Chapter 11 Reorganization Cases and the Delaware Myth

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I. INTRODUCTION

Since the mid-1990s, there has been a spirited debate concerning the emergence of the United States Bankruptcy Court for the District of Delaware (the "Delaware Bankruptcy Court") as the virtual Chapter 11 capital for distressed debtor corporations. The "Delawarization" of corporate reorganizations under title 11 of the United States Code (the "Bankruptcy Code"), which occurred during the 1990s as a result of the migration of Chapter 11 cases of large enterprises from other venues to Delaware, has provoked a stream of academic articles debating the consequences of Delaware's emergence. Armed with statistics purporting to demonstrate a high rate of recidivism among debtors reorganized under Chapter 11 in Delaware, critics have alleged that the Delaware Bankruptcy Court hurriedly confirms nonfeasible plans of reorganization in an attempt to attract more attorneys

* The author gratefully acknowledges the dedicated assistance of his associates Shai Y. Waisman and Craig E. Johnson and the access to the online WebBRD database of Professor Lynn M. LoPucki.

to bring their Chapter 11 cases to that court.[1] These critics have propagated a myth that there is something fundamentally wrong, perhaps even reckless, with the reorganization process as it is practiced by the Delaware Bankruptcy Court.[2]

To the contrary, a statistical review of the Chapter 11 cases filed in Delaware during the 1990s and an examination of the present state of corporate reorganizations reveal that the cause of Chapter 11 recidivism is not choice of venue, but other more substantive and fundamental defects in the reorganization process. Despite the bankruptcy court's ideal responsibility to confirm a plan only if "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor,"[3] the bankruptcy court, like all other trial courts, is in reality dependent upon the parties presenting the necessary facts to enable the court to apply the law. The bankruptcy court does not possess the resources or the capacity to undertake an independent financial and operational analysis of a plan's feasibility. In judging the feasibility of the proposed reorganization, as required by the Bankruptcy Code, the bankruptcy court is a captive of the principal parties (e.g., the debtor, the creditors' committee, and the secured creditors) and the professionals retained by the parties. The court must rely on the parties to present the relevant facts.

The recidivism related to the Delaware cases, to the extent that it truly exists, is not caused by the Delaware Bankruptcy Court. Rather, the reorganization failure rate for cases confirmed by the Delaware Bankruptcy Court is caused by factors that lie beyond the scope of the influence of Delaware bankruptcy judges. To understand the recidivism rate, reference must be made to the nature of the cases commenced in that district, the diminution of the debtor's bargaining power to craft a feasible plan of reorganization, and external influences, including the rise of distressed debt trading—sometimes referred to as "vulture investing."

Part II of this Article examines the legal tradition of venue selection. Choosing the most favorable venue in which to commence a case is one of the responsibilities that an attorney owes his client. In the context of a Chapter 11 reorganization, the Delaware Bankruptcy

1. *See* Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND L. REV. 231, 264 (2001) (stating that "a part of Delaware's appeal was its willingness to confirm no-questions-asked reorganizations").

2. *See id.* at 233 (describing Delaware as one of the "worst" jurisdictions in which to reorganize).

3. 11 U.S.C. § 1129(a)(11) (2000).

Court offers a large corporate debtor the critical elements of efficiency, accessibility, sophistication, and predictability. Part III of this Article analyzes the rate of recidivism among large, publicly owned corporations commencing Chapter 11 cases in Delaware between January 1, 1990 and June 30, 2001, and compares it with other jurisdictions. The statistics reveal that Delaware's recidivism rate is consistent with that of the other prominent Chapter 11 venue: the Southern District of New York. Part IV examines a bankruptcy court's limited ability to uncover and reject a nonfeasible reorganization plan. Part IV then explains how the diminution of the debtor's bargaining power relative to its creditors and outside pressures, such as the rise of distressed debt trading, further hinders the development of feasible plans of reorganization and limits the ability of the bankruptcy court to recognize potentially defective plans. Part V examines the rise of distressed debt trading and its effect upon the reorganization process. Finally, this Article concludes by examining Delaware's future as the venue of choice for the commencement of Chapter 11 cases.

II. DELAWARE AS THE VENUE OF CHOICE FOR DISTRESSED DEBTOR CORPORATIONS

A. Tradition of Venue Selection

At the outset of a legal case, criminal or civil, an attorney must make a number of strategic determinations. Because procedural and substantive law will vary from jurisdiction to jurisdiction, one of the most significant determinations an attorney will make is the choice of forum. Describing the importance of forum selection, one litigator stated,

> Choice of forum can mean joyous victory or depressing defeat. A wrong selection and it's enemy territory: a jurisdiction where the prevailing law, available remedies, courtroom procedures, and juror attitudes are inimical to your client. A correct choice and, as Don Corleone once said, "They will fear you."[4]

Although "forum-shopping" has slipped into the legal vernacular as a derogatory term, it is rightfully pursued by attorneys, including attorneys for the federal government, in the interests of their clients. Failure to select the most available and favorable venue may violate an attorney's responsibilities to the client.

Venue selection occurs in almost every legal context. For example, plaintiffs' attorneys resort to venues like Alabama to commence personal injury cases, because there is a precedent in Alabama

4. Gita F. Rothschild, *Forum Shopping*, 1998 A.B.A. SEC. LITIG. REP. 40, 40.

of favorable jury awards.[5] Many patent attorneys seek to have their cases litigated in Delaware because it has the most developed patent law.[6] Even the United States government is not above forum-shopping. The United States Attorney General commenced the government's criminal antitrust suit against General Electric for conspiring with a competitor to raise prices for industrial diamonds in the Southern District of Ohio,[7] because that particular district has a markedly higher conviction rate than other jurisdictions. Practitioners strive for predictability because it enables the accelerated determination of issues and reduces the costs and expenses associated with judicial proceedings.

