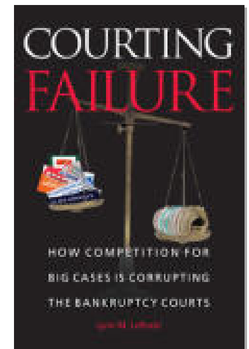
5. The Competition Goes National



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The Competition Goes National

> We are not lobbying to host a political convention or be the site for the Olympic Games. We are a federal court administering the laws of the United States as set out in the bankruptcy code.
>
> —Miami bankruptcy judge Robert A. Mark (2000)

> Without any discussion of interim fees, your court will have difficulty getting the big cases—in fact, you may make it impossible for big cases to file in your court.
>
> —Pittsburgh bankruptcy judge Judith K. Fitzgerald (2003)

Through most of the 1980s, the other courts (i.e., all courts other than Delaware and New York) got about 70 percent of the big cases. That percentage dipped a little as Delaware began attracting cases and then from 1993 to 1995 plunged to under 40 percent. There it remained.

Not only was the Delaware court taking cases from other courts, the Delaware and New York lawyers were taking cases from the lawyers in the rest of the United States. The dispossessed lawyers' initial reaction was to cry foul. Many backed the National Bankruptcy Review Commission's condemnation of forum shopping, applauded the revocation of the reference in Delaware, and waited for Congress to rescue them.

As described in chapter 3, that rescue failed to materialize. Delaware senator Joseph Biden engineered the omission of venue reform from the omnibus bankruptcy bill introduced in Congress the following year, and by 1998, it was clear that bankruptcy venue reform was dead.

The Competition Heats Up

Although beaten in Washington, the other court lawyers were not ready to give up. In nearly every major city, the bankruptcy lawyers, individually or as a group, approached their local judges to ask for changes in the courts' practices to make the local court competitive with Delaware. For the reasons described in the introduction, the judges in many cities were willing to do whatever they could.

The bankruptcy bars of cities such as Dallas, Chicago, and Houston had been hurt the worst by the sudden migration of cases. Those cities are headquarters to many big companies and had substantial bankruptcy bars in part because their bankruptcy courts had hosted big cases in the past (see table 8). Even with the freedom given them under the 1978 venue statute, companies still had lots of reasons for filing in their local courts. Typically, their regular legal and financial advisers are in the companies' home cities. Their executives and other employees are integrated into the local communities, making local officials particularly sensitive to the loss of jobs,

TABLE 8. Corporate Headquarters

Major City Courts with the Most Bankrupt Company Headquarters (1980–2004)		Major City Courts with Few Bankrupt Company Headquarters (1980–2004)	
City	Number of Companies	City	Number of Companies
New York	46	Philadelpia	8
Dallas	37	Cleveland	8
Chicago	35	Baltimore	6
Houston	34	San Diego	6
Los Angeles	25	Pittsburgh	5
Boston	24	Washington, DC	3
Denver	20	New Orleans	3
Newark	17	Nashville	3
Detroit	17	Minneapolis	3
St. Louis	16	Seattle	3
Alexandria, VA	13	San Antonio, TX	1
Atlanta	13	Buffalo	1

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

tax revenues, and business activity that might result from failure of a reorganization attempt. The home court is usually the most convenient for executives who may be required to participate personally in the bankruptcy case. Even though large public companies could file virtually anywhere they chose, over the past ten years 36 percent filed in the company's headquarters city. For the bankruptcy court of the company's home city, the case was its to lose.

Companies tend to have their homes in the largest cites, but as table 8 shows, the correlation between city size and numbers of bankrupt company headquarters is far from perfect. As more companies fled to Delaware and New York for their bankruptcies, the courts in the cities on the left side of table 8 tended to come under the heaviest pressure. While no empirical measure of these pressures exists, the pressures probably began to build as soon as the outflow of cases to Delaware became noticeable in early 1990s and accelerated once it became clear that Congress would not intervene.

Houston had been hit particularly hard by the competition. In 1999, Houston lawyers approached the Houston bankruptcy judges to complain about the city's losses to Delaware. The judges responded by requesting that the lawyers form a committee and formalize their recommendations for handling "complex" Chapter 11 cases.[1] ("Complexity" was merely a euphemism for big and lucrative; no court ever developed a method of determining complexity apart from company size.)

