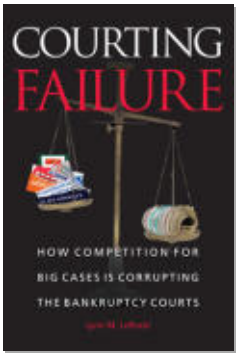
4. Failure



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Failure

Study Attacks Delaware Bankruptcy Court
—Headline in the *National Law Journal* (March 2002)

In the spring of 2000, UCLA law student Sara Kalin and I made a shocking discovery. The companies that had reorganized in Delaware from 1990 through 1996 were failing at an alarming rate.

The discovery came as the result of two accidents. The first occurred in the final months of the study Bill Whitford and I had done in the 1980s. Bill and I were studying the reorganization process from filing to confirmation. We were not collecting data on what happened to the companies after they emerged from the process, but the names of the 43 companies in our study were firmly etched in our minds. As we prepared to publish our findings in the early 1990s, we noticed some of those names in the newspapers again. Firms that had emerged from bankruptcy only a few years earlier were filing again. As the numbers of these refilings grew, we decided to count them. By the time we published the last article in our study in 1993, Bill and I identified 12 of the 38 emerging firms from our study (32 percent) as having refiled.[1]

The discovery surprised us. Refilings were supposed to be rare. The law required that, before confirming a plan, the bankruptcy judge find that confirmation was "not likely to be followed by . . . the need for further financial reorganization."[2] It appeared that the judges' findings had been wrong in almost a third of the cases.

I resolved to look into the refiling problem further, but other matters always seemed more pressing. Two years later Professor Edith Hotchkiss of Boston College published a study on the subject. She found that 32 percent of public firms emerging from bankruptcy "reenter bankruptcy or privately reschedule their debt."[3] Because she counted both refilings and out-of-court workouts and still reached a total of only 32 percent, I assumed that if she had counted separately she would have found a refiling rate considerably lower than the 32 percent Bill and I had found. Perhaps the cases Bill and I had studied had been a bad batch.

The LoPucki-Kalin Study

Although I could never find the time for a refilings study, each semester I tried to interest my seminar students in doing one. In the spring of 2000, one did. Sara Kalin tracked down the refiling data on each of the 188 large public companies that emerged from a bankruptcy court anywhere in the United States from 1983 through 1996. For each, she determined whether the emerging firm had filed a second bankruptcy by February 20, 2000. The task was difficult because about 30 percent of the firms changed their names at least once, some merged or were acquired in transactions that raised issues of how to count, and many dwindled in size until they could no longer be tracked in newspapers. Essentially, what Sara had to do was to use Securities and Exchange Commission filings, newspaper reports, bankruptcy services, business directories, court records, web sites, and other sources to track each of the companies from its emergence from bankruptcy to its ultimate fate. For some, that was more than a decade. I reviewed Sara's documentation with respect to each of the cases.

Among other contributions, Sara's seminar paper identified the period of enhanced risk of refiling shown in figure 4. The probability that any given public company will file bankruptcy in a given year is 0.77 percent. But for a company that has already been through bankruptcy, the refiling risk is higher, beginning at 1.6 percent in the first year, peaking at 4.4 percent in the third year, declin-

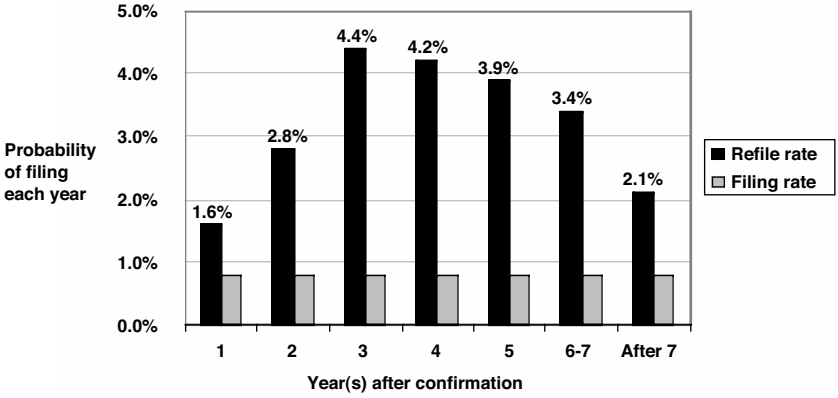

Fig. 4. Refiling and filing rates by year after plan confirmation. (Reprinted from Lynn M. LoPucki and Sara D. Kalin, "The Failure of Public Company Bankruptcies in Delaware and New York," 54 *Vanderbilt Law Review* (2001): 247.)

ing slowly to 3.4 percent in the sixth and seventh years, and falling to 2.1 percent after the seventh year.

Sara's project had nothing to do with Delaware. She did not collect data on the locations of the cases she studied. But those locations were already in my Bankruptcy Research Database (BRD). The second accident occurred just a couple of months after I added Sara's data to the BRD. In scanning the data, we noticed that most of the refilers had initially reorganized in Delaware or New York.