Because reorganizations are governed by both substantive principles and procedural rules that may vary from jurisdiction to jurisdiction, debtors typically will seek the most favorable venue to accomplish their reorganizations. When selecting a venue for a Chapter 11 case, a debtor must consider that court's past experiences and performances in administering Chapter 11 cases of comparable size and/or complexity as well as the court's disposition of issues similar to those expected to arise. For example, once the first health care provider commenced a Chapter 11 case in Delaware, other distressed health care providers followed because they had the benefit of knowing how the Delaware Bankruptcy Court ruled on certain issues and the comfort that the court understood, or at least had experience with, their very complex industry, organizational structures, and payment systems.[8] Such considerations are integral to a bankruptcy reorganization, because it is not a simple adversarial contest, but rather a panorama of socioeconomic and legal problems. Thurman Arnold, a

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5. *See* R. Bruce Dold, *Out of the Ordinary; the Civil Justice Courts Need Some Sense of Proportion; The Lawyers Get Richer and the Public Gets Poorer with Blockbuster Windfalls in the Courtrooms*, CHI. TRIB., Mar. 5, 1999, at 27, *available at* 1999 WL 2849917 (stating that Alabama juries have a reputation for granting large damage awards). *But see* David Firestone, *Alabama Acts to Limit Huge Awards by Juries*, N.Y. TIMES, June 2, 1999, at A16, *available at* 1999 WL 30485847 (reporting that Alabama's legislature passed a bill to limit the punitive damages awarded by juries, because Alabama juries have a tendency to award huge damages).

6. *See* Kimberly A. Moore, *Forum-Shopping in Patent Cases: Does Geographic Choice Affect Innovation?*, 83 J. PAT. & TRADEMARK OFF. SOC'Y 558, 568 (2001).

7. *See* United States v. Gen. Elec. Co., 869 F. Supp. 1285, 1288 (S.D. Ohio 1994).

8. *See* William H. Sudell, Jr. & Eric D. Schwartz, *What's Going on in Delaware?*, 8 AM. BANKR. INST. L. REV. 107, 107 (2000) (labeling Delaware a "hotbed" for health care bankruptcy filings). In 1998, FPA Medical Management, Inc. was the first major health care provider to commence a Chapter 11 case in Delaware, and it was followed by Vencor, Inc.; Sun Healthcare Group, Inc.; Lenox Healthcare Group, Inc.; Mariner Health Group, Inc.; Mariner Post-Acute Network, Inc.; and Integrated Health Services, Inc. *Id.* FPA Medical Management Inc.'s pleadings provided a model for all subsequent health care cases in Delaware. *Id.*

former head of the United States Justice Department's Antitrust Division, once described a corporate reorganization as

> [A] combination of a municipal election, a historical pageant, an antivice crusade, a graduate-school seminar, a judicial proceeding, and a series of horse trades, all rolled into one—thoroughly buttered with learning and frosted with distinguished names. Here the union of law and economics is celebrated by one of the wildest orgies in intellectual history. Men work all night preparing endless documents in answer to other endless documents, which other men read in order to make solemn arguments.[9]

Much in the same manner that Delaware has become the primary interpreter of corporate law principles because many corporations are incorporated under Delaware law and these corporations and their adversaries choose to litigate their disputes in the Delaware courts rather than in the state where the corporate headquarters or assets are located, the Delaware Bankruptcy Court has developed a body of law, services, and accessibility that is attractive to practitioners protecting their clients' interests. The judiciary's developing expertise and knowledge facilitates the presentation and administration of cases. Often, this benefits the parties in terms of expedition, economy, and the resolution of issues.

B. Delaware's Rise as the Chapter 11 Capital

During the 1980s, the United States Bankruptcy Court for the Southern District of New York (the "New York Bankruptcy Court") was the leading venue for large, publicly owned corporations to commence reorganizations. In 1990, Continental Airlines, Inc. commenced its Chapter 11 case in Delaware, marking the beginning of Delaware's ascent as the Chapter 11 capital of the United States.[10]

The Continental Airlines case was significant for two reasons. First, it offered the Delaware Bankruptcy Court experience with a large, complex Chapter 11 case. From this experience, Delaware began to develop a recognized expertise that attracted additional Chapter 11 cases.[11] Because large Chapter 11 cases are complex and time is almost always of the essence, court expertise is a critical decisionmaking

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9. THURMAN ARNOLD, THE FOLKLORE OF CAPITALISM 230 (1937).

10. Ad Hoc Comm. of CTA Bondholders v. Cont'l Airlines, Inc. (*In re* Cont'l Airlines), C.A. No. 93-252-SLR, 1995 U.S. Dist. LEXIS 22119, at *1 (Bankr. D. Del. Mar. 16, 1995). Case numbers 90-932 to 90-984, filed on December 3, 1990. This was Continental Airlines' second Chapter 11 filing. Continental Airlines' first Chapter 11 reorganization was commenced in the United States Bankruptcy Court for the Southern District of Texas, Houston Division, on September 24, 1983. Cont'l Airlines Corp. v. Nat'l Mediation Bd., 40 B.R. 299, 301 (Bankr. S.D. Tex. 1984).

11. *See* Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1373 (2000) (noting that Judge Helen Balick handled the Continental case proficiently and, in doing so, earned a reputation as being both accessible and pro-debtor).

factor for Chapter 11 debtors. An entity's first days of Chapter 11 may determine the success or failure of the reorganization effort. A court's lack of experience in dealing with the disposition of a debtor's initial needs may irrevocably impair the debtor's ability to reorganize.

Second, in the Continental Airlines case, the Delaware Bankruptcy Court confirmed its earlier decision that a corporation may, notwithstanding the location of its principal place of business, commence a bankruptcy case in the state in which it is incorporated.[12] Because Delaware is the most popular state of incorporation, it instantly became a viable bankruptcy venue for corporations throughout the United States.

Since the Continental Airlines reorganization, numerous large debtors have selected Delaware as a venue to reorganize, including Genesis Health Ventures; Integrated Health Services, Inc.; Armstrong World Industries, Inc.; Safety Kleen Corp.; Edison Brothers Stores, Inc.; Trans World Airlines, Inc.; Bruno's, Inc.; Montgomery Ward Holdings Corp.; W.R. Grace & Co.; Polaroid Corp.; Winstar Communications, Inc.; ANC Rental Corp.; USG Corp.; Burlington Industries, Inc.; United Artists Theatre Company; Owens Corning, Inc.; Federal-Mogul Corp.; Finova Group, Inc.; and Sun Healthcare Group, Inc. By the mid-1990s, professionals representing distressed debtors recognized that Delaware offered great accessibility, efficiency, sophistication, and predictability—elements of vital importance to large Chapter 11 debtors.

