EMPIRICALLY BANKRUPT

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Abstract

Empirical legal scholarship endeavors to resolve disputes that are indeterminate at the level of theory. The nature of empirical claims, however, requires that consumers of this work bring a healthy dose of skepticism to any of these projects. Three recent works in the area of corporate reorganizations illustrate how a project that appears on its face to settle scholarly debate can rest on choices that the researcher made rather than on the data itself. One of these works seeks to discredit proposals to make bankruptcy law a default rule rather than a mandatory rule, but it draws its data from a sample half of which is made up of individuals, who by definition are outside the reach of the proposed reform. Moreover, the entire sample omits publicly held corporations, the main target of the reform being examined. The second article discredits prior reorganization practice, but only by establishing a standard that no bankruptcy system has ever satisfied. The third piece concludes that competition for large Chapter 11 cases has corrupted our bankruptcy system, but the empirical basis for this conclusion rests on combining fundamentally different types of bankruptcy cases. For empirical work to be credited, at a minimum, it has to look in the right place, ask the right question and draw the right inferences. When empirical work fails to cross this threshold, it conclusions must be rejected.

Empirical analysis seeks to transform the terrain of legal scholarship. In the spirit of the natural scientist, the new cadre of empiricists attempt to use data that they have gathered to end debate over a wide array of legal issues that confront scholars and law makers. A case in point can be found in the law of corporate reorganizations. Three recent empirical efforts, taken together, conclude that the realities uncovered require that much prior theoretical work be

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rejected outright and that scholarly efforts be directed to other areas. Elizabeth Warren and Jay Westbrook, writing in the *Harvard Law Review*, conclude that their data demonstrate that academic calls to allow corporations to select their insolvency rules would result in inefficient redistributions and would create transaction costs that swamp whatever benefits the new system would bring.[1] Stephen Lubben, in the *Cornell Law Review*, deploys his data to rebut the notion that equity receiverships, which similar to current bankruptcy practice were dominated by senior creditors, were effective at resolving financial distress.[2] Finally, Lynn LoPucki, in a book published by the University of Michigan Press, says that his data demonstrates that bankruptcy courts are corrupt, and that this corruption is destroying companies that could have otherwise been saved.[3]

The promise of empirical legal scholarship is demonstrated in the nature of the claims these works put forward – each asserts that it has uncovered facts that put an end to the central theoretical debates that have dominated the literature. Contract bankruptcy is out, anything that would take us back towards the dominance that investment bankers played in the equity receiverships should be rejected, and corporations need to have their venue choices severely limited in

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[1] See Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention,* 118 Harv. L. Rev. 1197 (2005) (hereinafter "Contracting Out").

[2] See Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory,* 89 Cornell L. Rev. 1420 (2004)

[3] LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (MICHIGAN 2005).

an effort to eliminate the competition among bankruptcy courts. It is, in the language of one such effort, "time to move on"[4] from the debates of the past.

Yet precisely because empirical work seeks to end debate, law professors must be on guard against over-reading data and jumping to conclusions. This is not one theory battling another. Such debates produce iteration after iteration, and each new effort confronts the theories that have come before. Rather, all three pieces assert that they have established certain facts that are not subject to dispute. The other side is not pressed to come up with a better defense of its theory; rather, its theory should not be heeded because it runs aground on facts. This is not Burke versus Paine; it is Copernicus versus Ptolemy.

So the intellectual stakes are high here, very high. And the claims of the empiricists are very strong. Do they hold up upon examination? No. The fundamental problem is that the claims are not supported by the data.[5] All three works fail to explain *why* the data that they gathered supports the conclusions that they reached. Data is trotted out as a trump, banishing the theoretical claims made by other scholars. When the data is taken on its own terms, however, it

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[4] Warren & Westbrook, *Contracting Out, supra* note 1, at 1254.

[5] The issue on which this essay focuses is not the accuracy of the data per se. LoPucki freely makes his data base available, and corrects any errors that are drawn to his attention. See WebBRD. Lubben seems to have included most if not all of his data in his article. See Lubben, *supra* note 2, *passim.* Warren and Westbrook have described their database in a prior work, but they have not made the database itself publicly available. See Elizabeth Warren & Jay Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499 (1999) (hereinafter "Financial Characteristics").

falls far short of supporting the ambitious conclusions the authors reach. Indeed, when all of the claims are examined closely, it becomes clear that it is the critics own theoretical assumptions, not empirical evaluation, that is doing the heavy lifting.

At a minimum, empirical work has to look it the right place. For example, Warren and Westbrook investigate proposals aimed primarily at large corporations. Half of the debtors in their sample, however, are individuals, and the other half omits public companies. By not creating a representative sample, Warren and Westbrook's study gets no traction on the issue they wish to explore. Conversely, LoPucki is only able to generate statistically significant results by combining full-blown Chapter 11 cases which tend to last for months or even years with prepackaged cases that last for a few weeks.

Empirical work also has to ask the right question. Lubben is able to conclude that equity receiverships were ineffective only because he establishes a standard for reorganization law that no law to date has met. Compared to what we know about Chapter 11, Lubben's data actually shows that equity receiverships performed surprisingly well. Warren and Westbrook make assertions about the ways in which bankruptcy choice proposals would redistribute money from certain creditors, but they collected no data on what these creditors actually received. Data collected by others suggest that the

creditors they worry about by and large receive no distributions under current law.

Finally, empirical work has to draw the correct inferences. Data does not speak for itself. Warren and Westbrook's study counts the number of unsecured creditors in each case. From this number, Warren and Westbrook infer that the costs of allowing debtors to commit to insolvency rules would outweigh the benefits even though they have no information about either what parties would spend in a world of bankruptcy choice or what benefits would be gained. LoPucki assumes that there are cases that were filed in Delaware where the company would have reorganized successfully had the case been located elsewhere, but an examination of the cases themselves reveals that little could have been done to change the ultimate outcome for these enterprises.

This essay presents a cautionary tale. The growing use of empirical methods in legal scholarship is among most noteworthy scholarly trends of the last ten years.[6] It is beyond cavil that this work has extended our understanding of a wide range of legal topics. That said, one must always keep in mind that facts do not speak for themselves. Data must inevitably be interwoven with explanatory theory. The lesson of the studies considered here is that we must

[6] Indeed, Empirical Scholarship was the theme of the 2006 Annual Meeting of the Association of American Law Schools. As evidence of the increasing role of empirical legal scholarship, Tracey George has complied a ranking of law schools based on their output of such work. See Tracey E. George, *An Empirical Study of Empirical Legal Scholarship: The Top Law Schools*, 81 Indiana L.J. 141 (2006).

remain vigilant, in this era of empiricism, to avoid being taken in by arguments that advance tendentious theoretical claims as if they were 'just the facts'.

Legal scholars have gravitated to empirical work in recent years in large part because it offers the promise of resolving policy questions that remain indeterminate at the level of theory.[7] This "empirical turn" requires legal scholars to update their analytical toolboxes. We do not all need to become empirical scholars. Theory and doctrine remain honorable callings. This empirical turn, however, challenges us to consider the value of every bit of such work and to ensure that its contribution is sound and its value properly assessed.

I. Warren and Westbrook and Bankruptcy Choice

In a recent issue of the *Harvard Law Review*, Elizabeth Warren and Jay Westbrook report one of the first results from their more than decade-long project collecting data on business bankruptcies in this country.[8] This project

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[7] See, e.g., Ian Ayers, *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations,* 104 Harv. L. Rev. 817 (1991) (showing that in-race and in-gender discrimination was higher than cross-race and cross-gender discrimination); Bernard S. Black, et al., *Stability, Not Crisis: Medical Malpractice Claim Outcomes in Texas, 1988-2002,* 2 J. Empirical Legal Stud. 207 (2005) (showing that, contrary to many assumptions, malpractice recoveries have not increased substantially); Theodore Eisenberg & Jonathan Macey, *Was Arthur Andersen Different?: An Empirical Examination of Major Accounting Firms' Audits of Large Clients,* 1 J. Empirical Legal Stud. 263 (2004) (showing that, contrary to speculation in press, Andersen clients did not restate earnings more than clients of other major accounting firms).

[8] Warren and Westbrook presented a summary of their data in *Financial Characteristics of Businesses in Bankruptcy, supra* note 5. Warren, with Bob Lawless, has used the database in Robert

includes hundreds of thousands of data points about thousands of business bankruptcies across the United States. Warren and Westbrook combed through this data in an attempt to resolve the central academic debate in corporate reorganization law, whether bankruptcy should remain a mandatory rule.[9] In *Contracting Out of Bankruptcy: An Empirical Intervention*,[10] they assert that the data leave no doubt. Contrary to proposals put forth by various scholars, the federal government and not corporations should select insolvency rules. It has been "an entertaining debate, but it is time to move on."[11]

A. Warren and Westbrook's Intervention of Bankruptcy Choice

In the 1990s, law-and-economics scholars put forward several "bankruptcy choice" proposals. The gist of these proposals is that social welfare

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M. Lawless & Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 Cal. L. Rev. 743 (2005).

[9] *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 Stan. L. Rev. 311, 313-15 (in absence of bankruptcy law, creditors would contract to forgo individual collection rights, thus ensuring there would be no common pool problem); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Tex. L. Rev. 51, 55-68 (1992) (corporations should be allowed to commit to insolvency rules in advance of financial distress); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 Yale L.J. 1807, 1820-39 (formal model of how bankruptcy contracts can increase social welfare) (1998); *cf.* Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 Yale L.J. 317, 317 (1999) ("Since the publication of Professor Robert Rasmussen's landmark article in 1992, the central focus of bankruptcy scholarship has been to discover a practical method of contracting for bankruptcy procedure.").

[10] *See* Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out*, *supra* note 1.

[11] *Id.* at 1254.

will increase if corporations are allowed to commit to one set of insolvency rules well in advance of financial distress. These companies could, either when or before they borrowed, bind themselves to selling the corporation at auction, liquidating the company, cancelling the interests of junior investors, or going through something akin to Chapter 11 should the company run into financial difficulties.[12] The intuition is that the managers of companies, seeking to reduce their overall borrowing costs, would select the set of rules that would maximize the assets of the enterprise upon financial distress. By promising creditors more should financial disaster strike, the debtor reduces what it has to pay for credit. Creditors can then price their loans to ensure a market rate of return. The more they receive should things go awry, the less interest they will have to charge to cover this risk.[13]

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[12] There is no shortage of proposed alternatives to Chapter 11. Douglas Baird has suggested a mandatory auction. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganization,* 15 J. Legal Stud. 127 (1986). Baird and Randy Picker suggested a regime where the senior creditor would not be stayed but other creditors would. *See* Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations,* 20 J. Legal Stud. 311, 348 (1991). Lucian Bebchuk suggested issuing investors of the bankrupt company a series of options that reflect their contractual priority. *See* Lucian A. Bebchuk, *A new Approach to Corporate Reorganizations,* 101 Harv. L. Rev. 775 (1988). Barry Adler proposed a regime of "chameleon equity" under which default on any debt results in elimination of equity and a conversion of the lowest priority debt into equity. *See* Adler, *supra* note 2. Philippe Aghion, Oliver Hart and John Moore argued for an auction regime that allows for both cash and noncash bids, effectively combining the Baird and Bebchuk proposals. *See* Philippe Aghion, et al., *The Economics of Bankruptcy Reform,* 8 J.L. Econ. & Org. 523 (1992); Barry Adler and Ian Ayers have suggested a new approach to sell interests in the bankrupt corporation. *See* Barry E. Adler & Ian Ayers, *A Dilution Mechanism for Valuing Corporations in Bankruptcy,* 111 Yale L.J. 83, 140-49 (2001).
[13] *See* Rasmussen, *supra* note 9, at 56-57; Schwartz, *supra* note 9, at 1826-32.

Bankruptcy choice proponents have always been sensitive to the transaction costs their proposals would entail. Few companies would have the incentive to craft their own set of insolvency rules. The cost of drafting and disseminating such rules could well exceed the benefit that such rules would bring. Hence, bankruptcy choice proposals propose that the state out to supply a menu of terms from which the corporations would select.[14]

These proposals did not meet with unanimous acceptance in the academy. A vocal group of critics asserted that the proposals were ripe for mischief because sophisticated creditors and debtors would select regimes that would systematically reduce the recoveries of creditors who lacked the ability to protect themselves through adjusting the prices that they charged for credit.[15] Those opposed to bankruptcy choice also complained that the inevitable transaction costs attendant to these schemes would consume the benefits that choice would

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[14] Warren and Westbrook believe that the state would only supply the terms for selection under one variant of bankruptcy choice. *See Contracting Out, supra* note 1, at 1242 (pointing out that Rasmussen's menu-approach provides a set of choices). In this they are mistaken. *See* Schwartz, *supra* note 9, at 1850 (state should supply choices). Moreover, they assert that having a set of standard forms lessens the gains from bankruptcy choice. *See* Warren & Westbrook, *supra* note 1, at 1242. Such standardization, however, is a benefit of the system, not a cost. *See* Rasmussen, *supra* note 9, at 66; Schwartz, *supra* note 9, at 1242. For a general explanation of the efficiency enhancing properties of standardized terms, see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interaction Between Express and Implied Contract Terms,* 73 Calif. L. Rev. 261 (1985).