By the summer of 2000, the bankruptcy community was well aware of the forum shopping to Delaware and New York. They were also aware that substantial numbers of companies emerging from bankruptcy reorganizations were refiling. (A Chapter 11 case followed by another Chapter 11 case was widely referred to as a "Chapter 22.") But no one had noticed the connection between the two phenomena. To the contrary, legal scholars were lauding the forum shopping as healthy competition and Delaware as the best bankruptcy court in the United States.[4]

The correlation between reorganizing in Delaware or New York and later returning to bankruptcy was dramatic. Considering all 188 cases, Delaware's refiling rate (32 percent) was more than three

times that of all courts other than Delaware and New York (10 percent). New York's rate (28 percent) was similar to that of Delaware. (More detail on these refiling rates is shown in table 4.) The difference in the proportion of Delaware-reorganized firms refiling and the corresponding proportion for other courts was statistically significant at the .01 level, meaning that the odds of so great a difference occurring by chance were less than one in 100. (I will use "other courts" to refer to all courts other than Delaware and New York.)

In one important respect, these refiling rates made Delaware's performance look better than it was. Because the Delaware cases had been filed toward the end of the period covered by our study, the Delaware- reorganized companies had had less time in which to fail. To adjust for this problem, we recomputed our statistics, considering only companies that emerged from 1991 through 1996—the first years when companies were also emerging in Delaware. The recomputation included 127 of the original 188 cases. Delaware's recomputed refiling rate was 30 percent, as compared with 23 percent for New York and only 5 percent for all other courts. Measured simply by numbers of refilings, Delaware's refiling rate was six times that for other courts. Although based on fewer cases, this difference too was significant at the .01 level (see table 5).

The 30 companies that emerged from Delaware reorganization in the period 1991–96 were the reorganizations on which Delaware had made its reputation as the nation's best bankruptcy court.

TABLE 4. Refiling Rates by Court, 1983–96

Court	Number of Firms Emerging	Number of Firms Refiling	Percentage Refiling	Refilings per Year Followed (%)
Delaware	31	10	32	8.6
New York	36	10	28	5.2
Other courts	121	12	10	1.7
Total/Average	188	32	17	3.1

Source: Lynn M. LoPucki and Sara D. Kalin, "The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a 'Race to the Bottom'," 54 *Vanderbilt Law Review* (2001): at 249.

They were Delaware's great successes. But by February 20, 2000, nine of those 30 reorganizations had already failed. A reassessment of the Delaware court's performance seemed to be in order.

My study with Kalin reached essentially two empirically based conclusions. The first was that firms emerging from Delaware and New York reorganizations were significantly more likely to refile than firms emerging in other courts. The second was that the elevated refiling rates were a product of intercourt competition. As we explained in the study, this second conclusion was based on four sets of findings.

> First, Delaware produced high rates of refiling during its period of competitive success in the 1990s. Second, New York produced high rates of refiling during its period of competitive success in the 1980s. Third, the New York refiling rates declined after New York's period of competitive success. Fourth, the judge that made New York competitive in the 1980s had higher refiling rates than his colleagues on the New York court.[5]

That judge was Burton R. Lifland. His refiling rate for companies emerging in the 1980s was 57 percent.[6]

UCLA released our findings and conclusions in July 2000. At the same time, we posted the complete study on the UCLA Law School web site, including the names of the companies and the dates of every filing and refiling. Release of the data meant that no one would have to take our word for anything. Our study involved no

TABLE 5. Refiling Rates by Court, 1991–96

Court	Number of Firms Emerging	Number of Firms Refiling	Percentage Refiling	Refilings per Year Followed (%)
Delaware	30	9	30	7.9
New York	22	5	23	4.8
Other courts	75	4	5	1.1
Total/Average	127	18	14	3.1

Source: Lynn M. LoPucki and Sara D. Kalin, "The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a 'Race to the Bottom'," 54 *Vanderbilt Law Review* (2001): at 250.

sampling. It included every case in which a large public company debtor emerged from bankruptcy during the relevant period. Skeptics could check any item of data used in the study. They could reorder the data and recalculate the study in any way they chose. Everything was in the open. If our facts were wrong, we could be sure someone would tell us.

Reaction to the Initial Study

Our study, like the many bankruptcy empirical studies I had done before, was a study of human activity. Not surprisingly, the humans engaged in that activity—bankruptcy lawyers and judges—think they know a thing or two about what they themselves are doing. As a result, those humans tend to read such studies not so much for what they might learn from them as to judge them based on the readers' own experiences.

This phenomenon supports only two possible reactions to a newly released study, both bad. If the results conflict with the reader's personal experience, the reader concludes that the study is wrong. If the results accord with the reader's experience, the reader concludes that the study was unnecessary; it didn't tell the reader anything he or she didn't already know.

As a researcher, I much prefer the "it's wrong" reaction. If readers "knew that already," the study is quickly forgotten. Being told one is wrong can be unpleasant, but it has the potential to spark discussion, lead to controversy, and ultimately change people's minds.

We did get a little of the we-knew-it-already reaction. Bankruptcy Judge Russell Eisenberg wrote me that "[w]e all knew pretty well in advance what you would have found . . . ." But overwhelmingly, the reaction of bankruptcy practitioners was that the study just had to be wrong. A few days after we posted it, the *Delaware Law Weekly* reported that "[a]t least two local analyses are in progress to challenge the [LoPucki/Kalin] study."[7] One of the analysts was the prominent Delaware bankruptcy firm Richards, Layton & Finger. The article did not identify the other.

Three weeks later, the *National Law Journal* reported that "[Mark Collins of Richards, Layton & Finger] and other Delaware bankruptcy experts say that they will set the record straight with a written response to the LoPucki study that will review each of the refilings."[8] That response never came.

