose to view them as a response to their concerns." David A. Drexler, *The Growth of Corporate Law*, in *Delaware Bar*, *supra* note 42, at 583, 596-97.

104. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

ware bankruptcy judges and the bar.[105] Moreover, Judge Farnan is not viewed as part of the "in group" by the Delaware corporate bar, which suggests that he may be less likely than, say, a Delaware chancery or supreme court judge to respond to the perceived best interests of the Delaware corporate law culture.

Yet the order came too close on the heels of the venue controversy for the echoes of the corporate law shifts to be dismissed. Further, even if the impetus for the order was anger over reports of ex parte contacts, it nevertheless reflects a remarkable responsiveness to concerns about Delaware practice.

This responsiveness has important implications for the analysis of this part. On the corporate law side, even die-hard critics of Delaware's role in corporate law have acknowledged that the threat of federalization has had beneficial effects on Delaware lawmaking.[106] By analogy, this suggests that the threat that Congress will end domicile-based venue should assuage the concerns of those who are not persuaded that charter competition will, by itself, steer Delaware bankruptcy practice in the right direction.

E. The Problem of Creditor Inconvenience

Our analysis of charter competition has assumed that bankruptcy is simply an element of corporate law, and is influenced by essentially the same forces. While this is largely true, there is at least one important difference. Unlike other corporate law issues, which tend to involve two-party disputes between shareholders and directors, bankruptcy also implicates a large category of third parties: the creditors of the firm. It is in considering this additional constituency that we come to the second major concern with Delaware venue, the concern that Delaware filings will inconvenience the firm's creditors.[107]

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105. Another lawyer suggested that Judge Farnan was angry because the bankruptcy judges had submitted a request for additional bankruptcy judgeships without informing him first. Following the order and the controversy it provoked, a group of Delaware lawyers met privately with Judge Farnan on a weekly basis to discuss the status of Delaware bankruptcy court practice.

106. Melvin Eisenberg, co-author with the late William Cary and similarly skeptical of Delaware's role in corporate law, states in their casebook, for instance, that "[o]ver the past ten or fifteen years, Delaware's position on statutory innovations has been moderate, and often even statesman-like;" Cary & Eisenberg, *supra* note 50, at 129-30; and concludes that the threat of federal regulation has made it "no longer fair to say that Delaware is leading the race to the corporate bottom." *Id.* at 131.

107. As we saw in our historical debate over bankruptcy venue, *see* Part I(B), *supra*, these concerns about creditor inconvenience have a long history.

The concern can be seen most vividly if we consider a firm whose only real contact with Delaware is its status as a Delaware corporation. Suppose that the firm does much of its business in California, and many of its creditors, such as its suppliers, are located there. If bankruptcy were filed in Delaware, the costs of participation for California creditors might be prohibitive, whereas a California filing would be within reach. Eliminating domicile-based venue, the reasoning goes, would force firms to file in a more convenient location.[108]

While creditor inconvenience is a genuine concern, there are several reasons to believe it does not call for ending domicile-based venue. First, it is important to keep in mind that the firms that choose Delaware as a venue location nearly always are publicly held. The vast majority of firms are closely held and incorporate locally. With these firms, there will never be any serious question about venue. Moreover, those firms that are publicly held often do business in numerous states. As a result, any filing location is likely to inconvenience a significant number of creditors.

Second, the managers of a firm have a significant incentive to avoid venues that are inconvenient to the firm's headquarters.[109] If the bankruptcy is likely to be time-consuming, filing in a distant locale would mean serious disruption to their own work schedules, as the managers traveled to the bankruptcy forum to appear in hearings. The managers of Dow-Corning, for instance, have been quoted as saying they never considered filing anywhere other than Michigan, since that is where the firm's headquarters and much of its operations are.

To be sure, this still leaves a number of firms whose filing in Delaware would be further away for a majority of creditors than a filing in another plausible location.[110] Given that many of these creditors are unlikely to participate in any event, however, and

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108. For an effort to quantify the potential inconvenience of a Delaware filing, *see Federal Judicial Center Report*, *supra* note 62, at III-12 to III-25 (concluding that Delaware is more inconvenient on average than the firm's principal place of business, though the difference is much smaller when only large creditors are considered).