[15] *See, e.g.,* LoPucki, *supra,* note -, at 339 (bankruptcy choice has "the potential to redistribute wealth from noncontracting parties to contracting parties"); Susan Block-Lieb, *The Logic and Limits of Contract Bankruptcy*, 2001 U. Ill. L. Rev. 503, 516 (Opponents of bankruptcy choice "contend that [bankruptcy choice] would impose distributive costs on involuntary creditors, such as tort victims, unsophisticated creditors, and creditors whose small claims would not justify the cost of these complicated contractual remedies.").

bring.[16] Those in favor of bankruptcy choice responded that concerns about redistribution were unfounded, and that the transaction costs would not loom large.

To attempt to put an end to this debate, Warren and Westbrook turned to the database that they had developed as part of their business bankruptcy project.[17] The Business Bankruptcy database is comprised of 3201 business bankruptcy cases that were filed in 1994.[18] Warren and Westbrook generated this sample by identifying the judicial districts within the ambit of each court of appeals (other than the Federal Circuit and court of appeals for the District of Columbia) that had the greatest and the smallest number of bankruptcy cases filed. They then added an additional district from the Ninth Circuit. Two of the least active districts were swapped out for other districts in the relevant circuit due to lack of Chapter 11 activity.[19] After selecting these 23 districts, Warren and

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[16] Indeed, the concerns over the extent to which creditors can adjust their interest rates and transactions costs have been staples of the bankruptcy choice literature since its inception. *See, e.g.*, Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 68 S. Cal. L. Rev. 1107, (1994) (describing contracting costs as "trivial"); Donald R. Korobkin, *The Unwarranted Case Against Corporate Reorganization: A Reply to Bradley and Rosenzweig*, 78 Iowa L. Rev. 669, 720 (1993) ("[T]he administrative and disruption costs of coordinating the negotiation of a full network of default-contingent contracts are sure to be substantial."); Block-Lieb, *supra* note 17, at 517 ("Despite claims about the cost-saving effect of [bankruptcy choice], commentators are dubious that contractual substitutes will be less costly than the current bankruptcy process.") (citations omitted).

[17] *See* Warren & Westbrook, *Financial Characteristics, supra* note 5, at 503-517.

[18] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1209 & n. 43.

[19] *See* Warren & Westbrook, *Financial Characteristics, supra* note 5, at 510 (Eastern District of North Carolina selected from Fourth Circuit even though it was the third-lowest in terms of cases filed)

Westbrook then selected 50 business cases filed under each Chapter of the Bankruptcy Code during 1994.[20] To ensure that these cases were dispersed throughout the calendar year, they picked the first twelve or thirteen cases of each type filed at the start of each calendar quarter.[21]

Warren and Westbrook did not use the entire database for testing bankruptcy choice. Instead, they constructed a sub-sample of this larger pool by taking every fifth Chapter 7 and Chapter 11 case from the main source. This provided them with 386 cases. For each debtor within this sub-sample, Warren and Westbrook catalogued the number of creditors each debtor had, the nature of each creditor, and the amount of its claim.[22]

Warren and Westbrook examined the characteristics of each creditor because they were attempting to discover how many of a debtor's creditors lacked the ability to alter their interest rates in response to a debtor's bankruptcy selection.[23] Tort claimants, taxing authorities, utility companies, employees and individuals generally lack the ability to price credit based on the circumstances of the debtor. In addition, Warren and Westbrook posited that creditors with

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& 511 (District of Connecticut selected from the Second Circuit even though it was the second-lowest).

[20] Warren and Westbrook collected cases from Chapter 13, which is only available to individuals, as well as Chapters 7 and 11. In *Contracting Out,* they do not rely on any data regarding these Chapter 13 filings. See Warren & Westbrook, *Contracting Out, supra* note 1, at 1211.

[21] *See* Warren & Westbrook, *Financial Characteristics, supra* note 5, at 511.

[22] *See* Warren & Westbrook, *Contracting Out, supra* note 1 at 1210-11.

[23] *See id.* at 1214-15.

small claims would not take the effort to adjust their rate.[24] Warren and Westbrook focused on both of these groups of creditors because they saw them at risk should the law allow bankruptcy choice. They worried that debtors would systematically choose bankruptcy rules so as to redistribute money from these creditors to others, and that these redistributions would be inefficient.[25]

Warren and Westbrook also sought to assess the overall cost of bankruptcy choice by counting the total number of creditors each debtor had. They assumed that the greater the number of creditors, the more costly it would be for the creditors to learn about which set of rules would govern this debtor. Also, the more creditors a debtor has, the more contentious and costly would be the negotiations over the bankruptcy selection.[26]

Warren and Westbrook assert that their data on these points puts an end to the bankruptcy choice debate. Creditors who cannot adjust interest rates abound. Warren and Westbrook found that roughly a quarter of the creditors in their sample had claims held by entities who do not adjust their interest rate on a debtor-by-debtor basis.[27] Added to this, roughly 6% of the remaining debt was

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[24] *See id.*
[25] *See id.*
[26] *See id.* at 1249-50.
[27] *See id.* at 1238.

held in small chunks.[28] From these numbers, Warren and Westbrook infer that bankruptcy choice would cause redistribution among creditors, and that these redistributions would cause "substantial inefficiencies."[29]

Warren and Westbrook also report information on the number of creditors each debtor has. They find in their sub-sample that the mean for each debtor was 19, and that the maximum was 255.[30] The existence of this number of creditors implies that bankruptcy choice "would produce substantial transaction costs that would likely overwhelm any claimed gains."[31] For these reasons, they conclude that those who have argued for allowing debtors to choose bankruptcy rules in advance "have given us an entertaining debate, but it is time to move on."[32]

B. The Need to Look in the Right Place

The first task of any empirical project is to select the appropriate population to study. Here, the population is the set of entities to which the relevant legal reform would apply.[33] Gathering information about those whom a legal change would not affect pollutes the data. Conversely, leaving out those

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[28] *See id.* at 1248 n.1248 (reporting that small claims were roughly 7% of all unsecured claims and that 12% of these claims were held by creditors who could not adjust their interest rates regardless of claim size).
[29] *Id*. at 1248.
[30] *See id*. at 1250-51.
[31] *Id.* at 1253.
[32] *Id.* at 1254.
[33] *See* DAVID COPE, FUNDAMENTALS OF STATISTICAL ANALYSIS 102 (Foundation Press 2005).

whom a change affects impoverishes the analysis. When a researcher reports results drawn from too broad a population, the readers of the analysis do not know whether the information on which the researcher is relying comes from those to whom the legal change would apply or from those for whom the change would be a non-event. Conversely, when the researcher draws from too narrow a pool, the reader can only speculate about how those not studied might affect the result. Failure to specify the correct population thus derails the value of an empirical project before even the first piece of data is collected.

A. Selecting the Population

What, then, is the appropriate population for studying the impact of rules permitting choice of bankruptcy rules? The literature advocating bankruptcy choice has made it clear, from the selection of titles to the substance of the arguments, that these proposals only apply in the corporate setting. The first article in this spirit was called "Debtor's Choice: A Menu Approach to **Corporate Bankruptcy**." Other works in this genre describe rules that a corporation may select for parceling out its equity interests in an attempt to resolve financial distress. None of the proposals extend to individuals running sole proprietorships.

This is not a trivial or esoteric point. Bankruptcy law distinguishes between corporations and individuals. While both corporations and individuals can file under Chapter 7, only individuals can receive a discharge of their debts. Corporations cannot.[34] In Chapter 11, individuals post-bankruptcy earnings are not subject to creditor claims; all the earnings of a corporation, in contrast, go to its creditors. The law thus draws a clear line between the financial distress of individuals and that of legal entities.

Bankruptcy scholarship and commentary explain the reason behind this distinction. Corporate bankruptcy law seeks to put assets to their highest valued use.[35] It decides whether the assets should be sold to new investors, either piecemeal or in bulk, or kept in their current configuration. If the latter route is chosen, Chapter 11 provides a mechanism by which the capital structure of the business is readjusted.[36] Out-of-the-money interests are eliminated, and the remaining investors receive new rights against the business. Just as corporate

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[34] *See* 11 U.S.C. 726(a)(1) (limiting discharge to "individuals").
[35] *See* Rasmussen, *supra* note 9, at 62; Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice,* 1994 U. Ill. L. Rev. 1, 2; Schwartz, *supra* note 9, at 1203-04.
[36] There is no confusion on this point in the literature. For scholars making the point explicitly, see Ralph Brubaker, *Taking Exception to the New Corporate Discharge Exceptions,* 13 Am. Bankr. Inst. L. Rev. 757, 759-61 (2005); DOUGLAS G. BAIRD, ET AL., BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 561 (Foundation Press Rev. 3d ed. 2001).

law exists to maximize the value of the corporation,[37] so does corporate bankruptcy law.[38]

Individual bankruptcy law, in contrast, seeks to discharge debts so as to provide the individual with a fresh start in life.[39] The future earnings of the debtor go to the individual, not her pre-bankruptcy creditors. She can enjoy the fruits of her human capital unburdened from the claims pre-bankruptcy creditors. The discharge of past debts is the defining feature of individual bankruptcy law, but is absent when discussing corporate reorganizations. Giving a fresh start to the travel agent running a sole proprietorship out of her house is a fundamentally different endeavor from sorting out the affairs of United Airlines. Any empiricist setting out to test the bankruptcy choice proposals, therefore, needs to begin with the population of *corporations* that may file for bankruptcy.

"Contracting Out" did not so limit its sample population. Bankruptcy courts receive cases from both individuals and corporations. When Warren and Westbrook turned to the dockets of their chosen districts for cases, they included in their study sample individuals who indicated that they were engaged in

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[37] *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34-35 (Harvard 1991); REINIER R. KRAAKMAN, ET AL., THE ANATOMY OF CORPORATE LAW 17-19 (Oxford 2004).

[38] Warren and Westbrook, while expressing some discomfort with this limitation of the goals of bankruptcy, accept it for the purposes of their piece. *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1203-04.

[39] *See* Barry E. Adler, *Bankruptcy Primitives,* 12 Am. Bankr. L.J. 219, 236 (2004); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 225 (Harvard 1986).

business.[40] Later, in constructing the sub-sample for *"Contracting Out,"* they did not limit their debtors to corporations.

The result of the decision to include individuals is that roughly half of the cases that Warren and Westbrook examined are cases filed by individuals rather than corporations.[41] The population thus is fully fifty percent comprised of hairdressers, limo drivers, travel agents and the like who are not doing business in the corporate form. Bankruptcy law gives these individuals a right to enjoy the income from their human capital. Current law does not allow these individuals to waive their right to discharge, and no bankruptcy choice proposal would change this.

By including these subjects who are not in the relevant population, the study undermines its conclusions. To see how this can occur, recall that Warren and Westbrook devote much effort in *Contracting Out* to identifying certain types of creditors whom they believe could be harmed by bankruptcy choice. These are creditors that cannot adjust their interest rates to take account of the governing insolvency rules, and they consist of tort creditors, tax authorities, utility companies, employees, individuals and other creditors will claims of less than

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[40] *See* Warren & Westbrook, *Financial Characteristics, supra* note 5, at 512.
[41] *See id*. (Noting one-quarter of their Chapter 11 cases and three-quarters of their Chapter 7 cases were filed by individuals rather than legal entities.)

$5000.[42] But these classes of creditors are not distributed uniformly between corporate and individual debtors. Rather, one would expect that individual debtors, as compared with corporate debtors, would be more likely to have inadequate insurance, inadequate systems in place to pay taxes, utilities and employees, and indebtedness to individuals as well as having smaller debts.

In other words, individuals are more likely than corporations to have the very type of creditors whom Warren and Westbrook worry would be ill-equipped to confront bankruptcy choice. By including individuals in their sample, Warren and Westbrook thus increased the incidence of the phenomenon that form the basis of their claim. We have no way of knowing what their figures would look like had they limited their sample to the domain of debtors relevant to bankruptcy choice. We can say, however, that the data, so skewed, cannot support the broad conclusions that the authors draw.

B. From Population to Sample

Identifying the appropriate target population is only the first step in the analysis. Resource constraints mean that researchers often cannot collect

[42] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1227-44.

information about every member of the population.[43] Instead, they have to create a sample of the population.[44] The goal, ultimately, is to be able to assess how the proposed law reform will affect the entire population. By looking at a carefully selected subset of the population, the researcher endeavors to glean information that can be generalized to the relevant population in its entirety. In order to support such a generalization, the sample must share the attributes of the population that are relevant to the question being probed. *"Contracting Out"* does not construct its sample according to this principle, and, indeed, actually excludes from its sample the debtors most relevant to the issue of bankruptcy choice.

Warren and Westbrook draw cases only from 1994. This choice may render their sample uninformative for two reasons. The first is that the data are now over ten years old. Warren and Westbrook have been among the leaders in noting that bankruptcy practice today differs from that of the mid-1990s.[45] Creditors now exercise more control of the process than they did a decade ago.[46] Claims are now traded frequently, thus providing liquidity to any creditor who

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[43] Obviously, a population study is better than a sample. For example, Lynn LoPucki's well known database on large, publicly held corporation that file for bankruptcy is a census of that population rather than a sample. See http://lopucki.law.ucla.edu/contents_of_the_webbrd.htm.
[44] *See* Lee Epstein & Gary King, *The Rules of Inference,* 69 U. Chi. L. Rev. 1, 28-30 (2002).
[45] *See* Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession,* 22 Am. Bankr. Inst. J. 12, 12 (2003); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy,* 82 Tex. L. Rev. 795 (2004); *see also* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight,* 56 Stan. L. Rev. 673 (2003); Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?,* 47 B.C.L. Rev. 129 (2005).
[46] *See* Baird & Rasmussen, *supra* note 45, at 693-99.

does not want to pursue its claim in Chapter 11. Going-concern sales are common events in today's Chapter 11 cases.[47] These developments have an impact on the efficacy of Chapter 11, and thus the ultimate question of whether a new regime would improve matters.[48] Thus, there is a question as to whether time has robbed the data of explanatory value.