At the time we released our study, Harvey R. Miller was head of the bankruptcy department at Weil, Gotshal and Manges, the largest and most prestigious bankruptcy department in the country. A few months after the release, Miller, working with two Weil, Gotshal associates, obtained our data and began his own reanalysis. Miller filed numerous cases in New York and Delaware and strongly believed in the quality of those two courts. Yet in the article he published in 2002, Miller agreed with our conclusion "that the recidivism rates for both traditional and prepackaged and prenegotiated reorganizations are higher in Delaware than in all other jurisdictions minus the Southern District of New York."[9]

The Weil, Gotshal lawyers had used our data as their starting point. Had those data been materially wrong, these researchers were certainly in a position to notice. Later a doctoral candidate at the University of Chicago confirmed our results using data he compiled independently.[10] Within a few years, the bankruptcy world had accepted the fact that Delaware and New York had higher refiling rates than other jurisdictions—at least through 1996. What remained to be resolved was why—and what it meant.

Was Delaware at Fault?

Based on the data, Kalin and I attributed the elevated refiling rates to court competition. In our article, we speculated about the nature of the link. Intense examination of a few of the failed cases revealed that the Delaware court had adopted a laissez-faire approach to the confirmation of plans. If the major parties to the case—typically the debtor and a committee purporting to represent creditors—were in agreement, the court would confirm the plan without serious examination or analysis. Some of the plans presented had little chance of success.

The parties seemed to be presenting these shaky plans to avoid having to deal with the debtors' very formidable problems. Addressing the problems would have put the parties in conflict with each other. In those conflicts there would have been winners and losers. The companies' weaknesses would have been exposed. Managers might have been fired and the amounts owing to creditors slashed. For all parties, the day of reckoning would have arrived.

Better, the parties seemed to be thinking, to reach an agreement that papered over the companies' problems—a deal that ended the bankruptcy quickly, let the deal makers keep their jobs, promised creditors full or substantial repayment, and allowed all the professionals to claim victory. If the day of reckoning came knocking again—as it ultimately did in 54 percent of the Delaware cases—that would be later, perhaps on someone else's watch. It would be someone else's problem.

Consistent with these speculations, leading bankruptcy lawyers such as Harvey Miller,[11] Kenneth N. Klee,[12] and J. Ronald Trost[13] were complaining that distress debt traders were buying the bonds of bankrupt companies; forcing quick, ineffective reorganizations; and then cashing out before the companies inevitably crashed again. As Miller put it: "[T]hey get the debt, and then they sell the debt into the public markets and they're gone and then you have the same problem."[14]

Bankruptcy lawyers readily agreed that the Delaware judges were rubber-stamping plans (of course, the lawyers put it more delicately) but disagreed that the rubber stamping made the judges responsible for the ensuing refilings. Absent objection, the lawyers said, rubber-stamping the plans was what the judges were supposed to do. "The court is . . . permitting the parties-in-interest . . . to adjust their own debts," said Delaware bankruptcy lawyer John McLaughlin; "that's the way it's supposed to work."[15] Leading Delaware bankruptcy lawyer Laura Davis Jones explained that "[c]onfirmations of Chapter 11 cases in this district are thoroughly analyzed by professionals and advisers on all sides of table before the plans are presented to the court."[16] Harold Novikoff of

Wachtell, Lipton added: "It's difficult to go back and blame it on the judge when the plan was the result of extensive negotiation by sophisticated, well-advised parties."[17] Weil, Gotshal's Harvey Miller summed up: "You can't expect a judge to become a prosecutor. People come into court arm-in-arm singing 'We Shall Overcome.' "[18]

The debate quickly turned to whether it was even possible for judges to evaluate plans. Pittsburgh bankruptcy judge Bruce McCullough, who occasionally served as a visiting judge in Delaware, was skeptical.

> You must have seen some of these plans. Some of them are as big as the New York telephone book. How is a judge who is foreclosed from participating in the reorganization ever going to read that plan and find anything wrong with it? . . . I don't care how smart you are, you wind up talking to yourself, challenging your own assumptions and driving yourself crazy. The judge isn't going to be allowed to call in and examine a bunch of expert witnesses. That's not a typical judge's role. It may be the judges' responsibility, but as a practical matter they can't do it.[19]

Another highly respected bankruptcy judge, Barbara Houser, agreed.

> A judge is bound by the record that is presented. If you have good lawyers, they will present a record that establishes feasibility. If the judge reviews the disclosure statement and things leap out, I think the judge will ask questions. But if you have good lawyers and they're doing their job right, the likelihood of things jumping out is pretty slim. Lawyers may disclose assumptions, but in the absence of discovery or something being flagrant on its face, it's hard for a judge to know what's a wild assumption and what's not.[20]

St. Louis bankruptcy lawyer David Lander put it more bluntly: "If nobody's complaining, the notion that the judge should do his or her own feasibility analysis is crazy."[21] The reality, Harvey Miller said, was that "[i]f the banks say 'you have to carry so much debt' management will ultimately say okay . . . . Those deals go through.

Whether those plans are feasible or not is not ever really subjected, in my view, to an objective analysis."[22]

There were a few who disagreed. Los Angeles bankruptcy judge Lisa Fenning not only thought it was possible for the judge to second-guess the parties, she reported doing it.