A large, corporate debtor commencing a Chapter 11 case in a venue that did not offer the same benefits proceeded at its own risk.[13]

C. Delaware as a Venue for Reorganization

Delaware offers an efficient forum in which to reorganize. A reorganization depends upon an entity's ability to continue to operate. For a debtor with anxious employees and skeptical vendors, commencing a bankruptcy case is a hazardous proposition. Employees might refuse to work if they believe wages and benefits will not be paid. Vendors might stop supplying the debtor if they believe the debtor will not be able to pay its obligations. Therefore, it is vital for a debtor commencing a Chapter 11 case to be in a bankruptcy court that recognizes the need to approve "first-day motions," which, among other things,

12. *See generally In re* Ocean Props. of Del., Inc., 95 B.R. 304, 305 (Bankr. D. Del. 1988).

13. *See, e.g.*, David E. Rovella, *Bankruptcy Beauty Contest*, DAILY DEAL, Sept. 6, 2001, *available at* 2001 WL 25882316 (recounting the story of a Texas bankruptcy attorney who described the filing of a Chapter 11 petition in the Southern District of Texas as being "tantamount to malpractice").

provide the hope for a seamless transition into formal reorganization on as much of a "business as usual" basis as possible and relieve the immediate concerns of employees and vendors. The Delaware Bankruptcy Court promptly hears first-day motions and disposes of them expeditiously. Moreover, not only are the first-day motions often heard on the first day, but Delaware bankruptcy judges are also often willing to work late into the night to accommodate the debtor's needs and enable the debtor to issue communications to inform and calm employees, vendors, and customers on a reasonably contemporaneous basis. For a debtor in the financial turmoil of bankruptcy, having its first-day motions, including the often very important interim financing, considered and resolved may make a material difference in the ability to reorganize:

> The experience with Continental Airlines caused other practitioners to carefully consider their clients' best interests in selecting a venue for future filings, since what occurred with Continental became something that no other Bankruptcy Court seemed interested in offering. That "something" was a willingness—up front—to offer a supportive procedural environment that permitted businesses with thousands of employees worrying about their next paycheck and terrified customers worrying about the company's ability to deliver product on time—to know that these legitimate concerns would be addressed by the Bankruptcy Court promptly and predictably.[14]

A bankruptcy court that is not familiar with the problems inherent in large, complex Chapter 11 cases might delay or otherwise defer the resolution of initial proceedings without realizing the negative impact of this delay on the ability to stabilize the debtor.

Delaware also offers accessibility to the court. Chapter 11, from one perspective, involves crisis management, and, for entities in a crisis, access to the court may be the linchpin of survival. Delaware's bankruptcy judges make themselves available at almost any time. Emergency hearings are scheduled through the judges' courtroom deputies, rather than the clerk's office, allowing parties to schedule hearings quickly.[15]

In addition, the corporate law expertise rooted in Delaware provides a venue with a keen understanding of business and finance; this expertise, in turn, expedites the determination of issues in which Chapter 11 debtors often find themselves entangled.[16] Thus, in responding to issues posed by imaginative and novel business models and financing arrangements, the Delaware Bankruptcy Court has

14. Mark E. Felger & Jerrold N. Poslusny, Jr., *Corporate-Friendly Delaware is the Venue of Choice for Business Bankruptcies*, METRO. CORP. COUNS., Mar. 2001, at 44, *available at* www.lexis.com.

15. *Id.*

16. *See id.*; *see also Interview with New NCBJ President Judith K. Fitzgerald*, 20 AM. BANKR. INST. J. 1, 28 (2001).

been flexible in letting parties develop new and innovative settlements to complex cases.[17]

Finally, Delaware offers a debtor predictability.[18] According to one commentator, "[a]mong bankruptcy lawyers, [predictability] is the ultimate consideration when deciding which federal court best suits a corporate client seeking protection from creditors."[19] Until 1993, the Delaware Bankruptcy Court was a one-judge court. Even after a second judge was added, the two judges were fairly consistent in their rulings.[20] A two-judge court is in a good position to offer consistency and predictability, both procedurally and substantively, because although courts with more judges may institute procedural consistency, there is no guarantee that there would be consistency in their substantive rulings.[21]

Until 1997, corporations commencing Chapter 11 cases in Delaware could be assigned to one of two bankruptcy judges, unlike, for example, in the Southern District of New York, where a debtor could receive any one of eleven judges. However, in 1997, the Chief Judge for the United States District Court for the District of Delaware withdrew the order automatically referring Chapter 11 cases to bankruptcy judges.[22] As a result, Delaware's United States District Judges began to administer Chapter 11 cases. Once Delaware ceased offering the predictability associated with having only two judges, the percentage of large, publicly owned corporations selecting Delaware for venue purposes decreased, from 87% in 1996 to 50% in 1997, and to 43% in 1998.[23] In 1999, the percentage rose again to 65%, and it has lingered around 50% since that year.[24] On September 6, 2001, the automatic

17. Felger & Poslusny, *supra* note 14.

18. *See* Rasmussen & Thomas, *supra* note 11, at 1373 (citing James Agger, *Delaware Bankruptcy Order Unsettles Local Practitioners*, LEGAL INTELLIGENCER, Jan. 28, 1997, at 1 ("By having only two bankruptcy judges, there was an element of predictability in terms of how a case would be handled.")).

19. David E. Rovella, *Texas Leads a Charge to Dethrone Delaware's Bankruptcy Supremacy: Texas Changes Rules in Bankruptcy Case*, BUS. CREDIT, Oct. 1, 2001, at 69, *available at* 2001 WL 12570555.

20. *See* Rasmussen & Thomas, *supra* note 11, at 1373.

21. *See Interview with New NCBJ President Judith K. Fitzgerald*, *supra* note 16, at 28.

22. *See* Order Regarding Referral of Title 11 Proceeding to the United States Bankruptcy Judges for This District (D. Del. Jan. 23, 1997), *reprinted in Delaware District Court Withdraws the Reference in Chapter 11 Cases*, BANKR. CT. DEC. (LRP), Feb. 4, 1997 at A1, A8.

23. These statistics were compiled using Lynn M. LoPucki, *Bankruptcy Research Database* WebBRD [hereinafter WebBRD], *at* http://lawlibfs.lawlib.ucla.edu/LoPucki/query1.asp (last visited Sept. 12, 2002).