Warren and Westbrook address this problem by creating a new sample of 450 cases filed in 2002.[49] Missing from this addition, however, is any reason to believe that these 450 debtors are in all relevant respects similar to the 386 debtors in the older sub-sample. The study does not present comparative statistics for the debtors in the two samples in terms of assets, debts, employees, lines of business, or creditor recoveries. While they report a handful of ways in which the data about the creditors of these businesses differs, [50] one cannot rely on these with any confidence.

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[47] *See id.* at 675-78 (reporting that over half of the Chapter 11 cases of large, publicly held companies that were completed in 2002 were sales of the business).

[48] *Compare* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance,* -- Penn. L. Rev. – (2006) (arguing that changes increase welfare) *with* Westbrook, *supra* note 53, at 860 (suggesting that changes are "the occasion for concern, not celebration").

[49] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1208-09. These cases were selected from only eight districts, rather than original twenty-three. Moreover, they had difficulty collecting Chapter 7 business cases, so they only collected these from four districts, and then counted each case twice in order to fill out their sample. See *id.* at 1209.

[50] To be sure, they note that the 2002 cases had double the rate of what they term "maladjusting creditors," though the total amount of claims held by such creditors decreased by over 30%. *See id*. at 1237-38. They also offer that the number of small creditors remained about the same. *Id*. at 1248. Finally, the new cases had more claims overall. *See id.* at 1252. But because we have no way of knowing how the businesses sampled in 2002 compared with the businesses sampled in 1994, it is impossible to assign any weight to these observations.

The year 1994 is also problematic when one examines the bankruptcy activity for that year. Bankruptcy laws operate differently in different economic climates. Bankruptcy filing rates are sensitive to changes in the economy. Pulling cases from a single year necessarily means that all of the cases involve businesses that faced distress in a discrete part of the business cycle. When selecting cases from a single year, one runs a risk that that year turns out to be different in important respects than other years.

It turns out that 1994 was a particularly quiet year in terms of public companies filing for bankruptcy.[51] It had the fewest number of bankruptcies of public companies of any year in the past quarter century.[52] Moreover, the public companies that declared bankruptcy in 1994 tended to be relatively small. One has to go as far back as 1986 to find a year in which the average size of the corporation filing for bankruptcy was smaller.[53] The total assets of public companies filing for bankruptcy in 1994 were roughly $8 billion. The numbers today dwarf those of a decade ago. As of the start of 2006, there were seventeen companies in Chapter 11 that each listed assets in excess of $2 billion. Their total

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[51] The importance of public company bankruptcies to bankruptcy choice is discussed below. *See infra* text accompanying notes 57 - 74.
[52] *See* NEW GENERATIONS RESEARCH, THE 2005 BANKRUPTCY YEARBOOK & ALMANAC 28. In terms of business bankruptcies overall, it was more typical. *See id*. at 6. In other words, it was a low year for public bankruptcies both on an absolute and a relative scale.
[53] *See id*.

assets were over $175 billion.[54] To the extent that bankruptcy choice implicates public companies, a point discussed below, it turns out that 1994 is a particularly poor year to examine.

In addition to these problems identified with the selected population and time period, there is further reason to be skeptical of the representative nature of the *Contracting Out* study's sub-sample. Standard protocol provides for the selection of samples such that "each element in the total population has a known (and preferably the same) probability of being selected."[55] The Warren and Westbrook study, however, limited its data selection to 23 of the 89 judicial districts, and those 23 districts were not chosen in a random manner. Rather, these districts were chosen because they were the outliers in their respective judicial circuits, the most-active and (generally) the least-active districts within the jurisdiction of the court of appeals. While it is unclear whether selecting from the tails in this fashion biased the overall results, the study does not include any reassurances to allay fears of some systematic difference between the sample and business bankruptcies generally.

Skepticism must only increase when one considers that even this suspect sample was not considered in its entirety. Rather, the study identified a sub-sample for examination. It appears that this sub-sample, although random,

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[54] *See* Bankruptcy Week 13 (January 16, 2006).
[55] Epstein & King, *supra* note 44, at 108.

differs in material respects from the larger data set from which it was drawn. It turns out that the cases in the *"Contracting Out"* sub-sample are systematically smaller than the cases in the overall database. While the average for the entire dataset (limited to Chapter 7 and Chapter 11) is over $1.4 million, the average debt for the cases in the sub-sample is only $970,000.[56] In other words, the sample used for "*Contracting Out*" tilts towards small cases.

This tilt is due to the fact that the sub-sample omits large cases. For years commentators – including Warren and Westbrook – have recognized that the dynamics of corporate bankruptcies differ based on the size of the corporation.[57] As Warren has observed, "the experience of large, publicly traded companies in bankruptcy differs sharply from that of smaller, private companies.."[58] The financial distress of small corporations presents different problems than the distress of large companies. The problems of the limo service doing business as a limited liability company are different in kind from the problems of General

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[56] One can get this figure by averaging the mean Chapter 7 debt and the mean Chapter 11 debt. See Warren & Westbrook, *Contracting Out, supra* note 3, at 1210, tbl. 1.
[57] See ELIZABETH WARREN & JAY WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 678 (5th Edition 2006) ("But the huge difference between business and consumer cases can obscure another difference--a staggering variety within each of the two classifications.
Business cases include Tina's Tax Preparation & Tanning Salon, a Tupperware party planner, and a lawn service guy who has lost his mower (all companies in our Business Bankruptcy Project) along with some-what better known companies such as Enron, Worldcom, Alephia[sic], and perhaps every major airline carrier in the country. These tiny little businesses and great big businesses face many of the same formal provisions when they try to reorganize in Chapter 11, but the practical realities facing these businesses may be very different.").
[58] Elizabeth Warren, *The Untenable Case for Repeal of Chapter 11*, 102 Yale L.J. 427, 443 (1992).

Motors.[59] Whether bankruptcy choice would provide gains to small corporations is a different inquiry as to whether it would provide gains to the likes of Kmart.

Large corporations are defined by the separation between ownership and control.[60] The owners invest none of their human capital in the business. Investors tend to hold small interests and lack the ability to coordinate among themselves. Professional managers run the enterprise. The business is perfectly capable of functioning with a new set of investors and a new set of managers.[61] It is here were bankruptcy choice proposals have focused much of their attention. There are many ways in which the financial distress of these companies can be addressed. The business could be sold as a going-concern.[62] It could be liquidated piecemeal. It could be reorganized with a new capital structure. One can quickly identify a range of other possible alternatives in the literature, few of which would make any sense for a struggling restaurant.[63] Bankruptcy choice rests on the proposition that the investors in the business are better able to make this selection than is the government.

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[59] *See* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies,* 105 Colum. L. Rev. 2310, 2311 (2005) (Small businesses have "few assets beyond the entrepreneur's human capital, and these rarely have more value inside the business than outside.").

[60] *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

[61] There is an active market of managers whose sole task is to address a corporation's financial distress. *See* Baird & Rasmussen, *supra* note 48.

[62] *See* Baird, *supra* note 12.

[63] *See, e.g.,* Adler, *supra* note 12 (proposing "chameleon equity" financial structure); Bebchuk, *supra* note 12 (proposing exchanging existing debt and equity claims for financial options); Hart, et al, *supra* note 12 (proposing auction system that allows for non-cash bids).

Small corporations, in contrast, are basically human-capital firms.[64] The major asset of the business is the talent of the owner. The other assets are primarily standard goods that have no value above what they could fetch in a sale. The problem that bankruptcy law needs to focus on in these cases is whether the owner should stay with this corporate entity or move to another. The problems of large, publicly held companies are ones of corporate finance; those of small corporations are of labor economics.

To explore the effects of bankruptcy choice across corporations, one needs to divide the population of corporations appropriately. One can offer a number of plausible classifications to accomplish this.[65] It is not difficult to find laws that depend on the size of the corporation being regulated.[66] Perhaps the most basic and easiest demarcation would be to distinguish between private and public

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[64] *See* Baird & Morrison, *supra* note 59, at 2330-49.

[65] *See, e.g.,* Arturo Bris, et al., *The Costs of Bankruptcy: Chapter 7 Liquidation vs. Chapter 11 Reorganization,* 61 J. Fin. –, -- (2006) (breaking down sample according to less than $100,000 in assets; $100,000-$1million, $1 million-$10 million, and greater than $10 million); Douglas Baird, et al, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study,* working paper (using less than $100,000, $100,000-$200,000, $200,000-$500,000, $500,000-$1 million, $1 million - $2 million, $2 million-$5 million, and above $5 million); Warren & Westbrook, *Financial Characteristics, supra* note 3, at 521 (using less than $100,000, $100,000-$500,000, $500,000-$1 million, $1 million-$5 million, and above $5 million).

[66] For example, the Family and Medical Leave Act only cover private employers with 50 or more employees. See 29 C.F.R. 825.104. The American with Disabilities Act and Title VII both cover private employers with at least 15 employees. *See* 42 U.S.C. 12111(5)(A) (ADA); 42 U.S.C. 2000e (Title VII).

companies, a distinction common in both the bankruptcy and corporate law literatures.[67]

Despite the central importance of large corporations to the bankruptcy choice debate, Warren and Westbrook's study appears to have omitted all or nearly all public corporations. Warren and Westbrook provide little descriptive information about the cases in their sample, but from what they do provide it seems that there may be one relatively public corporation in the sub-sample.[68]

This failure to include public companies in the sub-sample means that the effects of bankruptcy choice on such companies are simply beyond the reach of the study. The creditors on whom Warren and Westbrook focus for much of their article – tort claimants, utilities, tax authorities, employees owed money and individuals – are not uniformly distributed with respect to all debtors. Large businesses have systems in place to ensure that taxes, utilities, payroll and the like are paid. They carry insurance that covers all but the most catastrophic claims. They borrow money from large commercial lenders, not friends and family. It may well be that large, publicly held companies, on the whole, lack the type of creditors on which Warren and Westbrook's conclusions rest.

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[67] *See, e.g.,* Warren, *supra* note 58, at 442 ("the data suggest a critical difference between the bankruptcy experiences of private and public corporations")

[68] In their larger database, Warren and Westbrook have six of the seventy public companies that filed for bankruptcy in 1994. *See* Warren & Westbrook, *Financial Characteristics, supra* note 5, at 548-49.

The absence of public corporations from the sample also makes it impossible to assess the aggregate welfare effects of bankruptcy choice. To be sure, these companies do not dominate bankruptcy court in terms of their numbers. Even in the most active year, public bankruptcies number less than 300.[69] Every year they are less than 1% of business bankruptcies.[70] But the assets that these companies own ensure that they have affects that extend well beyond their small numbers. In six of the last seven years the assets of these companies filing for bankruptcy exceeded $50 billion. Three of these years saw assets of over $100 billion in bankruptcy, and the largest single year witnessed almost $400 billion in assets entering into Chapter 11 as part of the filing of public companies.[71] Even though 1994 was the nadir in terms of public companies filing for bankruptcy, there were still 70 public companies filed for bankruptcy,[72] and the total assets for these companies exceeded eight billion dollars.[73]

In 1994 itself there were six filing companies each of which reported assets that exceeded the debts of Warren and Westbrook's entire sub-sample. The entire debt for the sub-sample, secured and unsecured, is $376 million. Memorex, which filed for bankruptcy in 1994, reported assets of over three times this

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[69] *See* NEW GENERATIONS, *supra* note 52, at 28 (listing number of publicly held companies filing for bankruptcy for each year since 1980).
[70] *Compare id.* (listing number of publicly held companies filing for bankruptcy each year) *with id.* at 6 (listing number of business bankruptcies filed each year).
[71] *Id.* at 28.
[72] This is the fewest number of corporate bankruptcies for any year since 1980. *See id.*
[73] Again, this figure is low by historical standards. *See id*.

amount. Five other companies -- Resorts International, House of Fabrics, Kash N Karry Food Stores, Merry-Go-Round Enterprises and F & M Distributors – each reported more assets than the cumulative debt in Warren and Westbrook's sub-sample.[74] Public companies play a crucial role in ascertaining the merits of bankruptcy choice, yet they are not included in the *Contracting Out* study.

The end result is that Warren and Westbrook have a dataset half of which is comprised of debtors who would never be subject to a bankruptcy choice regime, and the other half of which omits the type of debtor that motivated bankruptcy choice scholarship in the first instance. The study is unable, therefore, to any contribution to the debate about bankruptcy choice.

C. The Need to Ask the Right Questions

There is additional reason to doubt the conclusions of the Warren and Westbrook study. The paper devotes much of its discussion to the inefficiencies that might arise if debtors could redistribute wealth from the various "maladjusting creditors" that Warren and Westbrook catalogue.[75] The concern is that if these creditors are receiving substantial recoveries today, they will lose

[74] Three more cases – Westmoreland Coal, Crystal Brands, O'Brien Environmental Engineering – reported more than the $300 million in assets. The data on the assets value of the corporations comes from LoPucki's web-version of his database. *See* http://lopucki.law.ucla.edu/.
[75] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1219-53 (30 pages discussing maladjusting creditors as compared with 5 discussing transaction costs).

something in a system of bankruptcy choice. Such a redistribution might be inefficient,[76] and hence would weigh in the balance against bankruptcy choice.