> I frequently questioned the assumptions [underlying the financial projections]. If I thought there was a real question, I gave a heads up at the disclosure hearing that, even if everyone was in agreement, I would require testimony at the confirmation hearing. Occasionally, I required them to provide different scenarios varying a couple of the key assumptions in their projections . . . . Public companies have plenty of money to run scenarios.[23]

The direction the debate had taken surprised me. As Ken Klee, a UCLA Law School colleague and leading practitioner, put it: "Case law—not 100 percent, but almost 100 percent—says that in order to confirm a plan the judge has to find that [the Bankruptcy Code's feasibility requirement] has been satisfied. They have an affirmative obligation, even if nobody objects."[24]

At the end of each reorganization case, the judge signs a confirmation order. That order makes a finding of fact that "confirmation of the plan is not likely to be followed by the . . . need for further financial reorganization."[25] The judges I interviewed admitted that making that finding was a prerequisite to confirming a plan. Each of the judges required the proponent of each plan to provide evidence to serve as the basis for the finding—either by signed affidavit or testimony in open court. Those procedures had been followed for more than a decade before Delaware began attracting cases.

Now, after more than a decade of signing confirmation orders, Delaware's defenders were saying the whole confirmation process had been a sham from the beginning. The judges weren't doing what they purported to be doing—holding hearings, considering the evidence, and determining the likelihood of plan failure—because they couldn't.

The biggest problem with the judges-can't-judge-feasibility

defense was that it did not explain why refiling was a problem only in Delaware and New York. If the sophisticated judges in Delaware and New York couldn't determine feasibility, it would seem to follow logically that the unsophisticated judges in other courts couldn't either. And if the other judges couldn't determine feasibility, why didn't the other judges have a refiling problem?

When UCLA released our study in July 2000, Delaware's bankruptcy business was booming. That year, 45 large public companies chose the Delaware court for their bankruptcies, bringing the total number since 1990 to 136. Delaware's system for processing big cases was the envy of most other courts. When the clerk of some other court got his or her first big case, that clerk often called Delaware's clerk, David Bird, for advice.

Delaware's two bankruptcy judges were highly respected and among the most experienced in the world in large public company bankruptcies. Only a few judges in New York had done as many cases. When a judge in one of the other courts drew a large public company bankruptcy, it was usually the judge's first and rarely more than the judge's third. Other court judges were amateurs. The amateurs simply couldn't be doing a better job than the pros. There had to be some other explanation for the refilings.

Delaware's Defenses

Delaware's defenders accepted as axiomatic that the high refiling rates could not be the fault of the court. As Harvey Miller argued: "The similarity of recidivism rates in these two sophisticated jurisdictions [Delaware and New York] indicates that it is not the bankruptcy court that is the cause of subsequent failures . . . ."[26] Defenders offered several speculations as to what might be.

Professor Douglas Baird of the University of Chicago Law School suggested that the high refiling rate might not be a "Delaware or New York effect" but merely a "Balick/Lifland effect."[27] Others echoed that view.[28] The evidence, however, provided no support: Delaware's other bankruptcy judge, Peter J. Walsh, completed six cases during the 1991–96 period, and four of

them later refiled. (The four were Morrison Knudsen [2001, as Washington Group], Memorex [1994], Grand Union [1994], and Westmoreland Coal [1995].) On the face of it, his record was worse than Judge Balick's.

Some argued that the Delaware and New York courts were running higher failure rates because they were trying to rescue companies that other courts would have left for dead. This argument found similarly little support in the data. Including all cases filed and disposed of from January 1, 1990, through December 31, 1996, only 30 of 38 large public companies that filed in Delaware (79 percent) emerged; whereas 99 of 117 that filed in other courts (85 percent) emerged. This difference in rates was not statistically significant. Nevertheless, it suggested that Delaware filers were not only more likely to fail *after* their reorganization, they were also more likely to be liquidated *during* their reorganization. A larger percentage of Delaware-reorganizing companies was failing during the bankruptcy case, and then a larger percentage was failing afterward.

Perhaps the most brazen argument put forth on Delaware's behalf was that Delaware's refilings were not failures but merely the unfortunate, inevitable by-product of smart risk taking. Thus University of California, Berkeley, law professor Jesse Fried, in commenting on a draft of our paper, said: "I'm not sure that prepacks should be counted as bankruptcy filings for your purpose because they are essentially cheap, out-of-court workouts. There seems to be little cost . . . and so what is the big deal if they fail?"[29] Putting the same point more formally, Vanderbilt University law professors Robert K. Rasmussen and Randall S. Thomas wrote:

> [The] second reorganization proceeding [following a prepack] should not be considered a failure of the first bankruptcy proceeding. The first proceeding was designed to separate out those firms that need a full-blown Chapter 11 proceeding from those that do not. . . . The fact that a full-blown Chapter 11 proceeding follows a prepackaged bankruptcy cannot thus be viewed as a failure of the system.[30]

That argument, however, came almost exclusively from academics; practitioners rarely made it. The one exception I was able to find appeared in an article in *Bankruptcy Court Decisions* (*BCD*). The article quoted a "well-known New York bankruptcy attorney" (who had requested anonymity) saying essentially what Fried, Rasmussen, and Thomas had said. But Michelle Johnson, author of the *BCD* article, added that "most turnaround professionals are completely outraged at an answer like that."[31] ("Turnaround professionals" are managers who specialize in bankrupt or near-bankrupt companies. They manage during the crisis and leave when it is over.) Johnson went on to quote Bettina Whyte of Alix Partners—a leading bankruptcy turnround firm—saying "I think [refiling is] a crime practically. All the money spent on the first bankruptcy is lost. The morale and confidence of people is lost. The reputation and brand name, especially the consumer name, is lost. Vendors are very hesitant the second time around . . . . The chances of a company getting out [of bankruptcy] a second time are substantially reduced."[32]