24. *Id.*

referral of Chapter 11 cases to bankruptcy judges was reinstated in Delaware.[25]

Closely related to predictability is familiarity. The attorneys representing large Chapter 11 debtors have established credibility with the judges in Delaware.[26] Similarly, these attorneys are familiar with the judges' tendencies and can prepare their cases accordingly.

D. Challenges to Venue-Shopping and Its Benefits

Despite the fact that Delaware developed a specialized expertise for reorganizing large Chapter 11 debtors, critics of Delaware have clamored for changes to the Bankruptcy Code that would prohibit corporate debtors from selecting a venue based solely on the debtor's state of incorporation. The National Bankruptcy Review Commission proposed such a change to Congress in 1997. It was argued that the use of the state of incorporation for Delaware venue purposes prejudices creditors due to the inconvenience of traveling long distances to attend court hearings or to review court records. Nevertheless, the Delaware State Bar Association noted that the creditors in many large cases are widely dispersed and outside the debtor's principal place of business.[27] Generally, creditors in a large Delaware Chapter 11 case are located all over the United States and often all over the world. They would not be any more inconvenienced by coming to Delaware than by traveling to a different jurisdiction. In fact, it may actually benefit creditors to develop a familiarity with one court.

Moreover, creditors are not without alternatives when a debtor selects the Delaware venue. A creditor may move in the Delaware Bankruptcy Court to transfer the case to a more appropriate venue.[28] In May 2001, the Delaware Bankruptcy Court transferred the Pathnet Telecommunications, Inc. Chapter 11 case from Delaware to the East-

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25. *See In re* Referral of Title 11 Proceedings to the United States Bankruptcy Judges for This District (D. Del. Sept. 6, 2001) (declaring that the automatic reference would become effective October 6, 2001).

26. Felger & Poslusny, *supra* note 14.

27. *See* Leslie R. Masterson, *Forum Shopping in Business Bankruptcy: An Examination of Chapter 11 Cases*, 16 BANKR. DEV. J. 65, 69 (1999) (citing *Report of the Delaware State Bar Association in Support of Maintaining Existing Venue Choices*, NAT'L BANKR. REVIEW COMM'N, app. D-3 (Oct. 20, 1997), *available at* http://govinfo.library.unt.edu/nbrc/report/d3.pdf (last visited Sept. 12, 2002)). Beyond the Delaware Bar Association, perhaps the greatest obstacle to any venue change in the Bankruptcy Code is Senator Joseph Biden of Delaware. Senator Biden sits on the committee that controls bankruptcy legislation in the Senate and opposes any prohibition on using state of incorporation as a filing venue.

28. 28 U.S.C. § 1412 (2000).

ern District of Virginia.[29] Two of Pathnet's large creditors, Nortel Networks Corp. and Cisco Systems Capital Corp., requested a change of venue because most of Pathnet's creditors were located in the Virginia, Washington D.C., and suburban Maryland corridor. In addition, the overwhelming number of cases filed in Delaware might have prevented the Pathnet bankruptcy from receiving proper attention.[30] The Delaware Bankruptcy Court found the facts convincing and ordered the transfer of venue to Virginia.[31] Additionally, in December 2001, the Delaware Bankruptcy Court transferred the United Petroleum Corp. Chapter 11 case to the Southern District of Florida, and one month later, it transferred the Global Technovations, Inc. Chapter 11 case to the Eastern District of Michigan.[32]

Finally, despite its negative connotations, venue-shopping might encourage better practices by all courts. Venue-shopping appears to lead to competition among courts, and competition breeds more effective procedures and techniques.[33] Delaware's success in attracting Chapter 11 cases has influenced other bankruptcy courts to develop and use effective and efficient procedures in dealing with complex Chapter 11 cases.[34]

III. THE STATISTICAL DATA

Critics of Delaware's status as a reorganization capital for large, publicly owned debtors have characterized Delaware as the winner in a "race to the bottom."[35] In *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* Professor Lynn LoPucki and Sara Kalin tracked 188 public companies that emerged from large bankruptcy reorganiza-

29. *In re* Pathnet Telecomms., Inc., No. 01-1223 (Bankr. D. Del. May 18, 2001).

30. *See* Marc Hopkins, *Court Transfers Pathnet Ch. 11 Case to Virginia from Delaware*, DOW JONES NEWSWIRES, May 18, 2001.

31. *In re* Pathnet Telecomms., Inc., No. 01-1223 (Bankr. D. Del. May 18, 2001).

32. *In re* Global Technovations, Inc., No. 01-11667 (Bankr. D. Del. Jan. 7, 2002) (order transferring venue); *In re* United Petroleum Corp., No. 99-88 (Bankr. D. Del. Dec. 14, 2001) (order transferring venue).

33. *See* Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 WIS. L. REV. 11, 16 (1991); Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283, 291 (2001) ("To the extent that there is a problem with forum selection, it is not that there are too many forums to choose from; rather, there are too few. . . . Competition is a good thing.").

34. *See* Rovella, *supra* note 19 (noting that the Southern District of Texas Bankruptcy Court adopted new local rules expediting the initial, "first-day" hearings for large, publicly owned debtors).

35. *See* LoPucki & Kalin, *supra* note 1, at 271.

tions in the United States from 1983 through 1996.[36] They found that the recidivism rate in Delaware, although similar to New York's rate, was six to seven times as high as the rate for companies reorganizing in other United States bankruptcy courts.[37] The authors alleged that Delaware attracts Chapter 11 cases by "applying lax standards for plan confirmation that lead to the excessive refiling rates."[38] LoPucki and Kalin concluded that, paradoxically, large public companies in need of bankruptcy reorganizations are flocking to the courts that are allegedly the least likely to reorganize them successfully.[39] They use Delaware's supposedly high rate of recidivism as evidence of that Court's supposed infirmity.

The LoPucki and Kalin theory is flawed. Relying on Professor LoPucki's electronic database,[40] I performed statistical studies of the large, publicly owned corporations that filed in the United States between January 1, 1990 and June 30, 2001 and reached conclusions different from LoPucki and Kalin. First, between January 1, 1990 and June 30, 2001, the percentage of entities to emerge from Chapter 11 with a confirmed plan in Delaware that later returned to Chapter 11 was lower than the percentage of entities to emerge from Chapter 11 with a confirmed plan in the Southern District of New York that later commenced sequential Chapter 11 cases.[41] Consistent failure rates in New York and Delaware, two venues that attract the most sophisticated and complex reorganizations, indict the reorganization process, not the courts. Second, eight of the thirteen entities that refiled in Delaware were prepackaged or prenegotiated bankruptcies.[42] Because a court plays only a minor role in prepackaged and prenegotiated cases, the purported failures of these reorganization cases can hardly be laid at the door of the Delaware Bankruptcy Court.