In order to quantify the risk of such redistribution it is essential to have information about the types of creditors a debtor has and how much these creditors receive under current bankruptcy law. The type of creditor is relevant insofar as it suggests whether the creditor could adjust its interest rate in response to change in insolvency rules. Creditors who adjust their prices cannot be systematically disadvantaged. The amount the creditors receive is equally important to the overall efficiency inquiry. The concern over redistribution assumes a change in position for these creditors, from distributions that they are receiving to something less.

Nevertheless, Warren and Westbrook collect no information on creditor recoveries. They do report that almost a third of the dollar amount of unsecured claims in their sub-sample is held by the types of entities that will not respond for one reason or another to choices in insolvency rules. But they have no data on what these entities recovered under the existing bankruptcy regime. The dollar amount of debts owed to unsecured creditors provides no information as to these

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[76] Warren and Westbrook equate redistribution with efficiency, but they fail to specify the relationship between the two. Generally, a redistribution is inefficient only to the extent that the redistribution itself consumes resources. It is not the amount of the resources actually transferred. Since the transfer under bankruptcy choice would come through the selection of an insolvency regime, the redistribution argument is to a large extent parasitic on the transaction costs argument.

creditors' prospects for actual recovery, in light of the limited assets in the bankruptcy estate and the priority accorded to secured creditors and administrative expenses.

Recognizing a need for some data on this point, Warren and Westbrook cite to Lynn LoPucki's work on large, public corporations suggesting that, in those cases, general creditors often receive a substantial return on their claims.[77] Thus it is not obvious that the distribution to the creditors in the Kmart bankruptcy provides information as to the distribution to creditors in the bankruptcy of the local drugstore.

Data from other sources provides reason to conclude that the large majority of unsecured creditors in Warren and Westbrook's sub-sample received nothing. Half of the cases in Warren and Westbrook's study were filed under Chapter 7, and other studies have shown that in virtually every completed Chapter 7 case general creditors receive no distribution.[78] For the other half of debtors, those filed under Chapter 11, the general creditors probably did not fare much better. We know that approximately two-thirds of corporate cases that start out in Chapter 11 are either eventually dismissed so that creditors can

[77] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at n.75 (citing prepublication version of Lynn M. LoPucki, *The Myth of the Residual Owner,* 82 Wash. U.L.Q. 1341 (2004)).
[78] *See* Bris, et al, *supra* note 65, at 32 ("We find that unsecured creditors receive nothing in 95% of our Chapter 7 cases. The mean recovery rate is 1%, all driven by one case.").

exercise their state law remedies or are converted to Chapter 7.[79] As to the cases that the bankruptcy court dismisses, conventional wisdom is that a judge should dismiss a case when the senior lender is owed more than all of the assets of the business are worth.[80] Based on this, it is fair to infer most of the unsecured creditors in the dismissals receive nothing, just as do the unsecured creditors in the completed Chapter 7 cases. If Warren and Westbrook's Chapter 11 cases share the two-thirds conversion/dismissal found for similar cases, then in roughly two-thirds of their Chapter 11 cases, there were no distributions to unsecured creditors. Combining the cases filed in Chapter 7 with the Chapter 11 cases that were either dismissed or converted, it would appear likely that over 80% of the cases in the Warren and Westbrook sub-sample resulted in no distribution to unsecured creditors.

The creditors in the remaining cases most likely did not fare much better. Even in the remaining one-third of Chapter 11 cases, general unsecured creditors often are left out of the distribution. In these cases, the pattern tends to be that the smaller the case, the less likely it is that the unsecured creditors will see a return. For example, in completed Chapter 11 cases with assets of less than $200,000, general creditors usually receive nothing. Indeed, only when one starts

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[79] *See* Baird, et al, *supra* note 65, at 12 (reporting 2/3 dismissal or conversion rate); *see also* Edward R. Morrison, *Bankruptcy Decisionmaking: An Empirical Study of Continuation Bias in Small Business Bankruptcies,* 50 J.L. & Econ. (2007) (manuscript at 11-16) (showing that over 60% of Chapter 11 filings were dismissed or converted to Chapter 7).

[80] *See* Morrison, *supra* note 79, at 12-13.

looking at businesses with more than $5 million in assets does one find recoveries to the unsecured creditors which approximate those reported by LoPucki. There are very few such debtors in Warren and Westbrook's dataset.[81]

Considering the high likelihood that the creditors on whom Warren and Westbrook rely did not receive any satisfaction of their claims, it is difficult to credit a concern that forecasts a loss to this group. These creditors received nothing under current law. Thus, adopting bankruptcy choice could only improve their lot. Having failed to ask the right question, this study can make no claim to have found the right answer.

D. The Need to Draw the Right Inferences

Warren and Westbrook report that for the businesses in their data set, the average business had nineteen creditors, and the largest had 255.[82] The inference that they draw from these data is that bankruptcy choice would create

[81] Debtors of this size comprise 8.5% of the Chapter 11 debtors in their larger sample. *See* Warren & Westbrook, *Financial Characteristics, supra* note 5, at Fig. 3. There is no information which allows one to calculate how many of this size debtor is in the *Contracting Out* sub-sample, though given the information provided in terms of total debts for the entire sub-sample, the figure is likely to be less than 5%.

[82] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1250-51. These numbers again reflect the truncated nature of Warren and Westbrook's sample. When Baird, Bris and Zhu examined all corporate bankruptcies filed between 1995 and 2001 in the Southern District of New York and the District of Arizona, for cases that ended in a confirmed Chapter 11 plan there were, on average, over 160 unsecured creditors in each case. See Baird, et al., *supra* note 65, at Tbl. 1.

substantial transaction costs.[83] This inference from data -- the number of creditors – to conclusion – substantial transaction costs – is not sustainable.

The inference reflects a concern that, in a regime of bankruptcy choice, each creditor will have to gather information about the bankruptcy rules that the debtor has selected, and then negotiate with the debtor over them.[84] This is a concern about transaction costs and, as such, it contains assumptions about how bankruptcy choice would operate in practice. The first assumption is that creditors would need to ascertain what rules the debtor has chosen. This assumption is undoubtedly correct but trivial. Bankruptcy choice proposals all recommend that the state supply a set of bankruptcy rules from which the debtor could select.[85] A creditor would simply need to learn which set of rules had been selected, and price its terms accordingly. This effort is the kind of inquiry that creditors make on a regular basis. Creditors need to assess various aspects of the debtor's business in order to determine the likelihood of repayment. There is no explanation why asking about the debtor's chosen bankruptcy regime would pose any challenge to creditors different from what they routinely do before making a loan.

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[83] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1251-52.
[84] *See id.* at 1249.
[85] *See supra* note 16.

Warren and Westbrook assert there would be additional transaction costs arising from the need to negotiate over the insolvency rules selected. While they are not explicit on the point, this seems to be where they believe the bulk of the costs lie.[86] Bankruptcy choice proposals, however, have been sensitive to (and have expressly addressed) this concern. Bankruptcy choice, in all of its permutations, operates by the debtor selecting the appropriate insolvency rule, and the creditor pricing the extension of credit accordingly. (What they differ over is whether that selection is made in the corporate charter or in the lending documents themselves.) In competitive credit markets, one cannot systematically exploit creditors who can adjust their lending behavior. A term that lessens their recovery in bankruptcy will cause them to raise their interest rate. In expectation, they receive a competitive rate of return regardless of which choice a debtor makes.[87] There is no advantage to them to negotiate extensively here. They simply need to ascertain the governing bankruptcy choice, and price their credit appropriately. Creditors have nothing to gain by hammering out with the debtor which regime should be chosen. The number of creditors, therefore, does not necessarily translate into transaction costs that loom large.

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[86] *See* Warren & Westbrook, *Contracting Out, supra* note 1, at 1249 ("If, however, the reality of business bankruptcy is that most debtors have many claimants and that any negotiations will have to take place in a rented hall, then the efficiency gains from contract bankruptcy quickly fade, overwhelmed by the negotiating costs of dealing with many creditors.").

[87] That creditors in competitive markets is a standard assumption in the literature, and Warren and Westbrook do not take issue with it.

The contrary inference that Warren and Westbrook draw depends on a caricature of bankruptcy choice.

Moreover, Warren and Westbrook do not evaluate any possible benefits of bankruptcy choice before concluding that the transaction costs outweigh them. More data would be needed to support such a conclusion, which sounds a bit like inferring that education is socially wasteful because it is expensive. Some things are worth the cost.

To be sure, measuring efficiency gains presents a challenge, but one does not have look all that hard to find reasons to suspect that gains can be had. Bankruptcy choice rests on the assumption that it would provide a better sorting system for companies in financial distress than current law does. Some corporations would find themselves in regimes that handle financial distress more efficiently than Chapter 11. What is the magnitude of these gains? It is hard to say.

Proponents of bankruptcy choice suggest that alternative regimes will spare some of the deadweight costs seen under existing Chapter 11. Eliminating only some of these costs would itself bring substantial benefits. Just consider extreme cases like Eastern Airlines, where upwards of a billion dollars appears to

have been wasted.[88] To give another example, Merry-Go-Round is a case in Warren and Westbrook's initial dataset where $100 million dollars in cash went out the door during Chapter 11.[89] The fact that a substantial number of cases are filed in Chapter 11 but are ultimately converted to Chapter 7 or dismissed suggests that these debtors are being put into the wrong type of insolvency proceeding. Were these cases to start out under the appropriate set of rules, they would probably be resolved more quickly and creditors would see increased returns.

Quantifying the gains to be achieved by a counter-factual state of proposed law reform is a challenge, and no one can fault this study for failing to do so. But that does not mean that its authors are entitled to assume, without data or theory, that these gains are less than the costs that would arise in a world of bankruptcy choice. One cannot locate in their work the basis for this assumption.

Warren and Westbrook in *"Contracting Out"* make sweeping claims. They claim to have proven that a regime of bankruptcy choice would decrease overall welfare, and hence bankruptcy scholars who advocate such a regime should "move on." But the proof is elusive. Their claims rest on a series of fundamental

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[88] *See* Lawrence A. Weiss & Karen H. Wruck, *Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines,* 48 J. Fin. Econ. 55 (1998).
[89] *See* Elizabeth MacDonald & Scott J. Paltrow, *Merry-Go-Round: Ernst & Young Advised the Client, but Not About Everything,* Wall St. J., Aug. 10, 1999, at A1.

flaws embedded in their project, each one fatal. Rather than looking in the right place for data, they look at a sample comprised half of individuals and that all but omits public companies. Rather than asking the right questions, they simply assumed that their creditors received substantial recovery when other empirical evidence strongly suggests the opposite. Rather than drawing the right inferences, they attributed large negotiation costs to bankruptcy choice without support in either theory or data, and they inferred that these costs would exceed the benefits of the new law without any effort at ascertaining what benefits would flow from letting companies select their own insolvency rules.

Like all research and analysis, empirical research must cross a minimum threshold to generate insight and value. In part, this is accomplished through authors self-consciously policing their own assumptions, choices and inferences. Equally important is external critique. It is incumbent on serious scholars like Warren and Westbrook to be more careful and circumspect than they have been in their use of empirical data. It is incumbent on the rest of us to subject work such as this to rigorous review. The idea of "data" putting an end to complex theoretical and policy disputes is alluring – too alluring in this case. *"Contracting Out"* may be an entertaining read for those predisposed to accept its conclusions, but those interested in rigorous analysis of the bankruptcy choice debate would do better to "move on" to other work.

II. Steve Lubben and Equity Receiverships

Bankruptcy scholars have shown renewed interest in the equity receiverships that were created to handle the financial distress of the nation's railroads. The accepted wisdom since the New Deal is that investment bankers dominated these railroad organizations in order to benefit themselves and their clients.[90] One critic colorfully put it in 1938, "Railroad reorganization was a racket many years before the word racket was coined; and thousands of investors have paid tribute to it with the loss of their fortunes."[91]

Recent work, however, suggests that these receiverships performed about as well as could be expected. No one has asserted that railroad reorganizations were perfect. The problems raised by insolvent railroads were novel, and it would be shocking if those responsible for developing this mechanism had hit upon the ideal the right out of the box.[92] Rather, the new scholarship attempts to highlight the ingenuity behind the process. Receiverships were by no means

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[90] *See* Douglas G. Baird & Robert K. Rasmussen, Boyd's *Legacy and Blackstone's Ghost*, 1999 S. Ct. Rev. 393, 408-17 (describing New Deal hostility to equity receiverships).
[91] HAROLD PALMER, INVESTMENT SALVAGE IN RAILROAD REORGANIZATIONS 1 (1938).
[92] Lubben concludes that "receiverships were lengthy and perhaps quite expensive by modern standards." Lubben, *supra* note 2, at 1452. While making this observation, he never defends the proposition that one can glean any insights by comparing the length and cost of receiverships with those of today's Chapter 11. Improvements in information technology, the thickening of capital markets, and the learning that comes with decades of experience render comparisons such as the ones Lubben makes meaningless.

perfect, but neither were they the corrupt mechanism for fleecing the unsophisticated as the New Deal reformers alleged.[93]

A. Lubben on the Effectiveness of Railroad Receiverships

Against the backdrop of these divergent views about equity receiverships, Stephen Lubben investigated the extent to which railroad reorganizations were "effective."[94] He concluded that the data he has gathered shows that they were not.[95] The data is sound; it is the conclusions that are suspect.