Eleven lawyers served on the Houston "Advisory Committee on Chapter 11 Issues."[2] When the committee reported, it asked the judges for several procedural changes in essentially two categories. First, the lawyers wanted quicker hearings, at more predictable times. Second, the lawyers wanted the local judges to award professional fees at rates comparable to those in Delaware and New York.

The judges issued new local rules providing for the designation of cases as "Complex Chapter 11 cases" and giving them certain priorities in scheduling. But the agenda was clearly much broader. Introducing the new rules at a January 26, 2000, bankruptcy bar luncheon, Houston bankruptcy judge William R. Greendyke told

the assembled lawyers: "This is the sound bite. The war on fees is over."[3]

Houston was probably the first city to go through this process. But over the next two years, substantially the same thing occurred in Boston, Dallas, Chicago, Los Angeles, Minneapolis, Baltimore, Miami, and other cities. In each city, individual members of the local bankruptcy bar or an official delegation from the local bankruptcy bar association approached the local bankruptcy judges to express their dismay over the flight of local bankrupt companies to Delaware. In each city, the lawyers asked for the judges' help in dealing with the problem. In some—including Minneapolis and Chicago—the process included the preparation and submission of a written report. In some cities, judges actively participated in developing ideas for change. In Chicago, for example, the chief judge of the bankruptcy court convened a focus group that studied the "perceived loss of potential Chicago Chapter 11 Cases to Delaware."[4] In others they left development to the lawyers. But in nearly every city, the judges acknowledged problems and indicated their concern. In most cities, the judges' response included at least some changes to the local rules of court. In all or nearly all of the cities, the focus was expressly on the loss of cases to Delaware.

The rule changes differed from city to city. New York and Los Angeles committed by rule to match the Delaware practices that enabled companies with prepackaged cases to get in and out of bankruptcy in just over 30 days.[5] Courts that had not yet done so adopted the Delaware practice of paying fees at 30-day intervals rather than the customary interval of 120 days strongly suggested by section 331 of the Bankruptcy Code. (Section 331 provides that "any professional person . . . may apply to the court not more than once every 120 days . . . or more often if the court permits, for such compensation for services rendered. . . .") New York, Los Angeles, Houston, Dallas, Miami, Maryland, and Minnesota adopted new rules regarding first-day orders.

By October 2003, the process of organizing the bar and lobbying the judges to adopt megacase rules competitive with Delaware had been so routinized that an entire panel was devoted to the subject

at the Annual Meeting of the National Conference of Bankruptcy Judges.[6]

The courts claimed they made these changes because each was the right thing to do. As one put it: "I don't see us as competing with any other court at all. What we're trying to do is be the best court we can."[7] The changes, they claimed, would smooth procedures, make fee practices fairer, and make bankruptcy more efficient.

The courts' claims lacked credibility because the Bankruptcy Code and Rules had remained essentially the same for nearly two decades. The courts would have us believe they coincidentally discovered these long-standing needs at the same time they faced a competitive challenge from Delaware. Were we really supposed to believe that the competition had nothing to do with these changes?

The courts that proceeded by local rule changes were limited in what they could expressly commit to do. Local rules can deal only with matters of procedure not already addressed by the national rules. The things Delaware was doing to attract cases—approving high professional fees and executive retention bonuses, releasing those professionals and executives from liability for wrongdoing, approving sales of businesses without following plan procedures, and the like—were nearly all contrary to the code and the national rules. Courts could not commit by local rule to match Delaware on these kinds of issues. But the rule changes courts could make stood as symbols of the courts' willingness to bend to the necessities of the marketplace on substantive issues as well. Their court, the lawyers could boast, had adopted complex case rules. Their court was willing to play the game.

In the five-year period from 1998 through 2002, the world of big-case bankruptcy experienced an unprecedented boom. The number of filings nationally went from 17 in 1997 to 97 in 2001. The number of new filings fell in 2002, but that year seven of the 13 largest filers in history chose bankruptcy courts: Worldcom, Conseco, Global Crossing, United Airlines, Adelphia Communications, NTL, and Kmart. As more and bigger companies filed, the world of big-case bankruptcy was like a lottery in which anybody with a

ticket could win. The local court's willingness to compete was the bankruptcy professional's ticket.

Meanwhile, Back in Delaware . . .