109. A headquarters-based filing may be quite inconvenient to creditors if, for instance, the firm's operations are centered in a different state. But this kind of inconvenience is unrelated to the domicile-based venue issue, since the question here is whether a *domicile-based* filing undermines creditors' interests.

110. As indicated by the evidence analyzed in *Federal Judicial Center Report*, *supra* note 62, at III-11 to III-25.

will be represented in important respects by the creditors committee, it would be a mistake to eliminate domicile-based venue in an effort to facilitate creditor participation.[111] This is particularly true if we consider the offsetting benefits of Delaware venue. To the extent lawmakers wish to encourage creditor involvement, a better approach would be to approach this goal directly, through measures designed to reduce the cost of participation.[112]

F. Two Alternative Directions for Venue Reform

Roberta Romano has characterized charter competition as the "genius" of corporate law.[113] I have argued throughout this part that although the effect is attenuated in bankruptcy, the same process also provides grounds for optimism about Delaware's role in corporate bankruptcy, particularly when we take the effect of Delaware's judicial culture into account — and that this remains true even in view of concerns about creditor inconvenience. The obvious conclusion to draw from this is that it would be a mistake to eliminate domicile-based venue.

The attenuated nature of the benefits of Delaware bankruptcy does, however, raise the question whether bankruptcy venue could be adjusted in a way that offered still greater benefits. In this section, we will briefly consider two possibilities, each of which would preserve the possibility of Delaware venue.

First, rather than simply permitting debtors to file in their state of incorporation, lawmakers might *require* them to do so. Requiring firms to file in their state of incorporation would eliminate venue shopping, and it would also assure that the benefits of charter competition applied more fully to bankruptcy, since a firm's choice of domicile

111. The preoccupation with encouraging creditor participation has intriguing parallels to longstanding efforts in corporate law to use the federal securities laws to promote shareholder involvement in corporate governance. In the corporate governance context, Easterbrook and Fischel have argued powerfully that these efforts are costly and unnecessary, since most shareholders are rational in remaining uninvolved. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395 (1983).

112. LoPucki and Whitford have suggested several measures of this sort, such as permitting creditors to participate in hearings via telephone. LoPucki & Whitford, *supra* note 62, at 49.

113. Romano, *supra* note 72.

would determine its bankruptcy venue, just as it determines other aspects of state corporate law.[114]

An obvious concern with this approach (as with the existing approach, since it permits domicile-based venue) is that a firm might strategically change its state of incorporation on the eve of bankruptcy in order to take advantage of a particularly debtor-friendly venue. The possibility of strategic reincorporation undermines charter competition, the argument goes, because markets will not effectively account for differences in bankruptcy fora if a firm can make a last-minute switch.[115] On inspection, this concern proves quite manageable. Although shareholder or creditor approval of any reincorporation may not be an effective check,[116] venue manipulations can be addressed by simply disallowing eve of bankruptcy changes of venue.[117]

An additional concern with limiting venue to domicile is that there sometimes are good reasons for filing in a location other than the state of incorporation. If the case is likely to be protracted, for instance, filing near the firm's headquarters or principal place of business may reduce the disruption caused by the bankruptcy process.

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114. Recall that, in the current venue regime, a firm's venue choice cannot be determined in advance because firms have a variety of venue options at the time they file for bankruptcy. Limiting a firm's venue choice to a single option would improve the market's ability to account for the relevant bankruptcy regime in pricing the firm's stock. This, in turn, would enhance firms' incentive to seek, and bankruptcy judges to provide, efficient bankruptcy regulation.

115. In corporate law, Lucian Bebchuk has made the analogous argument that the possibility of opportunistic, midstream charter amendments may undermine the efficiency of corporate law. Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820 (1989).

116. Shareholder approval is problematic because shareholders may, like managers, benefit from the last-minute switch if the forum is biased in favor of their interests. Skeel, *supra* note 3, at 544. Creditor voting or a vote of all consistencies alleviates this problem somewhat, but would entail an appreciable administrative burden and in practice might prove to be, in essence, a referendum on the reorganization as a whole.

117. *Id.* at 544-45. In fact, the current venue provision already does just this, by basing domicile (as well as principal place of business and assets) on the firm's location during the majority of the 180-day period before bankruptcy. The provision thus gives effect only to venue shifts that occur at least ninety days before bankruptcy, since this assures that the firm has been in the new location for a majority of the 180-day period. Although one might wish to expand the period a bit, it nicely prevents last-minute domicile changes.