Lubben collected data on 53 railroads. Equity receiverships focused primarily on large railroads, so Lubben limited his criteria to railroads of more than 500 in length. Also, Lubben wanted to assess the effects of equity receiverships from 1900 until World War II. Thus, he defined his population as all railroads that had more than 500 miles of track in 1900 and that still existed as separate legal entities in 1937.[96]

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[93] *See* DAVID A. SKEEL, JR., DEBT'S DOMINION, 56-69 (Princeton 2001); Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations,* 87 Va. L. Rev. 921, 931-32 (2001); Baird & Rasmussen, *supra* note 90, at 403-06; David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing,* 25 Cardozo L. Rev. 1905, 1908-13.

[94] *See* Lubben, *supra* note 2, at 1423 ("railroad receivership offers a poor example of effective corporate reorganization"); at 1452 ("were they effective?"); at 1464 ("The Effectiveness of Receiverships – Regression Analysis").

[95] *Id.* at 1473.

[96] Fifteen railroads that had 500 or more miles of track in 1900 disappeared by 1937. *Id*. at 1453-54. One tantalizing fact which Lubben does not explore is that of the fifteen railroads which drop out of his sample because they were acquired by other roads, only one had gone through a receivership in the pre-war period. *See id.* There was something about going though a

Lubben divides his sample into two groups: those railroads that were reorganized in an equity receivership at least once between 1890 and 1917 and those that were not. Lubben gathers data on two fronts. He first compares the capital structure of those railroads that had been through an equity receivership during this time period with those that had not. He next examines whether a railroad that went through a receivership in the first period (1890 to 1917) was more likely to file for receivership in the second period (1921 to 1937) than was a railroad that did not undergo a receivership in the first period.

As to the capital structure of the reorganized railroads, Lubben finds that receiverships reduced a railroad's fixed charges – basically its obligations on its securities – by more than 25%.[97] Lubben compares the capital structure of those railroads that had undergone a receivership with those that had not for the period between World War I and World War II.[98] He finds that the fixed charges of both sets of railroads, when compared to each railroad's total income, are

receivership that made these roads toxic. As discussed below, it may be that the roads that went through receivership early had less desirable routes, which would explain both why they encountered financial distress earlier and why other roads did not find them attractive takeover candidates in a contracting market.

[97] *See id.* at 1462.

[98] There is thus a risk that Lubben has not captured fully the dynamics of the receivership process. A railroad's capital structure may have changed between the time it left the receivership and the interwar period that Lubben measures.

virtually identical.[99] Receiverships thus returned the capital structure of the distressed railroad to the industry average.

Despite having similar capital structures, the railroads that had undergone a receivership prior to the Great War were more likely to experience a receivership between the wars than were those roads that had not been in a receivership before 1917. Lubben finds that railroads that had gone through receivership were roughly two and a half times as likely to go through receivership in the interwar period as railroads that had never done so before.[100]

Lubben concludes that this recidivism rate "throws into question the efficacy of the receiverships that occurred between 1890 and the United States's entry into World War I."[101] The problem, according to Lubben, is that receiverships did not trim sufficient debt. "[R]eceiverships were not designed to provide railroads with optimal capital structures, but rather with typical capital structures such as those that might be found in a non-bankrupt railroad."[102] Hence, receiverships were not effective.

B. Selecting the Appropriate Baseline

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[99] Lubben, *supra* note 2, at 1462-63.
[100] The difference is significant at the 90% confidence level but not at the 95% confidence level. *See id.* at 1465, tbl. 11.
[101] *Id*. at 1466.
[102] *Id*. at 1462.

Lubben's project is to evaluate the past. He wants to assess the effectiveness of equity receiverships. Unlike Warren and Westbrook, Lubben looks in the right place. He has compiled a census of railroads over 500 miles in length. While equity receiverships eventually could be used for different types of businesses, they arose to meet the financial distress of the railroad industry. Railroads were thus the primary, though not exclusive, clientele.[103]

Lubben in part asks the right questions. He looks at the capital structure of the railroad after reorganization. The problem that the railroads presented is that they cost more to build than they were worth.[104] Once they were built, however, the assets were best used in their current configuration. Thus, the primary challenged of the receivership was to create a capital structure that better reflected the operations of the business.[105]

Lubben also explores the fate of the reorganized entities, again a relevant question. Those who devised equity receiverships sought to bring the railroad's obligations in line with its revenues. To see whether these reorganizers succeeded, Lubben assesses the performance of the railroads after reorganization, and looks to see whether a reorganized railroad filed for reorganization a second time.

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[103] On the expansion from railroads to other industries, see SKEEL, DEBT'S DOMINION, *supra* note 93, at 104-05; Baird & Rasmussen, *supra* note 87, at 408-10.

[104] *See* Baird & Rasmussen, *supra* note 93, at 925-27.

[105] *Id.* at 927-33.

Lubben goes astray, however, in that he evaluates the performance of receiverships against a standard that no bankruptcy system has yet to meet. By asking whether railroads were "effective" he both asks the wrong question and draws the wrong inference. To be "effective" for Lubben, the railroads reorganized between 1890 and 1917 would have to seek a reorganization in the second period at the same rate as those which had no prior receivership. An initial problem is that the lag between the first reorganization and the second is quite long. On average, it was sixteen and a half years.[106] This extended period of time raises questions as to the casual relationship that Lubben posits. It would take some foresight to spot problems in the first reorganization that would crop up a decade and a half later. Indeed, the railroads that underwent a subsequent receivership only did so after the onset of the Great Depression. It borders on the incredible to suggest that those concluding receiverships prior to the end of World War I could have designed a capital structure that would have insulated the reorganizing railroad from the ravages of the Depression.[107]

More problematic, however, is the standard for "effectiveness" itself. Lubben posits that an effective bankruptcy law would leave reorganized

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[106] Lubben, *supra* note 2, at 1466, n.210.

[107] The start of Lubben's second period conincides with the general decline of the entire railroad industry. See JAMES W. ELY, JR., RAILROADS & AMERICAN LAW 265 (KANSAS 2001) ("After World War I, the rail industry entered a prolonged period of contraction and stagnation."); JOHN F. STOVER, AMERICAN RAILROADS 192 (CHICAGO 1997, 2ND ED.) ("Ever since the First World War, American railroads have experienced a general decline. The year 1916 in severaly ways marked the end of the golden age of railroads.").

companies with the same chance of reorganizing a second time as all companies have of needing a reorganization in the first instance. Current law is clearly not effective against this metric. Regardless of the time period selected, when one looks at companies that reorganize under Chapter 11, they are more likely to file a second case than is another company likely to file a first.[108]

This pattern is not surprising. Companies file a Chapter 11 case because they are in financial distress. All things being equal, one would expect that a group of companies that have experienced financial distress to be more likely to encounter a second bout than a group of companies that had not had such prior problems. It is doubtful whether any bankruptcy system could ever ensure that a reorganized company would have the probability of filing as a company that had never had financial difficulties.

This is especially true in the railroad context. One cannot redeploy a railroad's assets nimbly. The route that the railroad is to take is pretty much fixed. One can prune operations selling some track here and some track there, but the basic contour of the line is fixed. To the extent that the necessity for a receivership prior to 1917 suggests a less desirable route structure, and hence a

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[108]The probability of any public company filing for Chapter 11 is less than 1%, and the odds of a company that at one time had gone through Chapter 11 filing again is much higher. See Lynn M. LoPucki & Sara Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 Vand. L. Rev. 232, 242 (background rate of .84%) & 245 (refiling rate after first bankruptcy of more than three-and-a-half times background rate) (2001).

greater likelihood of financial distress, there is little that can be done to alter this aspect of the enterprise. The future is uncertain and these roads may have been able to prosper had the demand for railroads increases. However, when demand falls, one would expect that these roads would be more vulnerable.[109]

Asking the wrong question leads Lubben to draw the wrong inferences. Consider the inference that he draws from the data which shows that a reorganization resulted in the railroad having a capital structure similar to those that prevailed in the industry. Lubben concludes that this data suggests that reorganizations where not effective, but one can draw this inference only by asking the wrong question. Those negotiating the new capital structure for a railroad in receivership had information about the current operating revenues and some prediction about future revenues as well. They had to decide how much debt the reorganized railroad should carry. As Lubben demonstrates, they seem to have chosen to give the reorganizing railroad a debt load similar to the debt carried by healthy railroads.

One would be hard pressed to gainsay this decision. The receiverships developed because the railroads could not service their debts. In deciding how

[109] Lubben argues differently. He assets that "[i]f receiverships effectively resolved a railroad's financial problems, we would expect that [the railroads that underwent a receivership before 1917] would encounter financial distress as often (or even less often) as the railroads [that did not]." Lubben, *supra* note 2, at 1464. Yet he never says why this is so. He never articulates a way in which the railroads that did need a second reorganization could have in fact been saved.

much debt the railroads could handle, mimicking the capital structure of successful railroads seems to be a sensible place to start. If other railroads could avoid financial distress with this capital structure, perhaps the reorganizing roads should follow suit.

Lubben, however, suggests that those orchestrating the reorganization should have taken a different route. He believes that the process should have put an "optimal capital structure" in place. Rather than following the example set by other railroads, the reorganizers should have aimed for a capital structure that better fit the road they were reorganizing. Yet precisely how where they to know what the "optimal" capital structure was? Lubben finds fault with the capital structure that the reorganizers selected because these railroads needed a subsequent reorganization at a higher rate than other railroads. This information, of course, was not available to those drawing up the capital structure for the reorganizing railroads.

There is an even deeper problem. Even today economists do not know what constitutes an optimal capital structure. Modigliani and Miller in 1958 famously demonstrated that in a frictionless world, the mix of debt and equity does not affect the value of the corporation.[110] Ever since, economists have offered reasons as to why a corporation may choose debt or equity, such as

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[110] See F Modigliani & Merton H. Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261 (1958).

bankruptcy costs, tax benefits and ease of financing.[111] Lubben certainly cannot point to any knowledge available at the time of the equity receiverships that would have told the participants what would constitute an optimal capital structure for their railroad. It is a bit like faulting Newton for not anticipating the work of Einstein.

There is much to learn from Lubben's data; we cannot conclude, however, that this data convicts the equity receiverships on the charge of being ineffective. If anything, his data points to the opposite conclusion.

III. Lynn LoPucki and Bankruptcy Court Competition

Starting in the late 1990s, bankruptcy scholars began to focus on the competition that seemed to be taking place among bankruptcy courts for large Chapter 11 cases.[112] Some took the position that this competition would be destructive; others that it would be beneficial; and still others that it would be

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[111] See, e.g., F. Modigliani & Merton H. Miller, *Taxes and the Cost of Capital: A Correction,* 53 Am. Econ. Rev. 433 (1963); Merton H. Hiller, *Debt and Taxes,* 32 J. Fin. 261 (1977); Henry DeAngelo & Ronald W. Masulis, *Optimal Capital Structure under Corporate and Personal Taxation,* 8 J. Fin. Econ. 3 (1980); Michael Bradley, G. Jarrell & E.H. Kim, *On the Existence of an Optimal Capital Structure: Theory and Evidence,* 39 J. Fin. 857 (1984); Stewart Myers, *Determinants of Corporate Borrowing,* 5 J. Fin. Econ. 147 (1977); Eugene Fama & Kenneth French, *Testing Trade-off and Pecking Order Predictions about Dividends and Debt,* 15 Rev. Fin. Stud. 1 (2002).

[112] *See* Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations,* 84 Cornell L. Rev. 967 (1999); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations,* 94 Nw. U. L. Rev. 1357 (2000); David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware,* 1 Del. L. Rev. 1 (1998).

something of a mixed bag.[113] LoPucki claims that his data has put an end to this theoretical uncertainty.

A. Competition and Corruption

LoPucki asserts that his data leaves no doubt that this competition has led to a bankruptcy system that is both "corrupt" and failing. "Corruption" is a serious charge, and it is a term that LoPucki uses deliberately.[114] He does not mean that bankruptcy judges are on the take, at least not directly. But it is close. LoPucki asserts that "[t]heir actions are 'corrupt' in that they are dictated not by an attempt to apply the law to the facts of the case but by the need to remain competitive."[115] They reflexively heed the requests of the "debtor's executives, professionals, and DIP lenders"[116] rather than apply the dictates of the Bankruptcy Code. In other words, the judges are not making a good faith attempt to apply the law.

Not following the law is bad enough, but the results are even worse. Perhaps adopting a strained reading of the Bankruptcy Code could be justified

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[113] *See* Eisenberg & LoPucki, *supra* note 112 (skeptical about competition); Rasmussen & Thomas, *supra* note 112 (arguing that competition may be beneficial for prepackaged cases but deleterious for traditional ones); Skeel, *supra* note 112 (arguing that the competitive pressures would improve the bankruptcy process).

[114] *See* LOPUCKI, CORRUPTION, *supra* note 3.

[115] *Id.* at 137; see also Lynn M. LoPucki, *"Corruption is the Right Word,"* Bankr. Ct. Dec. A7 (July 19, 2005).

[116] LOPUCKI , CORRPUTION, *supra* note 3, at 138.

on pragmatic grounds.[117] The bankruptcy judges, drawing on their expertise, would adopt the interpretation most likely to facilitate a successful reorganization. Yet this has not occurred. The effects of modern reorganization practice are, according to LoPucki, disastrous. Kowtowing to those who decide where large reorganizations will be filed has "destroyed companies that could otherwise have been saved."[118] Moreover, it has spawned a number of practices which, in LoPucki's view, will make matters even worse. Things are bad, they promise to get worse and there is no hope for a turnaround.