The years 1998 and 1999 were good years in Delaware bankruptcy practice. The increases in filings brought huge amounts of business to Delaware, giving Delaware bankruptcy lawyers more work than they could handle. Delaware firms expanded their bankruptcy departments, and bankruptcy firms from outside Delaware opened Delaware offices. In January 2000, the Los Angeles–based bankruptcy boutique Pachulski, Stang, Ziehl & Young announced that it was opening a Delaware office and that Laura Davis Jones, the highest profile bankruptcy lawyer in Delaware, would head it. Later that year, Florida-based Zuckerman, Spaeder hired bankruptcy attorney Thomas G. Macauley away from Skadden Arps's Delaware office to open its own Delaware office. Philadelphia-based Buchanan, Ingersoll followed in 2001. Wilmington office space was at a premium, and reservations at the luxurious duPont Hotel two blocks from the bankruptcy court were hard to get.

In 2000, Delaware got 45 of the 79 cases filed nationally (57 percent). In those 45 cases alone, the Delaware bankruptcy court would award over $700 million in professional fees and expenses.[8] Considering the fees and expenses of parties to the bankruptcy case not entitled to reimbursement through the court, the total professional fees and expenses in these 45 cases easily topped $1 billion. To put these fees in perspective, were they distributed pro rata to the residents of Delaware, each would be receiving $1,250 a year.

Of course, the money did not all stay in Delaware. Most of it went to professionals based in other states, who traveled to Delaware for hearings. But everyone involved knew that the longer the big bankruptcy cases continued to go to Delaware, the larger would be the percentages of fees sticking with Delaware professionals. In the early 1990s, lawyers from New York and other cities brought the cases to Delaware. The young Delaware bankruptcy lawyers such as Jim Patton; Laura Davis Jones; Thomas L. Ambro;

Gregg Galardi; William H. Sudell, Jr.; Mark D. Collins; and Anthony Clark served as local counsel. They sat in court, learned the ropes, and got paid for their time. But the lawyers from out of town were in charge of the cases and got nearly all the fees. In 1999, firms with offices in Delaware were lead counsel on some representations, but 76 percent of the fees awarded by the Delaware bankruptcy court were still going to out-of-state lawyers. In early 2003 Laura Davis Jones claimed that 75 percent of Pachulski, Stang's bankruptcy work in Delaware "was of the lead counsel variety."[9] Jones's statistic probably exaggerated the rapidity of the shift of business to Delaware-based lawyers, but the shift was certainly occurring. If the Delaware court could continue to attract the cases, Delaware bankruptcy professionals would eventually dominate the field.

Delaware's biggest problem was a shortage of judges and courtrooms. Congress awarded Delaware its second permanent bankruptcy judge in 1993, a year when four large public companies filed in Delaware. In 2000, 11 times that many large public companies filed in Delaware, but the number of permanent judges had not changed. Delaware's tiny court was drowning in its own success.

In the early years of that success, the Judicial Conference of the United States had refused to authorize additional judges for Delaware. Bankruptcy judges are generally awarded on the basis of caseloads, and on that basis Delaware's entitlement to more judges had been clear. But the Judicial Conference had ignored Delaware's numbers, claiming that Delaware's need was temporary. By 1999, however, the Judicial Conference could no longer maintain that fiction. It recommended increasing the number of permanent judges in Delaware from two to three.[10]

The Judicial Conference appears to be deeply divided over the court competition. At its June 2001 meeting, the Judicial Conference Committee on the Administration of the Bankruptcy System (the "Bankruptcy Committee") approved a recommendation that would have required debtors to file in their local bankruptcy courts and ended the forum shopping.[11] The Bankruptcy Committee placed the recommendation on the discussion calendar for the Sep-

tember 2001 meeting of the Judicial Conference. Then the Bankruptcy Committee mysteriously withdrew the recommendation without explanation. In 2002, the Judicial Conference recommended four additional bankruptcy judges for Delaware.[12] Through its Subcommittee on Venue-Related Matters, the Bankruptcy Committee then began working instead on a set of "best practices" with respect to the flurry of rule changes that was occurring. In June 2004, the subcommittee released the best practices report and recommended that the Bankruptcy Committee "reiterate its support for additional judicial resources in Delaware."[13]