A second alternative would be to permit firms to make their venue choice in advance, by specifying in their certificate of incorporation where any subsequent bankruptcy will be filed.[118] As with limiting venue to the state of incorporation, the contractual choice approach would harness market forces more effectively than the existing regime, since investors could price a firm's choice of bankruptcy venue along with the other factors that influence the value of a firm's securities. Moreover, in contrast to domicile-only venue, contractual choice would enable a firm to choose a bankruptcy venue that best fits the profile of the firm.

The principal limitation of contractual choice is that it assumes a firm can determine in advance what kind of bankruptcy regime will prove most efficient. In practice, this may often not be the case. Managers may not have the foresight to know, for instance, whether financial problems that arise a decade hence will be best addressed through a prepackaged bankruptcy (which Delaware currently specializes in) or a more lengthy renegotiation process (the New York speciality).

To enhance this approach, lawmakers could permit a firm to change its choice midstream, subject to a shareholder and/or creditor vote. A switching mechanism of this sort would not only pose an appreciable administrative burden, however, as noted above,[119] but managers also would often face a formidable signaling problem because a decision to switch bankruptcy venues midstream sends a strong signal as to the precariousness of the firm's current prospects.[120] What this suggests is that the contractual choice approach is likely to be most effective if firms generally can determine the most appropriate bankruptcy venue well in advance of actual financial distress.

Despite these caveats, both the "domicile-only" and contractual choice approaches have the important virtues of bringing market forces more fully to bear on the bankruptcy process, and thus encouraging bankruptcy judges to develop a reputation for efficiency. As a result, either might improve on the existing regime.

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118. This is the approach that Rasmussen and Thomas endorse and defend in their article on the Delaware venue controversy. Rasmussen & Thomas, *supra* note 4. As the analysis below suggests, I also find the approach attractive, but view it as having relatively significant limitations.

119. *See supra* note 116 and accompanying text.

120. Interestingly, a firm that decides to change its state of incorporation in a domicile-only regime may face less of a signaling problem, because it may be less obvious why the firm has decided to make the switch.

From this perspective, the existing regime may be a second-best approach. Yet the current approach does provide at least some of the benefits of the approaches we have just considered, which underscores the importance of preserving a domicile-based venue option.[121]

III. PUBLIC CHOICE AND THE FUTURE OF BANKRUPTCY VENUE

In the last part, we saw that the criticisms of Delaware venue are, on the whole, quite uncompelling. If this is so, why has the outcry against Delaware venue been so vociferous and widespread? Although concerns about inappropriate ex parte contacts surely are one factor, at least as important is the pervasive support for change among bankruptcy lawyers and bankruptcy judges. It seems at times as if everyone outside of Delaware favors the proposed reform.

From a political perspective, the stance of most bankruptcy lawyers and bankruptcy judges is not surprising. Nearly every prominent case filed in Delaware is a case that would have landed in a non-Delaware bankruptcy court, and benefitted non-Delaware lawyers, were it not for domicile-based venue.

The question we will consider in this part is whether this opposition to Delaware venue is likely to prove successful. Thus, we will shift from the normative question of whether reform is desirable, to the descriptive issue of whether it is likely. The methodology I will use throughout the analysis is that of public choice. After briefly describing the insights of public choice most relevant to the bankruptcy venue issue, I will integrate these insights into the historical analysis of the beginning of the article in an effort to isolate the key political variables in venue reform.

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121. The analysis of this part also suggests that the venue provision is overly generous in permitting firms to file in a location where any of their affiliates have filed. Because the additional option of filing in the location of a minor affiliate interferes with the market's ability to accurately price the effects of different bankruptcy regimes, it would make sense to require that consolidated filings be made in the location or domicile of the core business. Although complaints about using affiliate filings as a "venue hook" seem to have gotten drowned out by the furor over Delaware, the complaints were justified.