Few seriously question that at least some bankruptcy courts compete for cases.[119] The debate has been over the effect of this competition. The linchpin in LoPucki's argument is his claim that his data reveals that the leader in the competition for large cases – the Bankruptcy Court for the District of Delaware – mishandled cases. He considers cases that completed their stay in Chapter 11 during the years 1991-1996. [120] This is the period during which the Delaware bankruptcy court established itself as the venue of choice for large corporations.

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[117] On using pragmatic concerns in statutory construction, see Richard A. Posner, THE PROBLEMS OF JURISPRUDENCE 299-309 (Harvard 1990); William N. Eskridge and Philip P. Frickey, *Statutory Interpretation as Practice Reasoning*, 42 Stan. L. Rev. 321 (1990).

[118] LOPUCKI , CORRPUTION, *supra* note 3, at 258.

[119] *See* Rasmussen & Thomas, *supra* note 112, at 1369.

[120] It is clear why LoPucki begins his study with the 1991 calendar year. That is the year in which the Delaware bankruptcy court began receiving a large number of Chapter 11 cases where jurisdiction was based solely on the fact that one member of the corporate group was incorporated in Delaware. The reason that LoPucki chose 1996 as the cutoff date is that he first began to look at recidivism rates in 2001 and he explored whether the corporation refiled within five years of emerging from bankruptcy. *See* LoPucki & Kalin, *supra* note 109, at 250.

The metric by which LoPucki assess the performance of a bankruptcy court is whether, if a company emerges from a Chapter 11 proceeding, that company files a second bankruptcy case within the ensuing five years.

If cases were randomly distributed across jurisdictions, one would expect that the need for a second Chapter 11 proceeding would be randomly distributed across the jurisdictions as well. If anything, perhaps the preference for Delaware would imply that it would have a lower incidence of repeat filings.[121] The exact opposite occurred. According to LoPucki's data,[122] we see the following result:

	DE	SDNY	Other	Total
Cases completed	32	27	99	158
Cases with emerging company	28	19	77	124
Cases with emerging company that refiled in 5 years	11 (39%)	3 (16%)	4 (5%)	18 (11%)

[121] Of course, many cases are not filed in Delaware even though they could have been. One may conjecture that in those cases where Delaware was bypassed, those making the venue selection viewed the non-Delaware forum as superior. In words, Delaware provides the floor for any company seeking to reorganize. They will not file for Delaware when they sense an advantage by going to another court. On this view, Delaware would have a slightly higher rate of refilings.

[122] In his writings, at times LoPucki reports data based on "public" companies that emerged from Chapter 11 and at other times on "companies" that emerge, which includes both public and private companies. Compare LOPUCKI , CORRUPTION, *supra* note 3, at 113 tbl. 6 (using public companies emerging) & *id.* at 100 (using companies emerging). The numbers in the text are for all companies because there is no reason to think that the problems that LoPucki sees with Delaware are limited to cases where a public, rather than a private, company emerges.

The problem is obvious. Companies that reorganized in Delaware need a second reorganization at rates substantially higher than companies that reorganized elsewhere. This difference is statistically significant. "From the data it appears that if the Delaware-reorganized companies had filed in other courts, many more of them would have survived."[123]

Yet the problem is even worse according to LoPucki. It is not only that Delaware was sick, but that it was contagious. By the mid-1990s, bankruptcy professionals had realized that large, publicly held corporations were demonstrating a marked preference for Delaware. Some bankruptcy judges outside of Delaware, at times prodded by the local bankruptcy attorneys, responded by mimicking the Delaware practices. The hope was to attract large cases to their venue. Local attorneys can expect significant additional work when a large case ends up in their backyard. At the time, the failure rate of Delaware reorganizations was only beginning to manifest itself, and no one recognized the looming problem.

When other courts adopted Delaware practices, "they reproduced Delaware's failure."[124] In the four years between the beginning of 1997 and the end of 2000, Delaware's performance as measured by refiling rate remained

[123] *Id.* at 118.
[124] *Id.* at 122.

substantially unchanged, but the failure rates of the other courts caught up with that of Delaware:

	DE	SDNY	Other	Total
Cases completed	63	14	30	117
Cases with emerging company	38	10	20	68
Cases with emerging company that refiled in 5 years	16 (42%)	4 (40%)	7 (35%)	27 (40%)

Thus, Delaware was a failure. Other courts emulated the Delaware practice, and they became failures as well. This failure drives the remainder of LoPucki's analysis. It reveals the ills of competition. Hence, any subsequent developments in reorganization practice are the result of competition and these results are presumptively objectionable.

C. The Need to Look in the Right Place

LoPucki has defined his population so that he could conduct a census rather than take a sample. He is only interested in the bankruptcy of large, publicly held companies.[125] He defines "large" as a corporation that files for

[125] LoPucki has long been a leader in exploring the dynamics of large company reorganizations. *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy*

Chapter 11 and lists at least $100 million in assets, as measured in 1980. He defines "public" as any corporation that has publicly traded securities, be they stock or bonds.

Focusing on large companies is a justifiable restriction on LoPucki's project. As discussed above, the economic effects of Chapter 11 is concentrated in the large cases. Thus, to the extent that LoPucki is interested in the economic impact of Chapter 11, he will pick up a large portion of that impact by looking at large cases. While $100 million in assets in 1980 dollars is at some level arbitrary, it is a reasonable place to divide the cases. It is fair to assume that not much is lost by omitting publicly held companies with fewer assets.[126]

The limit to public companies is understandable as well. Public companies, by definition, have reporting requirements. Being a public company means that the corporation has to file various disclosures with the SEC. These disclosures provide useful information on the financial condition of the business. To be sure, there are some large privately held businesses that file for bankruptcy, but these are few and far between.[127]

Reorganization of Large, Publicly Held Companies, 139 U. Pa. L. Rev. 125 (1990); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companie,* 78 Cornell L. Rev. 597 (1993).

[126] For example, in 2004 92 public companies holding a combined $47 billion in assets filed for Chapter 11. See The 2005 Bankruptcy Yearbook & Almanac 28. LoPucki's database for that year contains 30 cases with roughly $32 billion in assets.

[127] For example, in 2002 New Generations Research reports seven private cases with more than 100 million dollars in nominal assets. See NEW GENERATIONS RESEARCH, THE 2003 BANKRUPTCY

The real problem with LoPucki's data is not what he left out, but what he clumped together. LoPucki's empirical results depend entirely on his decision to combine different types of bankruptcy cases. When academics, lawyers and the popular press consider large Chapter 11 cases, they focus on cases where a corporation files for bankruptcy and, while in bankruptcy, a decision is made about the future of the business. The headline grabbers of the past – Johns-Manville, Eastern Airlines, LTV, Texaco, WorldCom and Enron – all are this type of case. For want of a better term, call these "traditional" cases.[128] When LoPucki catalogues the ills that he finds rife in current bankruptcy practice, he focuses primarily on these types of cases.[129] When we look at all cases in LoPucki's dataset, of the over 700 cases it contains, over 75% are traditional cases.

The remaining 25% of Chapter 11 cases consist of so-called prepackaged cases and prenegotiated cases. In a prepackaged case, the debtor works with its major creditors and crafts a plan of reorganization before a bankruptcy petition is filed. The debtor also solicits sufficient acceptances to ensure that the plan will be

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YEARBOOK & ALMANAC 78-80. LoPucki's database, in contrast, reports that there were 81 public companies that filed for bankruptcy that had more than $100 million in 1980 dollars.

[128] "Traditional" is something of a misnomer. As Baird and I have explained elsewhere, corporate reorganization practice bears little semblance to the practice of decades ago. See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751 (2002); Baird & Rasmussen, *supra* note 45, at 675-85. Still, I would rather use the term "traditional" than burden the reader with "nonprepackaged, nonnegotiated."

[129] For example, he begins his book with a discussion of the Enron bankruptcy. *See* LOPUCKI, CORRUPTION, *supra* note 3, at 9-16. Of the practices that LoPucki labels as "corrupt," only one applies in prepackaged cases; the remaining six center on traditional ones. See *id.* at 139-81.

approved. These plans tend reduce the company's debt and make little or no change to its operations.[130] Indeed, the parties may first attempt an out-of-court workout, but turn to bankruptcy if the debtor cannot convince a sufficient number of debt holders to compromise their claims.[131] To avoid dissent that would impede quick implantation of the plan, prepackaged plans by and large pay trade creditors in full. Indeed, trade debt tends to be "unimpaired," which means that they receive the money that they are owed in the ordinary course of business.[132] In LoPucki's database, there are 61 of these cases, or a little less than 9% of the overall sample. Today, such cases have declined to less than 5% of cases involving companies with publicly traded securities, though for the period that LoPucki studies they made up over 20% of the sample.[133]

The remaining cases, roughly 15% of LoPucki's database (but only about 6% of the cases between 1991 and 1996), are prenegotiated cases. In these cases, the debtor reaches agreement with its major creditors about what will happen during the Chapter 11 proceeding. The ends to which prenegotiated plans are put have expanded over time. Originally, and continuing throughout the 1991 to 1996 period that forms the heart of LoPucki's empirical claims, prenegotiated

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[130] See REORGANIZING FAILING BUSINESSES, *supra* note 76, at 12-10 (ABA 1998) ("This technique is practical only in those situations in which the debtor's financial distress primarily is traceable to burdensome debt levels and the company does not need a comprehensive rehabilitation of its business operations.").
[131] See *id.* at 12-15 – 12-16.
[132] See 11 U.S.C. 1124.
[133] See THE 2004 BANKRUPTCY YEARBOOK & ALMANAC 163 (New Generations Research 2004).

cases were similar to prepackaged ones in that few operational issues were addressed and the primary purpose of the proposed plan of reorganization was to reduce the company's debt level. The company would reach an agreement with its major creditors, but would not obtain enough acceptances prior to bankruptcy to ensure that the plan would be approved. Some of the details of the financial reorganization still had to be ironed out.[134] Today, however, prenegotiated cases may include situations where the debtor has decided to sell itself, and the bulk of the proceeding is concerned with divvying up the proceeds.[135]

Thus, in LoPucki's dataset, three-fourths of the cases are traditional cases and one-fourth are prearranged ones. LoPucki's claims about competition and corruption necessarily are about traditional cases. Judges wield much more power here than in prepackaged and prenegotiated cases. Judges have the power to keep control of the case in the hands of the debtor. The Bankruptcy Code at the time granted to the debtor the exclusive right to file a plan of reorganization

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[134] For example, in the Grand Union case that was filed in Delaware in late January of 1996, the debtor's corporate structure was that there was a holding company whose sole asset was the stock of the operating company. The holding company had issued debt, as had the operating company. Roughly two months before the bankruptcy filing Grand Union entered into negotiations with its bond holders. At the time it filed for bankruptcy, it had reached agreement with those who held bonds issued by the operating company, but had yet to come to terms with those who held bonds issued by the parent company. An agreement with these bondholders was reached shortly after the company filed for bankruptcy, and the reorganization plan was confirmed in late May of 1996.

[135] *See* Baird & Rasmussen, *supra* note 45, at 675-85 (describing dynamics of modern Chapter 11 practice).

for the first six months of the case, but the bankruptcy judge has the power to extend this period of exclusivity.[136] Bankruptcy judges also rule on contested motions, such as whether the debtor's bankruptcy financing package should be approved, whether disgruntled shareholders can oust the board of directors and whether pension plans be jettisoned.[137] Bankruptcy judges also entertain first day orders which often establish the ground rules for the case.[138] To the extent that one posits that judges seek the challenges posed by large reorganization cases, it is the traditional cases that present these puzzles.

Traditional cases also pose more interest to lawyers. Not only are there more of them, but also each case generates more fees.[139] More importantly, local attorneys benefit more from a prolonged Chapter 11 taking place in their hometown than they do from a brief prepackaged reorganization. To the extent that lawyers are looking for big paydays, traditional cases are the mother lode.

Managers should also be more sensitive to traditional cases than to prepackaged or prenegotiated ones. Much has been written about managerial

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[136] See 11 U.S.C. 1121 (1994). Amendments in late 2005 limited the ability of the bankruptcy court to extend exclusivity more than 18 months after the case was filed. See 11 U.S.C. 1121(d)(2) (2006).
[137] See 11 U.S.C. 364 (court approval for financing); 11 U.S.C. 363 (court approval for transactions outside the ordinary course of business); 11 U.S.C. 1114 (court approval for termination of pension plans).
[138] *See* DEBRA GRASSGREEN, FIRST-DAY MOTIONS MANUAL (AM. BANKR. INST. 2003).
[139] *See* John J. McConnell, et al., *Prepacks as a Mechanism for Resolving Financial Distress: The Evidence*, 8 J. App. Corp. Fin. 101 (Winter 1996).

turnover during reorganization cases.[140] Yet the threat to managers of losing their jobs during a reorganization case looms much larger in a traditional case than in a prearranged one. Prearranged cases tend to be relatively quick affairs that focus on revamping a corporation's balance sheet. Given this, one would expect to see more turnover in traditional cases.

There is a second problem as well. LoPucki breaks on the results for Delaware and the Southern District of New York, and treats the rest of the courts the same. However, when one looks at the Chapter 11 activity in the rest of the courts during the 1991-1996 period, it turns out that one court received traditional cases roughly in line with that of the "Big 2," and that was the Central District of California. These three courts dominate reorganization activity.