The Judicial Conference's 2002 recommendation was to authorize a total of 36 new bankruptcy judgeships nationwide.[14] Knowing that senators and representatives from the areas slated to receive new judges would strongly support the authorizing legislation, congressional leaders decided to channel that support to a problem of their own. At the behest of banks and the consumer finance lobby, the congressional leaders were pushing an unpopular "omnibus" bankruptcy bill designed to make bankruptcy more difficult for consumer debtors. To increase support for the omnibus bill among reluctant rank and file members of Congress, congressional leaders were forcing any popular piece of legislation related to bankruptcy to be included in the omnibus bill. The judgeships bill was perhaps the most popular, so the congressional leaders included it. From 1999 to 2004, the omnibus bankruptcy bill continued to teeter on the edge of adoption, each time falling back. Delaware's new bankruptcy judges were held hostage to the omnibus bill, leaving the Delaware bankruptcy court to deal with the burgeoning caseload on its own.

Delaware used several strategies to cope with the problem. First, since Judge Farnan withdrew the reference effective February 1997, Delaware district judges had been handling some of the cases. Second, Delaware wrote to each of the more than 300 bankruptcy judges throughout the United States asking them to come to Delaware as "visiting judges." More than a half dozen responded by coming to Delaware to help out in their "spare" time. (The

Administrative Office of the U.S. Courts did not relieve the volunteers from any portion of their caseloads at home.) Third, the Delaware court began transferring some of its smaller megacases to other courts. Fourth, the Delaware court began assigning some of its megacases to judges from neighboring states who would do them as Delaware cases.[15] The Delaware court preferred such assignments to transfers because the assigned cases would continue to be counted as part of Delaware's caseload in computing the number of bankruptcy judgeships to which Delaware was entitled.

Even with these drastic measures in place, Delaware was losing ground. Debtors were having to wait longer to get hearings with the court, and the march of cases through the Delaware bankruptcy process was slowing. In 2001, for the first time since 1991, Delaware ended the year with more big bankruptcies pending than had been filed in the entire year. The slowing of Delaware's dockets began to show up in the exit statistics that same year (see table 9).

TABLE 9. Filings, Backlog, and Days from Filing to Confirmation in Delaware

	Cases Filed during Year	Cases Pending Dec. 31	Length of Non-prepackaged (listed in confirmation year)			Length of Prepackaged (listed in confirmation year)		
			Mean, in Days	Median, in Days	Number of Cases	Mean, in Days	Median, in Days	Number of Cases
1990	2	2			0			0
1991	4	5	286	286	1			0
1992	6	5	399	448	3	37	36	3
1993	5	3	415	302	5	38	38	2
1994	4	1			0	38	36	6
1995	9	6	611	139	3			0
1996	13	9	257	203	5	66	67	4
1997	8	7	435	448	8	37	37	2
1998	13	13	263	248	5	53	53	2
1999	28	20	420	319	16	70	79	4
2000	45	42	280	170	18	43	37	3
2001	41	52	456	415	30			0
2002	25	36	433	469	32	286	46	3
2003	17	23	557	425	23	53	51	3

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

Two, Three, Many Delawares

The clogging of the Delaware bankruptcy court in 2001 coincided with the efforts of other bankruptcy courts to attract cases. New York was the first to benefit. From 2000 to 2002, New York's market share rose from 6 percent to 26 percent. Delaware still attracted a larger number of big cases in those years. But among the very largest bankrupt companies—Enron, Worldcom, Global Crossing, Adelphia, and NTL—New York had become the court of choice.

New York was not, however, the only court gaining market share during this period. Through the decades of the 1980s and 1990s, the Chicago bankruptcy court had a total of only seven big public company bankruptcies. In July 2000, Susan Pierson Sonderby, then the chief judge of Chicago's bankruptcy court, commissioned a focus group "to discuss why Chicago lawyers want to travel to Delaware or New York, when we think we have an excellent reputation."[16] The focus group reported back that the Chicago court was doing a great job and merely suffered from "misperceptions." The court made some cosmetic rule changes, and in October 2000, the big cases began rolling in. In a period of 27 months, Chicago got 14 big public company cases—twice as many as in the preceding 20 years. They included some giants: Kmart, United Airlines, Conseco, National Steel, and Comdisco. Six of the 14—including Kmart—were forum shops to Chicago by companies headquartered elsewhere.

The explanation given by Daniel R. Murray, a bankruptcy lawyer with Chicago's Jenner & Block, was typical.