The losses companies suffer as a result of failed prepacks are substantial. In response to Rasmussen and Thomas's argument I did a small study to estimate those losses. The study included all nine companies that had by that time emerged from Delaware reorganization as public companies and refiled. (All of the refilings were within five years of plan confirmation in the initial case.) For each, I determined the amount of the operating losses reported for the period between bankruptcies—after confirmation but before the filing of the second petition. Those operating losses averaged 18 percent of the entire value of the company as reported on the company's last financial statement prior to the first filing. Operating losses are generally hard cash, and prepetition financial statements generally overvalue the companies' assets, so the 18 percent figure is a very conservative estimate of the losses that occurred between bankruptcies. For the five prepacks included in the study the average operating loss was even higher: 23 percent. To calculate the losses from failed reorganization one would also have to add the

cost of the additional bankruptcy. Refiling was far too expensive to be efficient.[33]

Three other possibilities that might have exculpated Delaware could not be so easily dismissed. First, prominent Phoenix bankruptcy attorney Tom Salerno argued that lower refiling rates in other courts did not mean those other courts had lower failure rates. The failed reorganizations from other courts, he proposed, might be more likely to be resolved in out-of-court workouts or liquidations, rather than in returns to the bankruptcy courts.

Second, several commentators asserted that the companies filing in Delaware and New York were bigger, more complicated, or otherwise more difficult to reorganize, making a higher refiling rate for those companies understandable.

Third, Professors Rasmussen and Thomas argued that because Delaware cases were faster, they were probably cheaper. The savings on professional fees in the larger number of cases that didn't result in refiling might be more than enough to offset the business losses on the few that did. I was skeptical, but without some data on the magnitude of professional fees I couldn't be sure.

My article with Kalin was published in the March 2001 issue of the *Vanderbilt Law Review*. The issue included two replies. One was by Professors Rasmussen and Thomas, the other by Professor David Skeel of the University of Pennsylvania Law School. In their replies, the three raised many of the issues just discussed. The issue also included a response in which I argued some of the points Rasmussen, Thomas, and Skeel had raised and agreed that others would require further research. By the time that issue was published, I was already well along on a follow-up study.

The Follow-up Study

The follow-up study focused on two of Delaware's potential defenses: (1) that refiling rates did not adequately reflect failure rates and (2) that Delaware had higher refiling rates only because the companies filing there were more difficult to reorganize.

Because this follow-up study would require sophisticated regression analysis, I invited Joseph W. Doherty, the associate director of the UCLA Law School's Empirical Research Group, to join me as a coinvestigator.

For the follow-up study, we narrowed the group of companies examined to those that were public after bankruptcy as well as before. Public companies must disclose their financial statements; private companies seldom do. Examining only public companies would mean that we could consider more possible explanations because we would have more information on each company. Narrowing the study to public companies emerging from 1991 to 1996 reduced the number of cases from 188 in the first study to 98 in the second. Of those 98 companies, 26 had reorganized in Delaware, 16 in New York, and 56 in other courts. More companies would have been better, but the 98 included every large public company that reorganized in the United States during the relevant period and remained a public company after reorganization.

The follow-up study had another advantage over the initial study. By the time we stopped collecting data for the follow-up study, each of the reorganized companies had been out of bankruptcy for at least five years. By counting only refilings that occurred in the first five years (later refilings were less likely the fault of the court) we could eliminate the methodological problems that came from comparing failure rates for firms that had been out for different lengths of time. Together, these changes in method brought the pattern of reorganization failure into sharper focus.

The follow-up study showed that the differences in refiling rates were even greater than Kalin and I had reported. Of the 26 large public companies emerging from Delaware reorganization, Doherty and I found that 11 (42 percent) had refiled within five years. The corresponding figures were three of 16 (19 percent) for New York and two of 56 (4 percent) for other courts. Companies reorganized in Delaware had refiled at more than ten times the rate for companies reorganized in other courts. These differences in

refiling rates were statistically significant at the .001 level, meaning there was less than one chance in 1,000 that so big a difference in filing rates would have occurred by chance.[34]

To investigate Tom Salerno's assertion that other court reorganizations failed without producing refilings, we looked at what happened to each of the 98 emerging companies in the five-year period after confirmation. We found that 28 of the companies (29 percent) had been absorbed into other companies by merger or simply liquidated. The liquidations were clearly failures. The mergers, however, included some that should be considered failures—mere sales of the assets of businesses that were unable to continue operations—along with others that should be considered successes. To achieve a rough separation of the two kinds of mergers, we calculated the total income of the company between its emergence from bankruptcy and its merger. If the income was positive, we classified the reorganization as a success; if it was negative—the company had lost money for the entire period from bankruptcy to merger—we classified it as a failure. Based on these classifications, we counted six of Delaware's 26 reorganizations (24 percent) as resulting in complete business failure within five years after reorganization. The corresponding failure rate for New York–reorganized companies was about the same: four of 16 (25 percent) failed. But among companies reorganized in other courts, only seven of 56 (13 percent) failed. Delaware and New York reorganizations were nearly twice as likely to result in complete business failure as were reorganizations in other courts.[35]

Some reorganized companies refiled without completely failing; others completely failed without refiling. To get a comprehensive picture of reorganization failure, we counted the numbers of companies that refiled or completely failed in the five years after bankruptcy. We found that 14 of the 26 Delaware reorganizations failed (54 percent). The corresponding figures for New York and other courts were five of 16 (31 percent) and eight of 56 (14 percent). Delaware reorganizations were almost four times as likely to fail as reorganizations in other courts.[36]

As a fourth measure of failure, we calculated the average annual earnings of each emerging company in the five years after bank-

ruptcy. The average of those averages, for all firms emerging from Delaware reorganization, was a 9 percent loss. For New York the corresponding figure was a 3 percent loss; for other courts it was a 1 percent profit. Delaware-reorganized companies were failing at least in part because their business losses—unlike the business losses of companies reorganized in other courts—continued after their reorganizations were complete.[37] (See table 6.)