Often described as the "use of economic tools to deal with the traditional problems of political science,"[122] public choice starts from (or explicitly challenges) the assumption that politicians, voters, and other relevant actors act in their own self interest.[123] For politicians, self interest generally means re-election; for voters, it means selecting the representatives most closely aligned with their interests. Yet general voters face a significant collective action problem: because they have relatively little stake in the outcome of an election, voters have little incentive to inform themselves. Concentrated interest groups, by contrast, participate actively in the political process — voting and contributing to legislators' campaigns, for instance. Because of this, re-election-minded legislators respond more to interest groups than to voters generally, and interest groups wield disproportionate influence.

While interest group theory alone is quite powerful as an explanatory tool, a more compelling account should take additional factors into account. Many otherwise apathetic voters may have strong views on some issues — a factor we can loosely define as ideology. Where this is so, general voters may have significant influence on the decision-making process.[124]

For our purposes, the most important extension of this analysis is the application of public choice insights to federalism — that is, the division of responsibility between Congress and the states. Although Congress might seem to have an incentive to legislate in as many areas as possible, federal legislators have left a wide range of issues to the states. Why is this? In an insightful article, Jon Macey argues that in some contexts, avoiding an issue rather than addressing it is the best way for Congress to maximize its rents from interest groups. He identifies several areas where self-interested federal legislators will accede to state control. If a state (or states) has developed particularized expertise or a reputational interest, for instance, Congress may obtain more support from local

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122. Gordon Tullock, *Public Choice*, in 3 The New Palgrave: A Dictionary of Economics 1040, 1040 (John Eatwell, et al., eds., 1987).

123. For a much more detailed discussion of public choice analysis, including each of the points considered in the text that follows, see David A. Skeel, Jr., *Public Choice and the Future of Public Choice-Influenced Legal Scholarship*, 50 Vand. L. Rev. 647 (1997).

124. *See, e.g.*, Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 Colum. L. Rev. 10, 31-32 (1991). For discussion of the role of ideology in bankruptcy legislation, see Skeel, *supra* note 10.

regulators if it agrees to forego federal legislation than it could by intervening.[125] As his principal illustration of such a context, Macey cites Delaware's interest in retaining its status as the preeminent regulator of corporate law.[126]

If we apply these insights to the earlier 1930s debate about Delaware venue, the result is puzzling. Even then, Delaware had a strong interest in state regulation of corporate law, since Delaware had displaced New Jersey as America's premier corporate address; and corporate reorganization was very much a part of the Delaware chancery court's practice.[127] Yet, by the end of the 1930s, Congress had eliminated firms' ability to look to their state of incorporation as a venue option.

Two factors help to explain why Congress eliminated Delaware venue in the Chandler Act, whereas the New Deal reformers failed in their efforts to propose a federal incorporation statute.[128] First, Delaware's role in corporate reorganization was quite precarious from the beginning. Although the Delaware chancery court developed a well-known expertise in handling equity receiverships, the equity receiverships filed elsewhere were routinely brought in federal courts in order to avoid the jurisdictional obstacles faced by a state court.[129]

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125. Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public Choice Explanation of Federalism*, 76 Va. L. Rev. 265, 276-81 (1990). Macey also identifies two other contexts where Congress will defer to the states: 1) if (as with gun control) the support-maximizing approach may vary from state to state; *id.* at 281-84; and 2) on particularly controversial issues (such as abortion), where every approach may be politically risky. *Id.* at 284-90.

126. *Id.* at 277-80. As the analysis below will make clear, state regulation of corporate law is better explained as a combination of one state (Delaware) having a particular interest in regulation, and other states having a similar though weaker interest in continued state control.

127. *See supra* note 20 and accompanying text.

128. While the reformers failed to enact a federal incorporation statute, they did of course federalize important portions of corporate law through the Securities Act of 1933 and the Securities Exchange Act of 1934. What they did not do is eliminate state charter competition and states' general preeminence in corporate law, which was the principal goal of a federal incorporation statute.

129. As noted earlier, the most widely-cited description of receivership practice is Cravath, *supra* note 10. For an argument that the shift from state to federal courts as the forum of choice in receivership cases reflected federal judges' efforts to enhance the prestige of the federal judiciary, see Frank H. Buckley, *The American Stay*, 3 So. Calif. Interdisc. L.J. 733 (1994).

