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# Courting the Big Bankrupts

BY LYNN M. LOPUCKI

On June 20, Sen. Joseph Biden (D-Del.) published a commentary in *Legal Times* titled "Give Credit to Good Courts." That commentary responded to one published two weeks earlier by Sen. John Cornyn (R-Texas), which argued for legislation to stop big companies based elsewhere from filing for bankruptcy in Delaware and New York. In these commentaries, Sen. Cornyn relies on, and Sen. Biden attacks, my research.

I write to set the record straight.

The big picture is that several U.S. bankruptcy courts are competing for the multibillion-dollar bankruptcy reorganization business. Current law essentially gives big bankrupts their pick of the courts. That option to forum-shop is undermining the courts' integrity.

## DELAWARE FIRST

The story begins with Delaware. By catering to the corporate executives and lawyers who choose courts for the biggest bankrupts, the U.S. Bankruptcy Court for Delaware went from a one-judge backwater that attracted no large public company cases in the 1980s to a near-national monopoly in 1996.

Delaware attracted 13 of the 15 big cases filed in the United States that year, and another 184 since then. (For purposes of my ongoing research, I've defined a "big bankruptcy" as one that is worth, in today's dollars, roughly $230 million or more.) Delaware sucked the most desirable and most profitable bankruptcy cases out of the rest of the country.

Under pressure from local lawyers, bankruptcy courts elsewhere set up committees to tell them how to compete with Delaware. The result was that from 1997 to 2002, the bankruptcy courts in nearly every big city adopted "complex case rules" and practices emulating those of the Delaware court.

The courts began approving higher fees for professionals and "retention bonuses" for failed executives. They rubber-stamped "prepackaged" plans in cases where creditors went unrepresented ("30-day prepacks"). They authorized tens, and in a few cases hundreds, of millions of dollars in preferential payments to creditors selected by the executives ("critical vendor orders"). Increasingly they let the executives commit the company to the course that the executives favored in the first days of the case—before creditors even knew what was happening (through "first-day orders"). The result: The failure rate for reorganizations of large public companies grew to triple what it had been before Delaware dominated the scene.

The bankruptcy court competition came at a time when big-case bankruptcy was booming. Tiny Delaware didn't have enough judges to handle the deluge of corporate giants that wanted to reorganize there. So the overflow went to the courts that next most aggressively solicited the big cases.

In the 27 months beginning in November 2000, Chicago (a division of the U.S. Bankruptcy Court for the Northern District of Illinois) got eight big bankruptcies—more than Chicago had received in the previous 20 years. They included forum-shoppers Kmart (from Detroit), Conseco, and National Steel (both from Indiana). But when Chicago judges failed to deliver on critical vendor orders and releases of liability for insiders, the cases abruptly stopped coming.

New York (that is, the U.S. Bankruptcy Court for the Southern District of New York) did not suffer such qualms. After the court failed to appoint a trustee to replace the corrupt management of Enron, three other managements accused of corruption—WorldCom, Adelphia, and Global Crossing—chose the same court for their cases. And so New York pulled ahead of Delaware in the competition.

Sen. Biden claims that "venue-shopping is relatively rare."

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Nothing could be further from the truth. Venue-shopping means picking your preferred court from among alternatives. That is what every big bankrupt does today. Not to do so, the lawyers are fond of saying, would be malpractice.

From 2000 through 2004, 60 percent to 70 percent of large public companies filed their bankruptcies in a court away from their headquarters. During that period, 65 percent of the billion-dollar-and-over bankruptcies were filed in just two of the 160 U.S. bankruptcy courts: Delaware (35 percent) and New York (30 percent). Nearly all of the big bankrupts whose names are household words were forum-shoppers. They included Enron, WorldCom, Adelphia, Global Crossing, Conseco, Kmart, Owens Corning, Bethlehem Steel, and Polaroid.

Sen. Biden claims that the current venue laws are "flexible enough to adjust" because they "provide for venue to be transferred 'in the interest of justice or for the convenience of the parties,' a consideration that carries real weight with the courts." In fact, courts virtually never surrender a big case. Of the 160 largest bankruptcy cases filed since Delaware entered the picture in 1990, courts transferred only one.