From these data Joe and I concluded that Delaware reorganizations did not merely result in more refilings, they also resulted in more reorganization failure. No matter how one measured failure, Delaware had more of it than other courts. A lot more.

Joe and I then turned to the second defense of Delaware—that the court had higher failure rates because it got the hardest cases. The defenders—mostly bankruptcy lawyers who did cases in Delaware and New York—argued that the Delaware and New York cases were harder because the companies were larger and the cases more complex. Harvey Miller, for example, wrote that the "higher percentages of recidivism may be attributed to the complex and sophisticated Chapter 11 cases that gravitate toward Delaware and New York"[38]

To the extent that the argument was based on company size, it was easily refuted. The companies reorganizing in Delaware were larger than those reorganizing in other courts. Lumping the Delaware companies together with those reorganizing in New York, the difference was even statistically significant. But until we

TABLE 6. Failure Rates by Court, Large Public Companies Emerging 1991–96

	Delaware	New York	Other courts
Refilings	11 (42%)	3 (19%)	2 (4%)
Business failures	6 (24%)	4 (25%)	7 (13%)
Reorganization failures	14 (54%)	5 (31%)	8 (14%)
Earnings	–9%	–3%	1%
Number of cases for this court	26	16	56

Source: Lynn M. LoPucki and Joseph W. Doherty, "Why Are Delaware and New York Bankruptcy Reorganizations Failing?" 55 *Vanderbilt Law Review* (2002): 1933–85, at 1939, 1942, 1944, 1945.

published our initial study showing higher failure rates in Delaware and New York reorganizations, nobody had ever argued that big companies were harder to save than small ones. Numerous studies had shown just the opposite: plan confirmation rates for small companies were in the neighborhood of 20 percent to 35 percent, while plan confirmation rates for large companies exceeded 90 percent.[39]

Because we were comparing relatively large companies in other courts with even larger companies in Delaware and New York, and studying refiling (long-term success) rather than confirmation (short-term success), our study differed from the confirmation rate studies. But among the 98 cases in our study, measuring size six different ways—by assets, sales, or numbers of employees, each before and after bankruptcy—Joe and I found no relationship between size and propensity to fail in the five years after reorganization.[40] Contrary to the premise underlying the size argument, larger companies were not harder to reorganize successfully.

The claim that Delaware and New York cases were more complex than those in other courts was more difficult to investigate. Of the commentators who raised the issue, only Professor Skeel made any attempt to define "complex." "The firms that file for bankruptcy in Delaware," he said, "may have more complicated capital structures—such as more classes of debt and stock—than firms that take their cases elsewhere."[41] To investigate the claim, Joe and I counted the number of separate classes of debt and stock in each of the 98 reorganization plans.

The results were startling. Instead of the greater complexity of Delaware and New York plans on which Skeel had premised his argument, we found significantly less complexity. Delaware and New York reorganizations averaged 12.6 and 15.5 classes per plan, respectively, while other court reorganizations averaged 17.7 classes per plan.[42]

Professor Barry Adler of the NYU Law School would later argue that because proximity to the court was a more important advantage in complex cases, debtors took only the simpler cases to Delaware and New York.[43] Although that assertion is consistent

with some of the evidence—for example, prepacks were simpler and prepacks went disproportionately to Delaware—Joe and I did not think it likely that the larger firms reorganizing in Delaware and New York had simpler capital structures than the smaller firms reorganizing in other courts. Instead, we concluded that the numbers of classes in plans of reorganization was probably not so much a measure of capital structure complexity as simply a measure of plan complexity. The professionals in other courts were drafting more complex plans, and more complex plans were more likely to succeed.[44] Even if the professionals in Delaware and New York were reorganizing more complex companies, they were not conducting more complex reorganizations.

In the follow-up study, we also investigated the possibility that the companies filing in Delaware and New York were in worse financial condition than those reorganizing elsewhere. In all, we tested eight different measures of company financial distress in the period immediately before bankruptcy. They included the companies' ratios of debts to assets (adjusted for industry and unadjusted), the companies' profits or losses during the one-year and five-year periods immediately prior to bankruptcy (including, as separate measures, operating profits or losses), and the companies' declines in profits or losses from the average of the five years before bankruptcy to the year before bankruptcy (including, as a separate measure, operating profits or losses). By none of these measures were the financial conditions of the firms filing in Delaware and New York significantly different from those of the firms filing in other courts. Finally, we looked for particular industries that had high failure rates and that might have been reorganizing disproportionately in Delaware and New York. We found none. If Delaware and New York were getting sicker or harder-to-reorganize companies, it was not showing up in any of these measures.