When we separate out prepackaged cases, prenegotiated cases and traditional cases, and include the Central District of California as a separate category, we get the following:

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[140] *See* Stuart C. Gilson, *Management Turnover and Financial Distress,* 25 J. Fin. Econ. 241 (1989); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies,* 141 U. Pa. L. Rev. 669 (1993).

Traditional Cases

	DE	SDNY	CDCA	Others	Total
Cases ending	12	23	12	67	114
Cases ending with emerging company	9	16	9	48	82
Cases with refiling	3 (33%)	3 (19%)	2 (22%)	2 (4%)	10 (12%)

Pre-negotiated Cases

	DE	SDNY	CDCA	Others	Total
Cases ending	5	1	0	5	11
Cases ending with emerging company	5	0	0	5	5
Cases with refiling	1	0	0	0	1

Pre-packaged Cases

	DE	SDNY	CDCA	Others	Total
Cases ending	15	3	2	13	33
Cases ending with emerging company	14	3	2	13	32
Cases with refiling	7 (50%)	0 (0%)	0 (0%)	0 (0%)	7 (22%)

These tables reveal that the Delaware refiling effect that forms the heart of LoPucki's normative conclusion is really a prepackaged refiling effect. Indeed, Delaware has the same number of traditional cases as does the Central District of California. The Southern District of New York has almost as many such cases as it two closest competitors combined. To the extent that one focuses on which jurisdictions attracted large cases for traditional reorganizations, this remains a New York story during this period, though Delaware did increase its share of traditional cases in later years, only to see the Southern District reassert its dominance.[141]

For traditional cases, the refiling rates are relatively the same across these three districts, and noticeably lower elsewhere. The difference between Delaware

[141] On the rise of Delaware, see Rasmussen & Thomas, *supra* note 112, at 1372-76. On the current division of cases, see NEW GENERATIONS RESEARCH, *supra* note 52, at 63 (reporting that in 2004 the Southern District of New York received about 16% of the cases filed by public corporations, and the District of Delaware received about 11% of such cases).

and the Central District is not statistically significant, and neither is the difference between Delaware and the Southern District. Now, when one adds up the "Big 3" and compares them to the other courts, one can get a statistically significant difference. One may have a story as to why the three busiest districts have refiling rates higher than the rest of the country, but it is not the story that LoPucki is telling. Delaware's refiling rate is statistically indistinguishable from that of the other busy courts.

When one looks at prearranged cases, it is only here that there is a noticeable Delaware effect. Delaware dominates to the extent that it attracts these cases. If anything, the chart above does not reveal the extent of Delaware's dominance in this area. Delaware had no prepackaged cases in 1991, but the Southern District of New York and the other courts had a total of three. Delaware received its first prepackaged case in 1992. During that year, there were nine prepackaged cases nationwide, of which Delaware received three. From 1993 to the end of 1996, however, Delaware received 12 of 20 cases. From 1997 to 2004, Delaware increased its dominance in this area, garnering 19 of 24 cases.

Prearranged cases thus drive LoPucki's results. Had the bankruptcy court for the Central District of California been the home to the prearranged cases, we would be talking about the Los Angeles effect rather than the Delaware effect.

Locating the driving force behind LoPucki's empirical claims in only a subset of the cases renders his empirical assertions unreliable. For traditional cases, the cases on which bankruptcy law focuses, there is no Delaware effect in terms of refiling rates.

C. The Need to Ask the Right Question

Traditional cases and prearranged ones thus differ both in terms of the demands they place on the bankruptcy court and the pattern of refiling. It is tempting to quote percentages in this context. Tempting but misleading. The number of cases that are examined is small. Delaware has only three traditional cases in the six-year period that end up as repeat filers. To be sure, this is a large percentage of the companies that emerged, but it is still the fact that the over all sample is low. In such a situation, it is difficult rely on statistical inferences alone. That is especially true when we know that cases were not randomly distributed. The appropriate response is such a situation is to example the underlying cases themselves.

When we look directly at the question of whether bankruptcy courts in Delaware were destroying cases as LoPucki asserts, one cannot find persuasive evidence on either score.

1. *Traditional Cases*

LoPucki equates a refiling within five years as a failure of the first reorganization. Postulating a correlation between refiling and failure is not outrageous. There are undoubtedly situations where a different course of action could have prevented the second bout of bankruptcy. Bankruptcy law is designed to address the problems associated with financial distress, and a second filing suggests that those problems were not adequately addressed in the first proceeding. A second filing is hardly the hallmark of a successful reorganization.

But it is not necessarily the case that the second bankruptcy petition condemns the first proceeding. It may be that the subsequent failure is unrelated to the first. In other words, the five year window is a proxy. It is an attempt to locate cases where the bankruptcy process failed to solve the problems afflicting the business. Yet, as with any proxy, it is a rough guide. If we have a sufficient number of observations, five years may be a suitable proxy. But Delaware in the relevant time period had only three traditional cases that refiled in five years. When one looks at the history of these three companies, the problems with Delaware are difficult to locate.

Consider first the reorganization history of Harvard Industries, a company that emerged from the Delaware bankruptcy court in 1992 and later returned to bankruptcy court within five years. Harvard was an automotive

parts maker whose major customers were the American Big Three automakers. In 1991, some of its creditors filed an involuntary petition against Harvard, and they filed the petition in Delaware.[142] Harvard undoubtedly was in financial distress. Less than three years before filing it had undergone a leveraged buyout, and the net revenue from its operations could not cover the interest payments on its debts. The plan of reorganization that was eventually approved focused on the financial side of the business. It converted $200 million of subordinated debentures into preferred and common stock, and the company emerged from bankruptcy in August 1992.[143]

In 1993, a new CEO took the reigns at Harvard. The enterprise operated profitably for the next two years. Then it bought Doehler-Jarvis, a maker of cast-aluminum car parts. This acquisition significantly increased Harvard's debt level. Twenty months later, the CEO who had instigated this transaction had resigned and Harvard filed for a second bankruptcy. The automotive press attributed the bankruptcy to problems at the Doehler-Jarvis operation.[144]

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[142] *See Harvard IndustriesFiles for Chapter 11 Protection*, Wall. Str. J. A3 (May 3, 1991)

[143] *See Harvard and Debentureholders Reach Revised Agreement in Principle,* PR Newswire (April 9, 1992).

[144] *See* Kris Hundley, *Harvard Seeks Debt Relief,* St. Petersberg Times 1E (May 9, 1997).

It strains credulity to attribute the second bankruptcy petition of Harvard to dereliction on the part of the bankruptcy court in the first case.[145] The second case was caused by what turned out to be a failed acquisition that was orchestrated by a CEO put in place after the conclusion of the first case. It may have been that the acquisition itself was an improvident decision. It may have been that the acquisition was a good idea at the time, but the company failed to integrate its operations well. Or it may have been that the acquisition was a good idea, but that it simply turned out wrong. The market for supplying auto parts for American manufacturers is dwindling, and the past fifteen years have seen substantial consolidation in the industry.[146] Perhaps the best strategy in such a situation is to attempt to acquire others so that, when the dust settles, you are one of the corporations still standing. Maybe Harvard missed a chance to be a survivor; or maybe it was one the many corporations that despite best efforts fell victim to a shrinking market. Whatever the explanation, the second bankruptcy case flowed directly from its ill-fated acquisition by a new CEO and not from any defect in the first proceeding.[147]

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[145] Cf. Harvey R. Miller, *Chapter 11 Cases and the Delaware Myth,* 55 Vand. L. Rev. 1987, 2005 (2002) ("the return to Chapter 11 by Continental Airlines in 1990 was not the result of a defective Chapter 11 plan in 1986").

[146] Currenly a number of auto parts makers, including Delphi, Tower Automotive, Dana and Collins & Aikman are in Chapter 11.

[147] Perhaps the second case was a failure. A new CEO was put in charge. He adopted a strategy of trying to move Harvard away from its reliance on the automotive sector. He shed assets and looked for acquisitions. In the end, Harvard filed for a third time in 2001. There was no effort to

An even more attenuated story between the first and second cases can be found in United Merchants and Manufacturers, the second of Delaware's traditional refilers. As its name implies, much of the company's operations were in manufacturing. In the summer of 1990, its then CEO orchestrated an out-of-court workout to reduce the debt level.[148] This workout, however, was not sufficient to solve United Merchants' financial woes. Shortly thereafter, on November 1990, United Merchants filed for Chapter 11 in Delaware. By the time it had reached the bankruptcy court, it had been in a period of decline for years. Revenue had shrunk from $1 billion in the late 1970s to $250 million. Its textile and home furnishing operations faced stiff competition. United Merchants' did have one operating unit that was financially vibrant. It owned 80% of the stock in Victoria Creations, a manufacturer of jewelry. When United Merchants filed for bankruptcy, however, Victoria Creations did not.[149]

United Merchants exited the Delaware Bankruptcy Court in 1992. It had sold substantial assets while it was in bankruptcy. Upon exiting Chapter 11, it consisted of three operations – apparel textiles, home furnishings and accessories

keep the corporation as a stand alone entity. Rather, it was put up for sale. This has been a tough time for autopart makers. Also, Harvard was in a vulnerable position due to its reliance on the Big 3. Its sales went down dramatically during the decade. It closed plants, but was left with retiree medical expenses. Harvard simply had no going concern value.

[148] *See UM&M Completes Exchange Offer,* 160 Women's Wear Daily No. 10, p. 6 (July 16, 1990).

[149] *See UM&M, Two Units File Chapter 11,* 160 Women's Wear Daily No. 88, p. 19 (Nov. 5, 1990).

(Victoria Creations).[150] By the middle of 1995, United Merchants had sold all of its assets but its interest in Victoria Creations.[151] Thus, by this time, United Merchants was a shell that only owned a single operation, an operation that had not been involved in the first Chapter 11 case.

Victoria Creations, however, was not able to service its debt (some of which it acquired when it guaranteed the obligations of its parent), and its lenders forced both it and United Merchants to file for bankruptcy on February 23, 1996, four and a half years after the first reorganization had ended. One month later, potential buyers for Victoria Creations surfaced. Eventually, the company was sold to a group led by the founder of the company.[152] United Merchants second Chapter 11 case, like that of Harvard Industries, thus was filed more that four and a half years after the first and centered on a company that was not even a part of the first reorganization.

The delay between the first and second petitions in Harvard Industries and United Merchants and Manufacturing illustrate the dangers that arise when one uses proxies with a small sample. LoPucki finds a statistically significant effect for Delaware when he compares the refiling rate for Delaware-reorganized companies with companies that reorganized in courts other than the Southern

[150] *See* Sidney Rutberg, *UM&M Plans to Sell its Apparel Units,* 21 Daily News Record No. 109, p. 10 (June 5, 1991).
[151] *See UM&M, Victoria Creations Set Up a Refinancing Plan,* Women's Wear Daily 19, August 7, 1995.
[152] *See* Brian C. Jones, *Victoria Creations Bid OK'd,* Providence Journal-Bulletin 1F (June 26, 1996).

District of New York. Yet this result depends crucially on the five-year window. As we have seen, both Harvard Industries and United Merchants had a second reorganization more than four-and-a-half years after the first petition. Had LoPucki used a four-year window instead of five, Delaware would be statistically indistinguishable from the other courts, even if one did not include the Southern District of New York and the Central District of California.

The final traditional Delaware case that is a failure by LoPucki's definition is TWA. TWA had been taken over by Carl Ichan in 1988. In its first bankruptcy case, it shed roughly $4 billion in debt. Ichan left as CEO during the case.[153] Nevertheless, these steps were not enough to return TWA to profitability. Two years later, it filed a prepackaged case in St. Louis. The case, which lasted 30 days, pared another half a billion off of TWA's debt load.[154] To be sure, following TWA's second bankruptcy, it was able to remain outside of Chapter 11 until 2001, when it filed for a third time in order to consummate its sale to American.[155] This longer period between Chapter 11 cases, however, may well be attributable to the economic climate of the last part of the 1990s. This was a time of

[153] *See* Agis Salpukas, *T.W.A. Files its Plan to Leave Bankruptcy,* NY Times D4 (Feb. 18, 1993).
[154] *See Bankruptcy Court Clears TWA Reorganization Plan,* Wall St. J. B8 (Aug. 7, 1995).
[155] *See* Baird & Rasmussen, *supra* note 48.

unparalleled profitability for all airlines. In the end, TWA never turned a profit after it was taken over by Ichan until its demise.[156]

It is difficult to judge any court by the way in which airlines have performed after bankruptcy. The legacy airlines have had a difficult time since the end of airline regulation in 1978. Most have filed for bankruptcy (Northwest, Delta, United, USAir, Continental) and many have gone out of business (Pan Am, Eastern, TWA, Braniff). There is not a single legacy airline that was TWA's size or smaller that is currently operating. Moreover, there has yet to be a legacy airline that has solved its financial problems in a single trip through the bankruptcy court. The only legacy airline currently flying but not in financial distress is Continental. Continental filed its first bankruptcy in Houston in 1983 and emerged in 1986. It filed again for bankruptcy a second time in 1990. Continental has not filed for bankruptcy since. This by all accounts successful reorganization occurred in Delaware.[157] Given the history of airline reorganizations, it is an unwarranted stretch to assume that had TWA filed its first case elsewhere it would still be in business today.