The results of the statistical studies are produced below in Tables 1 through 5. For the purposes of this study, a "large" corporation is one with assets having a value of $100 million in 1980 dollars.[43] A company is considered to have "emerged" from Chapter 11 when "a

36. *Id.* at 235.

37. *Id.*

38. *Id.* at 237.

39. *Id.* at 236.

40. *See* WebBRD, *supra* note 23, *at* http://lawlibfs.lawlib.ucla.edu/LoPucki/query1.asp (last visited Sept. 12, 2002).

41. *Id.*

42. Those that refiled and that were prepackaged or prenegotiated were: Cherokee, Inc.; Grand Union Company; Ithaca Industries, Inc.; Memorex Telex Corp./Memorex Telex N.V. (twice); Morrison Knudsen Corp.; SPI Holdings, Inc.; and Westmoreland Coal Co. *Id.*

43. *See* WebBRD, *supra* note 23, *at* http://lawlibfs.lawlib.ucla.edu/LoPucki/million.htm (last visited Sept. 12, 2002).

stand-alone company continued to operate after confirmation of the plan of reorganization. If the debtor was liquidated or acquired during bankruptcy or under the plan of reorganization, no company emerged."[44]

Table 1 compares the cases in Delaware with the cases in all other jurisdictions in the United States. Table 2 compares the cases in Delaware and in the Southern District of New York with the cases in all other jurisdictions. Tables 3, 4, and 5 factor in prepackaged and prenegotiated reorganizations.

Table 1
(for the period January 1, 1990 through June 30, 2001)

	All Bankruptcy Courts Except District of Delaware	District of Delaware
Total Chapter 11 filings	216	152
Cases still pending as of June 30, 2001	37	47
Cases where a company emerged with a confirmed plan	99	37
Percentage of total filings where the court confirmed a plan	46%	24%
Cases where a company emerged with a confirmed plan and later refiled	13	13
Percentage of cases where a company emerged with a confirmed plan and later refiled	13%	35%

As seen in Table 1, thirteen of the thirty-seven (35%) large, publicly owned entities that commenced Chapter 11 cases in Delaware between January 1, 1990 and June 30, 2001 emerged with a confirmed plan and later required additional debtor relief.[45] In contrast, thirteen of the ninety-nine (13%) large, publicly owned entities that commenced Chapter 11 cases in venues outside of Delaware between January 1, 1990 and June 30, 2001 emerged with a confirmed plan

44. *See* WebBRD, *supra* note 23, *at* http://lawlibfs.lawlib.ucla.edu/LoPucki/define.htm (last visited Sept. 12, 2002).

45. The following thirteen debtors filed in Delaware, emerged with confirmed plans, and thereafter filed sequential Chapter 11 cases, although not all of them in Delaware: Cherokee, Inc.; County Seat, Inc.; Edison Brothers Stores, Inc.; Grand Union Company; Harvard Industries, Inc.; Ithaca Industries, Inc.; Memorex Telex. Corp. (twice); Morrison Knudsen Corp.; SPI Holding, Inc.; Trans World Airlines, Inc.; United Merchants & Manufacturers Inc.; and Westmoreland Coal Co. *See id.*

and later returned to Chapter 11.[46] In this table, the ratio of refiling in Delaware is roughly three times that of all other jurisdictions.

Also, the number of entities to emerge with a confirmed plan as a percentage of the total filings in Delaware (24%) is substantially lower than the number of entities to emerge with a confirmed plan as a percentage of the total filings in all other jurisdictions (46%). This statistic could indicate that the Delaware Bankruptcy Court is more selective than all other jurisdictions in confirming Chapter 11 plans.

Table 2
(for the period January 1, 1990 through June 30, 2001)

	All Bankruptcy Courts Except Southern District of New York and District of Delaware	Southern District of New York[47]	District of Delaware
Total Chapter 11 filings	172	44	152
Cases still pending as of June 30, 2001	29	8	47
Cases where a company emerged with a confirmed plan	80	19	37
Percentage of total filings where the court confirmed a plan	46%	43%	24%
Cases where a company emerged with a confirmed plan and later refiled	6	7	13
Percentage of cases where a company emerged with a confirmed plan and later refiled	8%	37%	35%

Table 2 sets forth the same statistics but separates the Southern District of New York from the pool of all other jurisdictions. Delaware's percentage of entities emerging with confirmed plans and later refiling remains at 35%, but the percentage of refilings in all other jurisdictions minus the Southern District of New York drops to 8%. Delaware's percentage of refiling is therefore roughly five times greater than that of all other jurisdictions minus the Southern District of New York.

46. *See id.*

47. The Southern District of New York includes White Plains.

Notably, however, the percentage of refiling entities in Delaware is lower than the percentage of refiling entities in the Southern District of New York even during the period during which Delaware is considered to be the capital of corporate Chapter 11 cases. When compared to the Southern District of New York, Delaware appears to produce more successful Chapter 11 reorganizations.[48] The similarity of recidivism rates in these two sophisticated jurisdictions indicates that it is not the bankruptcy court that is the cause of subsequent failures, but rather the internal operating and financial problems that were either not cured prior to exiting from Chapter 11 or that arose postconfirmation from activities or events that may not have been contemplated at the time the entity emerged from Chapter 11.

A closer examination of the statistics reveals other important details about the cases filed in Delaware.