Nor did it appear from the data that sicker companies were harder to reorganize. That is, post-reorganization failure rates were not higher among the companies that had been sickest prior to bankruptcy. This finding may seem counterintuitive, but it makes perfectly good sense once one understands a little about the

reorganization process. The financial condition of a company coming out of bankruptcy bears no necessary relationship to the financial condition of the company going in. Reorganization can change anything or everything about the company. For large public companies, bankruptcy reorganization is essentially surrender of the company to its creditors. The creditors own the stock of the emerging company and can cause the company to owe them as much or as little of the prepetition debt as they choose. Only when they choose an amount the company can't pay does refiling become likely. No good reason exists for a company to emerge with more debt than it can pay.

Lack of profitability is a bigger problem but still not one that necessarily takes any great business acumen to solve. Most large companies are engaged in several businesses, offering multiple products and services. Bankruptcy allows the company to keep what is good about its business and shed the rest. Most companies can be rescued simply by getting rid of the bad businesses and product lines while keeping the good ones. That is a substantial part of what happens in reorganization. As a result, companies on average shrink by about 20 percent to 25 percent during reorganization. Because the reorganizing business can jettison its problems, the size of those problems often does not matter. Even if the business is entirely bad and can't be fixed, the parties can avoid a later refiling or plan failure—and the accompanying losses—by liquidating the business in the first bankruptcy. Reorganizing businesses don't have to commit to any more than they can do. When they do, it is nearly always the result of miscalculation or control by someone with nothing to lose in any subsequent failure.

In summary, the Delaware- and New York–reorganizing companies were bigger, but bigger companies didn't fail more often after reorganization. The confirmed plans for Delaware- and New York–reorganizing companies were actually simpler than the plans of companies reorganizing in other courts. The Delaware- and New York–reorganizing companies were not sicker than those filing in other courts, and even if they had been, it wouldn't have justified higher refiling rates. The reorganizations of sicker companies weren't more likely to fail. In short, the causes of the high fail-

ure rates for Delaware- and New York–reorganizing companies were not in the companies. They were in the courts.

In a separate study conducted later, Joe and I tested the assertion made by Professors Rasmussen, Thomas, and Skeel that because Delaware was reorganizing firms faster, it was reorganizing them more cheaply. On the basis of actual fees and expenses approved by the courts in 48 cases, Joe and I found that despite Delaware's speed, the cost of reorganizing a company in Delaware was slightly higher than the cost of reorganizing it elsewhere.[45] (The difference was not statistically significant.) Delaware's cost advantage could not justify its higher refiling rates because Delaware had no cost advantage.

Why Were Delaware and New York Reorganizations Failing?

The companies choosing Delaware or New York reorganization were not different from the companies choosing other court reorganization at the time they went into bankruptcy. They were, however, different by the time they came out. The most important difference was that companies emerging from other courts had generally solved their profitability problems; companies emerging from Delaware or New York had not.

The follow-up study did not tell us what practices caused Delaware's high refiling rates, but it did offer some clues. First, Delaware processes cases faster than other jurisdictions; we found that speed was associated with failure. Prepacks were significantly more likely to fail than nonprepacks, and even controlling for whether the case was prepackaged, faster reorganizations were more likely to fail than slower ones. In practical terms, our regression model predicted that a firm whose bankruptcy lasted 100 days had a 44 percent chance of failing, a bankruptcy that lasted 200 days had a 31 percent chance of failing, and a bankruptcy that lasted 500 days had only an 18 percent chance of failing.[46] Delaware had high failure rates in part because it processed cases too quickly.

Second, Delaware's plans were significantly simpler than plans

in other courts, and simpler plans were significantly more likely to fail than complex ones. That simplicity itself caused failure does not seem plausible. More likely, simplicity correlated with some other factor—such as a less-than-thorough negotiation between the debtor and its various classes of creditors—that was capable of causing failure.

From the data it appears that if the Delaware-reorganized companies had filed in other courts, many more of them would have survived. Court competition was not merely eroding the integrity of the courts, it was actually destroying companies.

Reaction to the Follow-up Study

In February 2002, Professor Robert K. Rasmussen convened a conference at the Vanderbilt Law School titled "Convergence on Delaware: Corporate Bankruptcy and Corporate Governance." I presented the follow-up study at that conference. Most of the leading bankruptcy academics in the United States were in attendance. They listened to my presentation and found no fault with the study. But when I spoke with individuals afterward, I found few convinced that Delaware was the problem.

The academics began with a firm conviction that markets work—particularly in big bankruptcies where sophisticated clients were represented by even more sophisticated professionals. The companies' choice of Delaware proved Delaware "efficient." If Delaware's outcomes were worse in some respect, they had to be better in some other even more important respect we had not yet discovered. Essentially, the academics were rejecting our empirical findings because they conflicted with their theories.

"It Changed since Then"

In listing the possible responses to social science empirical research earlier in this chapter, I left one out. Even a study that records human behavior perfectly becomes obsolete when that behavior changes. Because there are no limits on how quickly human behav-

ior can change, any study of it can be met with a seat-of-the-pants rejoinder that "it changed since then."

A study of the causes of reorganization failure is particularly vulnerable to this defense because failure is not immediate. The refiling curve defined by Sara Kalin's data and depicted in figure 4 shows that bad reorganizations take about two to seven years to manifest in refilings or distressed mergers. To reach reliable conclusions, researchers must follow the companies for three to five years at a minimum.