Thus, looking the traditional bankruptcy cases both quantitatively and qualitatively, one cannot conclude that Delaware performed worse than other

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[156] *See* Nikhil Deogun, et al., *TWA Approves Chapter 11 Filing, Buyout,* Wall St. J. A3 (Jan. 10, 2001).
[157] Indeed, it was this case that established Delaware as an attractive venue for Chapter 11 proceedings. See Rasmussen & Thomas, *supra* note 115, at 1372-73.

courts. That LoPucki has not produced evidence to support his assertion that Delaware reorganization practice has destroyed businesses that could have been saved does not exonerate the Delaware court. Things may have indeed been terrible there, even corrupt. The point is that LoPucki's data provides no evidence that his theory is correct. When looking at the companies that did fail, at most Delaware could be faulted for allowing companies whose time had past to be given one last attempt. To the extent that LoPucki wants to make an empirical claim about traditional cases, he simply has fallen short.

2. *Prenegotiated and Prepackaged Cases*

We saw above the LoPucki's data does show that prepackaged bankruptcies are more likely to need a second petition. Given Delaware's domination in the area, however, one cannot ascertain whether this is a reflection of prepackaged bankruptcies or an effect of Delaware.

Moreover, it is not the case that Delaware was approving prearranged cases that others were rejecting. From the first prepackaged case until the case of Glenoit in 2000, all prepackaged plans were approved regardless of the court in which they were filed. All prepackaged cases got approved. Moreover, not a single prepackaged proceeding involved any challenge to the way the business

was to be operated. In this environment, one would be surprised if the subsequent need for a second petition stemmed from actions taken by the Delaware bankruptcy court.

Indeed, when one looks at the history of the companies that refiled, one cannot put the blame on the court. Seven prepackaged cases that were filed in Delaware underwent a second Chapter 11 case within the next five years. In two of these, Westmoreland and Morrison, Knudson, the second case can be traced to factors that arose after the case was completed. Westmoreland was a coal company that, prior to its first bankruptcy petition, had decided to dispose of its properties in the eastern United States. It filed its first case solely so it could assign a contract over a partner's objection.[158] The second case was filed to years later in order to resolve a labor dispute. This case was dismissed after the parties agreed to binding arbitration. Neither the first case nor the second involved any alteration of the company's capital structure.

Morrison, Knudson filed its first Chapter 11 petition due to decisions of its then CEO, William Agee, to move the venerable construction corporation into the mass transit business.[159] After its prepackaged bankruptcy, the business had

[158] The Bankruptcy Code grants this power to the debtor, even though the contract could not be assigned outside of bankruptcy. *See* 11 U.S.C. 365.
[159] Its many projects include the Hoover Dam and the Alaska Pipeline.

no debt.[160] To extent that one looks to bankruptcy law to trim debt, it is impossible to imagine a more drastic reduction than took place here. The tonic worked; Morrison, Knudson reported fourteen consecutive profitable quarters. The company then bought the construction unit of Raytheon, which turned out to more troubled than had been thought. It was this dispute with Raytheon that caused the second case.[161] After the second case, Morrison, Knudson again had no long-term debt.

Putting aside the cases of Westmoreland and Morrison Knudson, Delaware in 1991-1996 had five prepackaged cases where, after the completion of the first bankruptcy, a second bankruptcy petition was filed.[162] These five cases involved four separate companies, as Memorex Telex filed a prepackaged case in 1992, a second prepackaged case in 1994, and filed for a third and final time in 1996. These four companies share a common feature. All of four of the companies

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[160] The operating company itself never filed for bankruptcy, only the parent company. The prepackaged case was designed to both merge Morrison, Knudson with the Washington Group and to eliminate all of the corporation's long-term debt. *See Morrison Knudson Files for Protection from its Creditors,* Wall St. J. B2 (June 26, 1996).

[161] *See Court-Appointed Examiner Concludes RE&C Transaction was Direct Cause of Washington Group's Filing,* Business Wire (Aug. 28, 2001).

[162] As to the one prenegotiated case that refiled, it was the Grand Union case, *see supra* note 133. It filed a second prepackaged case after it could not find its footing in the market place. Investors who had financed Grand Union initially but lost most of their investment include GE Capital, the Disney Corporation and George Soros. Eventually, Grand Union filed Chapter 11 a third time and was liquidated.

had, within the prior ten years, taken on substantial public debt, three of them as part of a leverage buyout.[163]

The plans in all of the cases were substantially similar. The only party affected was the public debt holders. The bank debt, which was senior to the public debt, was left intact, as was the trade debt. Typically, the public debt was reduced by half, with the bonds receiving substantially all of the equity in exchange.[164]

There is no question that these four companies not only refiled, but eventually failed.[165] Yet LoPucki has not identified a single action that the bankruptcy court could have taken to prevent the ultimate failure. An examination of the cases themselves does not reveal any quick fixes that, even in retrospect, could have preserved the corporation.

SPI Holding's business was Spectravision, a service that provided movies to hotel guests. After its first case which reduced its debt burden, it invested

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[163] Indeed, when one looks at all of the prepackaged cases the ended between 1991 and 1996, the vast majority of them were situations where the corporation had taken on substantial public debt either as part of a leveraged buy-out or in connection with an acquisition. We see this pattern in Charter Medical (LBO), JPS Textile (LBO), Edgell (LBO), Gaylord Container (Acquisition Debt), USG Corp. (debt incurred in response to hostile takeover attempt); Restaurant Enterprises (LBO), Petrolane (acquisition debt), Thermadyne (LBO), Mayflower Group (LBO), Great American Communications Company (LBO).

[164] In the second Memorex case, all of the remaining public debt was eliminated, and these bondholders received the equity in the reorganized business. In SPI Holding, the debt holders received only 64% of the equity. The remaining equity went to Marvin Davis, who had originated the LBO, in exchange for Davis's fresh contribution of $25 million.

[165] Cherokee still exists, but all of its operations closed. Its only asset is its trademark, and all of its revenues come from licensing it to manufacturers overseas.

heavily in delivering films via satellite.[166] This technology that did not pan out, and it was eventually sold to OnCommand, which uses cable to deliver its programming. OnCommand bought Spectravision solely to acquire its access to hotels. After the acquisition, OnDemand replaced all of Spectravision's technology with its own.[167] SPI Holding, after its first case, made a sensible business decision that turned out poorly. This decision was not influenced by the first case, and there is basis to conjecture that the company would have adopted different technology had a court other than Delaware approved the prepackaged plan.

Cherokee and Ithaca Industries were both domestic textile manufacturers, that, in the end could not compete in an outsourcing world.[168] Given the decimation of the domestic textile industry, the only plausible flaw is not that the cases refiled but that the operations where not closed more quickly.

This leaves Memorex Telex. The company was formed by the LBO of Memorex and Telex. In the early 1990s, Memorex Telex operated at a profit. The problem was that the profits were not sufficient to service its debt obligations. Memorex Telex had hitched its star to IBM mainframes. Telex made nodes for

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[166] *See* Jim Mitchell, *Spectravision Hires Cable Exec as CEO,* Dallas Morning News 2F (Sept. 10, 1994).

[167] *See On Command Corporation Announces 1997 Fourth Quarter and Year-End Financial Results,* PR Newswire (Feb. 18, 1998).

[168] Ithaca closed its doors. Cherokee, in contrast, closed all of its operations, but retained the Cherokee brand. Today, the company is profitable, but its only asset is the Cherokee license. *See* Kathleen O'Steen, *Cherokee Makes the Most of its Trademark,* LA Times B8 (Sept. 21, 1999).

individual users. Memorex made storage devices for IBM mainframes. In the recessionary times, computer purchasing was down, as was Memorex Telex revenues. The management team of Memorex Telex began restructuring discussions with the banks and bondholders. The two largest single bond holders were legendary vulture investors Carl Ichan and Leon Black. Eventually, the parties proposed a plan where roughly half of the bond debt would be eliminated. In exchange for reducing their debt, the bondholders would receive 95% of the equity in the reorganized company, and that stock would be publicly traded. The remaining 5% would go to the managers, the preferred shareholders and common shareholders. Trade creditors would be unimpaired under the plan. In other words, their bills would continue to be paid as they became due.

Shortly after the parties agreed to the plan, Memorex Telex reported disappointing revenues. Still, the plan was sent out to the affected creditors and shareholders. Over 85% of each class voted for the plan. The plan was approved in then record time.[169]

The fortunes of Memorex Telex, however, continued to decline. By now, it was becoming apparent that having a business model tied to the market for IBM mainframes was no longer viable. The CEO who had steered Memorex Telex through its first bankruptcy retired, and he was replaced by a veteran of the

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[169] *See Memorex Telex N.V.*, Wall St. J. A2 (Feb. 19, 1992).

computer industry. The new CEO undertook a review of the company's operations and began to steer away from reliance on the mainframe market. Still, the inevitable shrinking of that market continued, and the new CEO opened discussion with the debt and equity holders.

The parties reached agreement on the following terms. All existing stock would be cancelled, as would all debt other than that debt that arose from operations. In other words, all of the leverage acquired in the acquisition of Memorex and the acquisition of Telex would be eliminated. The architects of those transactions were left with no interest in the reorganized business.[170] The new equity was given to the old bondholders. As with the first plan, the trade creditors would be unaffected. This plan was approved by over 95% of the claimants voted in favor of the plan. After this restructuring, Leon Black and his investment company controlled roughly 15% of the equity and Carl Ichan another 14%.[171]

The CEO then launched a third business model. Now, Memorex Telex was going to be a service provider. Rather than selling parts for your network, they

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[170] The old stock holders did receive warrants that would be in the money if the stock of the reorganized corporation reached $14 a share.

[171] *See* Cecile Gutscher, *Future Uncertain for Prepackaged Memorex Telex Plan*, 4 High Yield Report No. 7, p. 6 (Feb. 21, 1994).

sought to manage it.[172] Of course, to the extent that Memorex Telex had expertise in this area, it was almost exclusively focused on IBM products.

Eventually, this strategy was not sufficient to turn around Memorex Telex's fortunes. The CEO brought in after the first bankruptcy left in March of 1996. Memorex Telex was now in a liquidation mode. It sold its Pacific Asia operations in July of that year. In October, it filed for bankruptcy a third time, announcing that it was searching for a buyer.[173]

The story of Memorex Telex is not a happy one. Its employees lost their jobs; its investors lost their shirts. Yet it is far from clear how the Delaware Court's handling of the two prepackaged bankruptcies contributed to this failure. The restructuring in the first bankruptcy was based on Memorex Telex's historical earnings. Few, if any, at the time appreciated the fundamental changes that were sweeping the computing world. In the second case, all of the debt was wiped out, and the old debt holders emerged with complete control of the company. To be sure, they did not find a way to save the business, but it is doubtful that any court could have engineered a different result.

It is unclear what actions would have saved any of the companies. Even had the debt been wiped out in its entirety in the first case, failure seems

[172] *See Telex Outlines new Business Strategy to Target Enterprise Networking,* Business Wire 9July 18, 1994).
[173] *See Telex N.V. Announces Intent to Sell U.S. Operation*, Business Wire (Oct. 15, 1996).

inevitable.[174] SPI Holding and Memorex had technology that lost in the marketplace. Cherokee and Ithaca Industries got crushed in the outsourcing wave that has decimated America's textile industry. In the end, these companies failed because they could not find their way in a competitive market place. It is simply a flight of fancy to suggest that had they filed their prepackaged bankruptcies in other jurisdictions, their fate would have been any different.

A puzzle still remains. It is still the case that no other court during this period had a refiling. Part of the answer is that just as a second filing does not necessary imply a failure of the first bankruptcy proceeding, the lack of a filing cannot be treated as a success. Of the 12 prepackaged cases with emerging public companies that finished between 1991 and 1996 and did not take place in Delaware, only two of those companies are continuing in business as public companies today.[175] The others have been merged or acquired by other companies. For Delaware cases, fives are still in business.[176] It may be the case that, for prepackaged bankruptcies, simply looking at whether a second petition was filed fails to provide adequate information about the post-bankruptcy fate of the corporation. Regardless of the reason for the Delaware difference in

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[174] No one suggests that eliminating all public debt in a prepackaged bankruptcy is the optimal strategy for every company. Debt has a disciplining effect which the investors may well want to keep in place.

[175] They are Southland and Gaylord Container.

[176] They are Charter Medical, Cherokee, Westmoreland, USG Corp. and Morrison Knudson.

prepackaged cases, we can clearly reject the notion that the failure of Delaware prepackaged cases arose from actions taken by the Delaware bankruptcy court.

In the end, LoPucki has presented a theory. This theory may well be correct. It may well be that the choice of bankruptcy venue has had a deleterious effect on corporate reorganization practice. This theory, however, is contestable.[177] Today we see creditors often getting control of the enterprise before the filing. They may choose a venue that increases the value of the enterprise. The empirical evidence that LoPucki presents does not allow for a choice between these two theories.

Conclusion

The strength of legal scholarship is that it borrows from various sources in attempts to answer real world problems. This strength, however, is also a weakness. Legal scholars tend to come to debates with strong views. Empirical data is often ambiguous. The risk is high that one can invariably find what she is looking for. Failing to look in the right place, ask the right question or draw the right inference can end up confirming a bias that was brought to the project. A healthy skepticism needs to be applied to empirical work as much as to

[177] For arguments that competition may be beneficial, see David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 Vand. L. Rev. 309 (2001).

theoretical work. In both, it is necessary to articulate the crucial assumptions and inferences on which conclusions rest.