48. LoPucki and Kalin recognize a similar statistical consistency within the Southern District of New York. *See* LoPucki & Kalin, *supra* note 1 at 235. Further, LoPucki and Kalin found that ten of the thirty-one companies (32%) that reorganized in Delaware between 1983 and 1996 eventually refiled and that ten of the thirty-six companies (28%) that reorganized in the Southern District of New York between 1983 and 1996 also refiled. *Id.* at 248. Nevertheless, LoPucki and Kalin drew a distinction between Delaware and New York because Delaware's refilings had occurred more quickly following their emergence from Chapter 11. *Id.* Further comparing Delaware and the Southern District of New York, the Federal Judicial Conference conducted a study of seventy-seven companies that emerged from bankruptcy in 1994 and 1995. *See* Gordon Bermant et al., *Chapter 11 Venue Choice by Large Public Companies: Report to the Judicial Conference Committee on the Administration of the Bankruptcy System*, FED. JUD. CTR., 36-37 (1997). Seventeen cases were filed in Delaware with a median of thirty-eight days between filing and confirmation; eighteen cases were filed in the Southern District of New York with a median of 756 days between filing and confirmation; and forty-two cases were filed in the remaining districts with a median of 473 days between filing and confirmation. *Id.* Importantly, of the cases filed in Delaware, thirteen of the seventeen cases were confirmed in less than fifty days. *Id.* All of these cases, however, were prepackaged or prenegotiated. *Id.* In the Southern District of New York, the time between filing and confirmation ranged from fifty-three days to 5.9 years. *Id.* The authors of the FJC Report speculated that corporate debtors that wished for a speedy confirmation would file in Delaware, while those seeking a prolonged reorganization would file in the Southern District of New York. *See id.* at 38-39.

Table 3
(for the period January 1, 1990 through June 30, 2001)

	All Bankruptcy Courts Except Southern District of New York and District of Delaware	Southern District of New York	District of Delaware
Cases where a company emerged with a confirmed plan	80	19	37
Cases where a company emerged with a confirmed plan in a traditional reorganization and later refiled	5	6	5
Percentage of the total confirmed cases where a company emerged with a confirmed plan in a traditional reorganization and later refiled	6%	32%	14%

Significantly, only five of the thirteen entities that refiled in Delaware between 1990 and 2001 were traditional or "free fall" Chapter 11 cases.[49] The remaining eight cases were either prenegotiated or prepackaged reorganizations.[50] Once the failed prepackaged and prenegotiated reorganizations are removed from consideration, the instances of entities that emerged with a confirmed plan in Delaware and then later refiled drops to 14% as compared to the Southern District of New York, which remains at 32%, while all other jurisdictions have a 6% refiling rate. Removing prepackaged and prenegotiated reorganizations that refiled from consideration, the percentage of Delaware debtors emerging and later refiling decreases from five times that of all other jurisdictions minus the Southern District of New York, to a little over two times the percentage. Elimination of refiling prepackaged and prenegotiated reorganizations from the analysis is warranted, because in those cases, the bankruptcy court's role is substantially diminished.[51] The Chapter 11 plans in those cases are nego-

49. These five entities are County Seat, Inc.; Edison Brothers Stores, Inc.; Harvard Industries, Inc.; Trans World Airlines, Inc.; and United Merchants & Manufacturers, Inc.

50. Delaware attracts a greater percentage of prepackaged and prenegotiated Chapter 11s. Twenty-eight of the forty-five prenegotiated bankruptcies (62%) filed nationwide between January 1, 1990 and June 30, 2001 were filed in Delaware. Similarly, twenty-eight of the fifty prepackaged bankruptcies (56%) filed nationwide between January 1, 1990 and June 30, 2001 were filed in Delaware.

51. In their response to *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* Professors Robert K. Rasmussen and Randall

tiated prefiling, are consensual, and ordinarily do not present controversial proceedings. Rather, these cases are presented as the will and consensus of the parties that are the economic stakeholders. Therefore, if all parties are in agreement by the required statutory majorities, the court's function is to administer the case in the context that no party objects to confirmation.

Tables 4 and 5 divide the total cases where an entity emerged with a confirmed plan into two categories. Table 4 examines cases in which an entity emerged from a traditional reorganization with a confirmed plan and later refiled, while Table 5 examines cases in which an entity emerged with a confirmed plan pursuant to a prepackaged or prenegotiated reorganization and then later refiled.

S. Thomas contend that prepackaged reorganizations must be separated from traditional, "full-blown" Chapter 11 cases in order to assess accurately whether the choice of venue affects the success of the reorganization. *See* Rasmussen & Thomas, *supra* note 33, at 291.

We suspect that firms filing for prepackaged bankruptcy may differ significantly from firms filing a traditional Chapter 11 proceeding. This difference stems from the nature of the two proceedings. A prepackaged bankruptcy allows a firm to adjust its capital structure, but it is not a good vehicle for changing its operations. A full Chapter 11 proceeding, on the other hand, allows both an adjustment of capital structure and a revamping of operations. Thus, one would expect prepackaged bankruptcies to be initiated when the firm's managers believe that the firm may be experiencing only financial distress and not economic distress. If the managers conclude that the firm is facing both financial and economic distress, the better choice is to file for Chapter 11. To be sure, there is the possibility that a firm filing a prepackaged bankruptcy may in fact be facing economic distress as well. We would expect that these firms would subsequently file a second reorganization petition, this one for a traditional Chapter 11 proceeding. *Id.*

Table 4
(for the period January 1, 1990 through June 30, 2001)

	All Bankruptcy Courts Except Southern District of New York and District of Delaware	Southern District of New York	District of Delaware
Cases where a company emerged with a confirmed plan from a traditional reorganization	58	16	15
Cases where a company emerged with a confirmed plan from a traditional reorganization and later refiled	5	6	5
Percentage of cases where a company emerged with a confirmed plan from a traditional reorganization and later refiled	9%	38%	33%

Table 5
(for the period January 1, 1990 through June 30, 2001)

	All Bankruptcy Courts Except Southern District of New York and District of Delaware	Southern District of New York	District of Delaware
Cases where a company emerged with a confirmed prepackaged or prenegotiated plan	22	3	22
Cases where a company emerged with a confirmed prepackaged or prenegotiated plan and later refiled	1	1	8
Percentage of cases where a company emerged with a prepackaged or prenegotiated plan and later refiled	5%	33%	36%

As illustrated in Table 4, the rate of recidivism of entities reorganized in traditional Chapter 11 cases in Delaware is higher than the rate of recidivism for entities reorganized in traditional Chapter 11 cases in all other jurisdictions minus the Southern District of New York. Similarly, as depicted in Table 5, the recidivism of entities reorganized pursuant to prepackaged or prenegotiated plans in Delaware is also higher than the recidivism rate for companies reorganized pur-

suant to prepackaged or prenegotiated plans in all other jurisdictions minus the Southern District of New York.