> This is definitely not a coincidence. Large cases like Conseco, UAL, and Kmart don't just end up in any court by accident. . . . The number one reason for Chicago seeing these big Chapter 11 cases is simple: Chicago is an attractive venue.
>
> For one thing, the courts in Chicago are readily available, with 10 bankruptcy judges at a time when many courts are suffering a judge shortage. . . . Hearings in Chicago move quickly and the judges are highly qualified. It is these factors primarily that have contributed to the shift of complex Chapter 11 cases from Delaware to Chicago.[17]

Murray's benign explanation, however, runs afoul of two nasty facts. First, even during Chicago's amazing 27-month run, as many large public companies were shopping out of Chicago as were shopping in (six). Chicago was merely holding its own. Second, Chicago's run ended in December 2002, without any change in the factors Murray cites in his explanation. Not a single big bankrupt shopped into Chicago in 2003 or the first half of 2004. Of the three Chicago companies filing bankruptcy during that period, two shopped out.[18]

Attracting big bankruptcy cases takes more than good judges in ample supply. The lawyers and executives who choose venues for large public companies—the case placers—are hard-nosed businesspeople. They know they have something valuable to offer: tens or hundreds of millions of dollars of business for local bankruptcy practitioners. They expect something in return: advantages their bankruptcy courts at home would not give them. They know they cannot get a binding commitment. The placement of a megabankruptcy case is a transaction that must be done on trust. But among repeat players, trust is possible even without honor.

The case placers place their trust along with their case. The court chosen is one they believe will reciprocate. If a court does not reciprocate, neither the lawyers nor the executives can do much about it in that case. But future lawyers and executives can take their cases elsewhere. The Delaware bankruptcy community understands this; Delaware was in the trust business long before the first big bankruptcy case arrived. In comparison, the Chicago bankruptcy community was naive.

In 2003, the Chicago bankruptcy court failed to deliver on two matters of trust in two very high profile cases. First, the executives of Conseco came to Chicago expecting releases from personal liability for their own wrongdoing. Some creditors objected to the releases,[19] but Conseco bought the objectors' approval by increasing the amounts the objectors' class would receive under the plan.[20] In other courts, the resulting lack of objection would have guaranteed confirmation. But Chicago's U.S. trustee pursued the objections the creditors had dropped, and Chicago bankruptcy judge

Carol Doyle refused to confirm the plan while the releases remained in it.[21] The U.S. trustee and the judge were doing the right thing, but it wasn't the competitive thing. Shortly after filing the Conseco case in December 2002, debtor's counsel James Sprayregan had said he expected Conseco to be out of bankruptcy no later than by the end of June.[22] Judge Doyle did not confirm the plan until September.

Chicago's second failure was the reversal on appeal of the critical vendor order in the city's most prominent case, Kmart.[23] (Critical vendor orders are discussed in more detail in the next chapter.) The Chicago court's reluctance to approve critical vendor orders had been cited in the Chicago focus group report as one of the reasons debtors preferred Delaware to Chicago.

Susan Pierson Sonderby—the Chicago judge who had commissioned the Chicago focus group report—was the judge on the Kmart case. The critical vendor order she entered was a whopper. It authorized a $300 million slush fund from which Kmart could immediately begin paying prepetition debts owing to "critical vendors" selected by Kmart's top managers.[24] (The money would come out of the entitlements of other, less fortunate unsecured creditors who were not selected for special treatment.)

But on appeal, the Chicago District Court reversed the bankruptcy court's decision, saying that *all* critical vendor payments violated the Bankruptcy Code and strongly implying that the bankruptcy court should order return of the money.[25] Kmart appealed to the Seventh Circuit Court of Appeals. While the appeal remained pending, Judge Sonderby refused to order the critical vendors to return Kmart's money. But the matter was already beyond her control. In February 2004, the Seventh Circuit agreed with the district court that the Kmart critical vendor order had been improper.[26] Kmart had trusted the Chicago bankruptcy system, and the Chicago bankruptcy system had not come through. To use the lawyers' favorite code word, Chicago lacked "predictability."

Chicago may or may not survive these failures. Pressure will continue for the Chicago judges to keep trying. The judges who

made the decisions in Conseco and Kmart have likely already felt the heat from Chicago boosters. Maybe next time they will give in. Maybe not. (District Judge Grady has life tenure.) But if the Chicago judges do not give in, other judges in other cities will. The cases will go there, Chicago bankruptcy practice will wither, and the corruption of the bankruptcy courts will continue unabated.