The second, related factor stems from the very different impact that curbing Delaware's role in corporate reorganization would have on other states, as compared to taking similar action in corporate law generally. If Congress were to enact a federal incorporation statute, every state would lose its authority over firms incorporated in the state. As a result, Delaware had a large number of potential allies in its efforts to prevent federalization of corporate law.[130] By contrast, eliminating Delaware venue in corporate reorganization would have little adverse impact on other states, since no other state benefitted from domicile-based venue.

The importance of these factors is plain to see in the events of the 1930s. Ideology loomed particularly large during the 1930s, and on federalism issues in corporate law took the form of strident populist criticism of Delaware's authority over firms whose physical assets were centered in other states.[131] As we have seen, Delaware was able to preserve domicile-based venue for corporate reorganizations in 1934 due to the happy accident that the principal player in the reform was a Delaware senator, Senator Daniel Hastings. But Senator Hastings departed in 1936, and the New Deal reformers eliminated Delaware venue (temporarily) in the second wave of reform that produced the Chandler Act in 1938.

As always is the case with public choice analysis, it is far easier to provide a coherent explanation of the past than to offer useful predictions for the future. Nevertheless, our historical analysis does suggest several important lessons for the current venue controversy. First, as in corporate law generally, Delaware has a vested interest in attracting prominent bankruptcy filings.[132] This interest is much more precarious than Delaware's stake in corporate law, however. Because bankruptcy already is regulated by Congress, and because other states would lose little if Delaware lost its status in corporate reorganization, it is not difficult to imagine a successful effort to eliminate domicile-based venue.

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130. Stated differently, every state is the state of incorporation for many small firms and at least a few publicly held corporations, and thus has an interest in retaining authority over these firms.

131. *See supra* notes 24-35 and accompanying text.

132. Just as the principal opponents of domicile-based venue are non-Delaware bankruptcy judges and bankruptcy lawyers, the principal beneficiaries in Delaware are Delaware's bankruptcy judges and bar.

Yet Senator Hastings' role in the early 1930s illustrates the importance of a second factor — the fact that a well-placed legislator may be enough to protect Delaware's interests.[133] This seems particularly true now, since the liquidity and relative purity of the American securities markets has dampened the appeal of populist arguments against Delaware's role in corporate affairs. For now, at least, Delaware has a present-day equivalent of Senator Hastings in Senator Joseph Biden, who serves on and previously chaired the Judiciary Committee. So long as Senator Biden stays on the committee, even as a member of the minority, he can probably quell venue reform.[134] Moreover, even off the judiciary committee, he could perhaps protect Delaware's status so long as he remains in the Senate.

Thus, venue reform seems unlikely in the near term, although this could quickly change in the absence of Senator Biden, much as the departure of Senator Hastings and rise of the Democrats transformed the landscape by the late 1930s. In the meantime, Delaware's bankruptcy judges almost certainly will temper the practices that have brought them under fire. As the analysis of this article makes clear, both these changes and Delaware's likely resilience should be seen as distinctly good news.

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133. Where, as in this context, the legislator is well placed due to his or her role on the relevant oversight committee, the influence is very much related to the role that the committee structure plays in preserving legislative bargains. *See, e.g.*, Shepsle & Weingast, *supra* note 37; Barry R. Weingast and William J. Marshall, *The Industrial Organization of Congress: or, Why Legislatures, Like Firms, are not organized as Markets*, 96 J. Pol. Econ. 132 (1988). Because the relevant committee, here the Judiciary Committee, serves as a gatekeeper, an influential member can prevent reform from reaching the full House or Senate.

134. As evidenced by Senator Hastings' success under these conditions in 1934.

CONCLUSION

In concluding this analysis, I would like to put venue reform back into the larger context with which I began. As I noted at the outset of the article, so long as the existing corporate reorganization framework remains in place, the single most important variable in bankruptcy practice will be the effectiveness of bankruptcy judges. Because charter competition and Delaware's corporate culture will prod Delaware's judges in the right direction, it would be a mistake to eliminate state of incorporation as a venue option.

But the effect of charter competition is attenuated in a variety of ways and is unlikely to have a nationwide effect. In consequence, it is important to consider other possible inducements to judicial performance. Attractive candidates include a domicile-only or contract choice approach to venue, or giving bankruptcy creditors a say in the reappointment process; one can imagine others as well. Even without such changes, however, the quality of bankruptcy judges has risen noticeably in recent years, and Delaware's bankruptcy court is an important part of this.