This Article does not dispute 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. Nevertheless, as demonstrated in Tables 4 and 5, Delaware's percentages are very much consistent with the percentages of the Southern District of New York, the other venue attracting the larger, more complex, and difficult reorganization cases. Thus, higher percentages of recidivism may be attributed to the complex and sophisticated Chapter 11 cases that gravitate toward Delaware and New York. In addition, as this Article will further develop in Parts IV and V, these higher percentages of refilings are a result of certain inadequacies in the Bankruptcy Code and external pressures on the reorganization process, as opposed to shortcomings of the Delaware Bankruptcy Court.

The nature and type of the Chapter 11 cases commenced throughout the United States differ greatly as to size, complexity, and financial sophistication. All of these factors play at least some role in the propensity for the future need for further restructuring. Chapter 11 cases commenced in Delaware and New York prior to 2000 were larger and more complex than other Chapter 11 cases.

However, in their article *The Failure of Public Company Bankruptcies in Delaware and New York Revisited*, Professor LoPucki and Joseph Doherty conclude that there is no reason to believe that the large, publicly held corporations reorganizing in Delaware differ in ways that would make them more difficult to reorganize than corporations reorganizing elsewhere.[52] The authors examined eleven factors that they suspected might make corporations more difficult to reorganize. Eight of the eleven factors were measures of the reorganizing firms' levels of financial distress prior to their initial bankruptcy filing, including leverage before bankruptcy, abnormal leverage before bankruptcy, four measures of prebankruptcy earnings, and two measures of decline in earnings in the year prior to bankruptcy.[53] The remaining factors were size, complexity of capital structure, and industry.[54] The authors concluded:

> We identified only one prefiling characteristic that made a significant difference in firms' abilities to reorganize successfully: capital structure complexity. That relationship was weak and appears to run in the direction opposite that needed to explain Dela-

52. Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933, 1939-45 (2002).

53. *Id.* at 1946-5, 1955.

54. *Id.* at 1951-55.

> ware's high failure rates. The ten other characteristics we investigated appeared unrelated to failure. Thus, no difference in those characteristics between Delaware-reorganizing firms and Other Court–reorganizing firms could explain Delaware's higher refiling rates.[55]

LoPucki and Doherty, nonetheless, concede that firms reorganizing in Delaware and New York had significantly higher average prefiling sales and prefiling numbers of employees than firms reorganizing in other courts.[56] These two factors may demonstrate a certain operational complexity that evaded LoPucki and Doherty's statistical analysis and that supports the notion that there is something fundamentally different about the cases being reorganized in Delaware and New York in contrast to those being reorganized in other jurisdictions.

Moreover, sheer statistical analysis is meaningless without further researching the actual and specific causes of an entity's refiling. For example, the return to Chapter 11 by Continental Airlines in 1990 was not the result of a defective Chapter 11 plan in 1986. After the 1986 confirmation, and during an era of easy credit and economic growth, the reorganized Continental Airlines pursued a debt-financed expansion that involved the acquisition of People's Express, Frontier Airlines, and Eastern Airlines. With the onset of a recession, lower passenger revenues, and drastically increased fuel prices, Continental could not service its outstanding debt. This scenario illustrates that recidivism may be the result of external factors that occur after the successful emergence of an entity from Chapter 11 that could not have been anticipated at the time of plan confirmation.[57] There was nothing about Continental's first Chapter 11 plan that would have resulted in its subsequent need to seek a second reorganization, albeit as a business operation vastly different from the entity that emerged from the prior Chapter 11 case. Thus, LoPucki and Doherty have still failed to provide adequate explanations as to why companies refile—explanations that may have nothing to do with the Delaware Bankruptcy Court or, indeed, with the Chapter 11 process.

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55. *Id.* at 1956.

56. *Id.*

57. *See* Rasmussen & Thomas, *supra* note 33, at 301. A "reason a firm may refile is that it has experienced an external shock to its business. Even if a firm leaves bankruptcy with a sensible capital structure and healthy operations, it is not assured success. A sudden downturn in the sector, the rise of a new competitor, or a post-bankruptcy decision that turns out poorly can all result in a second bankruptcy proceeding involving the same firm." *Id.*

IV. OBSTACLES TO SUCCESSFUL REORGANIZATION

A. Limitations on the Bankruptcy Court's Power

Under Chapter 11, the debtor and its creditors largely determine the extent and mode of a debtor's reorganization. The Bankruptcy Code was designed to give the court a limited role. The Bankruptcy Reform Act of 1978 contemplated that the formulation of a plan of reorganization should be the result of negotiation among the parties holding the economic interests in the debtor. The bankruptcy judge was intended to determine cases and controversies—not to be involved in the administrative aspects of a Chapter 11 case. Thus, the court is not involved in the formulation of a plan of reorganization. Further, in prepackaged reorganizations, the bankruptcy court has little or no opportunity to influence the outcome of the case.

Although the Bankruptcy Code requires the court to assess the feasibility of a plan before it is confirmed,[58] in many cases the court has only limited authority, ability, resources, and expertise to make such a determination. Bankruptcy judges must rely on the parties to produce proof and evidence of their contentions. Bankruptcy judges are not investment bankers and may not possess the financial expertise or the independent resources to determine plan feasibility. If the debtor and the creditors support a plan, and there is no objection to confirmation, it is unlikely that a bankruptcy judge will deny confirmation. If the financial advisors for the debtor and the financial advisors for the creditors attest to a plan's feasibility based upon complex financial models, and no one challenges the advisors' conclusions, the court is all but incapable of mounting its own challenge. While the court may ask questions, it will not have had the opportunity to make, nor could it undertake, an independent analysis of the substantive provisions of a plan. In addition, the number of cases assigned to bankruptcy judges is a factor that precludes such a lengthy, independent analysis.[59]

A history of Chapter 11 reveals the legislative objective of diminishing judicial involvement in the administration of corporate reorganizations. The underlying concept of the 1978 Bankruptcy Reform Act was to leave the economics of reorganization to be resolved by negotiations between the debtor and its creditors outside the bankruptcy

58. 11 U.S.C. § 1129(a)(11) (2000).