Joe and I were able to release our five-year study within a few months after the last cohort of cases reached that age. That our findings were almost as up-to-date as possible did not, of course, exempt us from the "it changed since then" defense. By the time we released our study, five to 11 years had elapsed since the deeds that sowed the seeds of reorganization failure in those 98 companies. In the meantime, 58 more bankrupt companies had emerged and the large majority of them had not yet failed.

Defenders of Delaware and New York sometimes concede that those two courts had problems in the past, but they insist that the problems have been fixed. Near the end of a lengthy discussion I had with a prominent bankruptcy lawyer, the lawyer reluctantly conceded that the Delaware bankruptcy court confirmed bad plans in the period 1991–96. But the lawyer ended the interview by assuring me that the problem had been solved and so I was "just writing a history book." My response, of course, is that any book based on facts is, to that extent, necessarily just a history book.

The Bankruptcy Research Database (BRD) is my effort to deal with the argument that "it changed since then." I continuously update the BRD data (and make them available online). The BRD makes it possible to rerun studies as often as necessary to keep them up-to-date.

Table 7 shows the latest five-year refiling rates I could calculate in time for inclusion in this book. The first line of data in that table reproduces the five-year refiling rates reported earlier in this chapter for firms emerging during the years 1991 through 1996. The next four lines show the five-year refiling rates for firms emerging as

public companies for each year from 1997 through 2000. The last line of that table combines the five-year refiling rates for firms emerging from 1997 through 2000. Comparison of the rates in the first and last lines of that table show that refiling rates have increased from the earlier period. (The increase will ultimately be greater than shown here because the firms emerging from bankruptcy in 1999 and 2000 had not yet had a full five years in which to refile when this book went to press.)

For Delaware, which already had high refiling rates, the increase was slight—from 42 percent to 46 percent. For New York and other courts, which had relatively low refiling rates in the earlier period, the increase was huge. New York's refiling rate went from 19 percent to 67 percent; the other courts' refiling rates went from 4 percent to 46 percent.

The difference in New York's refiling rates for the two periods is significant at the .107 level, which means there is about a 10.7 percent chance that so great a change would occur between the two periods even if refilings were distributed randomly among years. The difference in other courts' refiling rates for the two periods is significant at the .001 level, which means there is less than one chance in a thousand that so great a change would occur between the two periods if refilings were distributed randomly among years. The likelihood of the two changes occurring in tandem is far lower than the likelihood of each. *Something* must have caused these sudden, simultaneous changes at the end of 1996. Yet Congress made

TABLE 7. Refiling Rates for Public Companies Emerging 1997–2000

	Delaware			New York			Other Courts		
	Emerged	Refiled	%	Emerged	Refiled	%	Emerged	Refiled	%
1991–96	26	11	42	16	3	19	56	2	4
1997	6	2	33	3	2	67	4	2	67
1998	2	1	50	1	1	100	2	1	50
1999	8	5	63	2	1	50	2	0	0
2000	8	3	38	0			5	3	60
1997–2000	24	11	46	6	4	67	13	6	46

Source: Data from Lynn M. LoPucki's Bankruptcy Research Database.

no change in the bankruptcy laws during the relevant period and the courts handed down no major bankruptcy decisions.

From 1996 to 2001, initial bankruptcy filings by large, public companies increased sharply and steadily—from 17 to 97 (nearly six-fold). From 1997 to 2002, almost the same period, refilings increased sharply and steadily—from 1.6 percent of the companies that could have refiled in 1997 to 18.8 percent of the companies that could have refiled in 2002 (nearly twelve-fold). That near-coincidence might suggest that both increases were driven by general economic conditions, not court competition. But general economic conditions cannot explain either (1) why 78 percent of the increase in initial filings had occurred by the end of 2000, while the U.S. economy was still healthy, or (2) why Delaware's refiling rate would remain steady while the refiling rates for other courts increased sharply.

The similar movement of initial filing and refiling rates during this period seems more likely to have resulted from the effect of court competition on both rates. That is, the competition may have drawn companies into bankruptcy that would not otherwise have filed. For example, section 363 sale cases account for a substantial portion of the increase in initial filings. Some of the companies conducting those sales might not have filed at all but for the courts' increased willingness to approve 363 sales on short notice without adequate disclosure.

The refiling pattern shown in table 7 is consistent with court competition as the principal cause of high refiling rates. Delaware was an active competitor for cases from 1991 through 1996. During those years Delaware had high refiling rates. New York and other courts barely participated in the competition from 1991 through 1996. They had relatively low refiling rates during those years. The competition for big cases became the center of the bankruptcy world's attention in late 1996 and early 1997 with the coincidence of four major events. In June 1996, the National Bankruptcy Review Commission released its recommendation to end forum shopping. That year, Delaware obtained a near monopoly on big cases filings. In January 1997 the Federal Judicial Center released its

bombshell study and Judge Farnan revoked the reference in Delaware. That quick succession of events focused the bankruptcy world's attention on the loss of cases to Delaware. That attention resulted in increased pressure on the other courts to adopt Delaware's methods in order to match Delaware's attractiveness.

Delaware's high refiling rates remained undiscovered until mid-2000. The other courts probably copied Delaware's practices thinking they would reproduce Delaware's success. Instead, they reproduced Delaware's failure. Beginning abruptly with firms emerging in 1997, refiling rates in the rest of the country jumped to roughly the same level as refiling rates in Delaware. As Delaware responded by adopting changes of its own, the competition intensified, transformed the bankruptcy system, and ultimately corrupted additional courts. The human interaction that produced those changes is the subject of the next chapter; the changes themselves are the subject of chapter 6.