Winn-Dixie is a grocery chain based in Jacksonville, Fla. It has stores and distribution centers throughout the Southeast, but none in New York. To justify a New York filing, Winn-Dixie's lawyers incorporated a New York subsidiary, had it assume some debt, and then 12 days later put the subsidiary into bankruptcy in New York. Minutes after that, the parent company filed in New York, claiming venue was proper because "the bankruptcy of an affiliate" was pending there.

Astonishingly, the New York court held the filing to be in good faith. The case was transferred to Jacksonville only when Winn-Dixie, embarrassed by newspaper stories about its forum-shopping, requested the transfer.

## WHAT CREDITORS REALLY WANT

Enron had 7,500 employees in its 50-story Houston headquarters, compared with about 60 employees in New York. Yet Enron filed in New York, and the New York court kept the case, saying the venue was "in the interests of justice and for the convenience of the parties." Sen. Biden defends the decision, claiming that "the court specifically ruled that the case should remain in New York to help Enron's victims—and the victims agreed."

Of course, Enron's victims were never polled on their choice of bankruptcy courts. Only the 14-member creditors' committee agreed. Sen. Biden is hiding behind the legal fiction that the creditors' committee represents the creditors.

On the issue of venue, however, creditors' committees have an inherent conflict of interest. Because the Enron case was filed in New York, only those willing to serve in New York were appointed to the committee. Six of the 14 were New Yorkers. And the committee hired a New York law firm to represent it. Had the Enron case been transferred to Houston, thousands more creditors would surely have found it cost-effective to participate in the case—and that would probably have boosted their recoveries at the expense of the creditors on the committee. In short, creditors' committees have reasons not to consider the interests of all creditors.

The stance of the creditors associations is a better gauge of creditors' interests. Two of the largest, the Commercial Law League and the National Association of Credit Management, have endorsed Sen. Cornyn's bill to restrict forum-shopping. None oppose it.

## 'STUFF OF MYTHS'

Sen. Biden's misdirection also extends to my own research. The four studies that serve as the foundation for my book—*Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts* (University of Michigan Press, 2005)—were published in 2001, 2002, and 2004. Months before each publication, my co-authors and I posted both our raw data and statistical runs on the Internet so that anyone interested could check our work. To date, no academic journal has published any challenge to the accuracy of our data or the correctness of our empirical findings. Nor do I know of any unpublished manuscripts challenging them.

That has not prevented Sen. Biden and various self-appointed defenders of the bankruptcy courts from claiming that our data are inaccurate and our studies flawed in some unspecified way.

In his commentary, Sen. Biden says that "Vanderbilt law professors Robert Rasmussen and Randall Thomas analyzed LoPucki's methodology and concluded that it is significantly flawed." In fact, Rasmussen and Thomas ultimately deleted their claim of methodological flaw before publishing. What they published was that they "have no quarrel with [LoPucki's] factual findings."

Sen. Biden writes that "[o]ne of the country's premier bankruptcy law practitioners, Harvey Miller, conducted a statistical study on the issue and concluded that LoPucki's claims are 'the stuff of myths.' " In fact, Miller analyzed our data and admitted that he "does not dispute that the recidivism rates for both traditional and prepacked and prenegotiated reorganization are higher in Delaware than in all other jurisdictions minus the Southern District of New York." His "stuff of myths" remark in that same article was not about my studies, but about critiques of Delaware generally. The full sentence reads: "While critics of Delaware contend that there is something wrong with how the Delaware Bankruptcy Court deals with reorganization cases, their critiques are the stuff of myths."

Sen. Biden also claims that "[u]sing a multivariable regression analysis, [professors Kenneth Ayotte of Columbia Business School and David Skeel Jr. of the University of Pennsylvania Law School] concluded that LoPucki's study is faulty." In fact, Ayotte and Skeel ran no regression analyses of my studies and make no criticism of any of them. They studied different measures of the effects of venue choice than I did, reaching conclusions generally favorable to the Delaware court. Our factual and statistical findings in no way conflict with theirs.

Meanwhile, the bankruptcy courts' race to the bottom continues. Tucked away in the bankruptcy reform bill enacted in April is a provision awarding Delaware four new bankruptcy judgeships. (It currently has two.) The Delaware court's glamorous docket will certainly attract high-quality applicants. But the Delaware docket will continue to be glamorous only if the new judges continue to win the competition for bankruptcy cases. We should all worry about what the new judges might do to accomplish that.

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