59. The Administrative Office of the United States Courts in Washington, D.C. reported that for December 2000, the weighted caseload per bankruptcy judge in Delaware was 7,193 compared with the national average during the same month of 1,321. *See* Hopkins, *supra* note 30.

court. The precursors of modern Chapter 11 were Chapter X and Chapter XI of the Bankruptcy Act of 1898, added by the Chandler Act of 1938.[60] Chapter X, primarily drafted by the Securities and Exchange Commission ("SEC") under the leadership of the then-Chairman, William O. Douglas, was intended for the comprehensive reorganization of publicly owned corporations.[61] Chapter X provided for, among other things, the active involvement of the SEC, including its analysis of the feasibility of a proposed plan of reorganization; the mandatory appointment of one or more trustees if the noncontingent liquidated debt equaled or exceeded $250,000; the requirement that almost all substantive matters be determined by a United States district judge; the strict application of the "disinterestedness principle"; the exclusive right of the appointed reorganization trustee(s) to propose a plan of reorganization, unless the trustee filed a report as to why it would not file a plan; the limitation that only plans found worthy of consideration would be distributed for acceptance or rejection by parties entitled to vote; and the strict application of the absolute priority or fair and equitable rule.[62] The SEC's scrutiny provided a greater guarantee that nonfeasible plans would not be confirmed.[63] Beyond SEC approval, there were further checks on reorganizations under Chapter X. A reorganized entity was typically required to demonstrate feasibility via successful operations before it could emerge from Chapter X.[64] As a result, Chapter X cases tended to extend over many years.

Chapter XI, on the other hand, originally was designed for small businesses and was limited to arrangements of unsecured debts and liabilities.[65] Chapter XI provided that the debtor could continue to manage and operate its business and properties as a debtor-in-possession, although many bankruptcy courts appointed receivers; the debtor had the exclusive power to propose an arrangement; from 1952 the absolute priority rule did not apply in Chapter XI cases; and the SEC had no statutory role beyond the ability to move to convert a Chapter XI case to a case under Chapter X.[66]

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60. Harvey R. Miller & Jacqueline Marcus, *The Crumbling Debtor Leverage in Chapter 11 Cases—An Implementation or Perversion of the Bankruptcy Reform Act of 1978*, C371 ALI-ABA 105, 114-15 (May 4, 1989).

61. *Id.* at 114.

62. *Id.* at 114-15.

63. *Id.* at 115.

64. *Id.*

65. *Id.* at 117-18.

66. *Id.*

Many large, publicly owned debtors as well as creditors found Chapter X with its SEC scrutiny, mandatory trustee provision, and other rules, too rigid and too slow. Because no statutory language in the Chandler Act precluded large corporations from using Chapter XI, many public corporations found the ability to reorganize under Chapter XI attractive.[67] Nonetheless, the SEC possessed the authority to challenge a corporation's use of Chapter XI and often did. In the years following the Chandler Act, the SEC challenged attempts by publicly owned corporations to use Chapter XI. The Supreme Court's decision in *SEC v. United States Realty & Improvement Co.* appeared to limit resort to Chapter XI by publicly owned corporations.[68] Nevertheless, subsequent decisions opened the door to Chapter XI for publicly owned corporations if it could serve the needs of the debtor and its creditors. Accordingly, as business failures became larger and more sophisticated, imaginative and innovative lawyers devised means to expand the use of Chapter XI.[69] It became accepted that publicly owned corporations could invoke Chapter XI in an appropriate case, and by the 1960s and early 1970s, the use of Chapter XI to reorganize publicly owned firms was increasingly routine.[70] By the mid- to late 1970s, many large, publicly owned debtors had successfully reorganized under Chapter XI.[71] These success stories provided the drafters of the Bankruptcy Code with a mandate to eliminate the rigidities of Chapter X and enlarge the precepts and philosophy of Chapter XI into one comprehensive reorganization chapter.[72]

As a result, Chapter 11, as enacted, removed SEC oversight and scrutiny—particularly as to a proposed plan. Although Chapter 11 mandates a finding of feasibility, it does not provide an adequate means to enable an independent and thorough review in the absence of objections. A bankruptcy judge cannot perform such a review without specialized financial expertise, investigations, and appropriate resources.

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67. David A. Skeel, Jr., *An Evolutionary Theory of Corporate Law and Corporate Bankruptcy*, 51 VAND. L. REV. 1325, 1374 (1998).

68. *Id.* (citing SEC v. United States Realty & Improvement Co., 310 U.S. 434, 457-58 (1940)).

69. Miller & Marcus, *supra* note 60, at 118.

70. Skeel, *supra* note 67, at 1374-75; *see also* Paul F. Festersen, *Equitable Powers in Bankruptcy Rehabilitation: Protection of the Debtor and the Doomsday Principle*, 46 AM. BANKR. L.J. 311, 311-18 (1972).

71. Miller & Marcus, *supra* note 60, at 119-20 (citing United Merchs. & Mfrs., Inc., Case No. 77-B-1513, 1981 U.S. Dist. LEXIS 15874 (S.D.N.Y. Nov. 18, 1981); Miller-Wohl, Case No. 72-B-892 (S.D.N.Y.); Daylin, Inc., Case No. BK 75-02958(JM) (C.D. Cal.); Dynamics Corp. of Am., Case No. 72-B-750 (S.D.N.Y.)).

72. *Id.* at 120.

Moreover, the Bankruptcy Reform Act of 1978 ("Reform Act") was premised on the legislative conclusion that the bankruptcy judge would no longer play an active and intimate role in the administration of bankruptcy cases.[73] To the contrary, under the Reform Act, the bankruptcy judge "would be a brooding presence limited to the role of an adjudicator of actual controversies requiring judicial intervention."[74] Despite some regression of that concept, the Reform Act divorced the bankruptcy judge from the intricacies of the debtor's business and essentially consigned the judge to chambers until the bell rang for the first round of litigation.[75] According to the legislative history,

> The bill removes many of the supervisory functions from the [bankruptcy] judge in the first instance, transfers most of them to the trustee and to the United States trustee, and involves the judge only when a dispute arises. Because the judge no longer will have to take an active role in managing bankruptcy cases, the bankruptcy court should become a forum that is fair in fact and in appearance as well.[76]

Furthermore,

> The foundation of the 1978 reform was premised upon the principle that the entity best suited to administer and effect a rehabilitation and reorganization of a financially and operationally distressed debtor would, in most circumstances, be the debtor, with appropriate input from its creditors' committee. The tension between the debtor and a sophisticated creditors' committee was expected to result in knowledgeable and meaningful negotiations which would enable the formulation of a plan with minimal resort to the bankruptcy court.[77]

The objective of creating a judiciary removed from the active management of a case was somewhat diluted with the amendment of § 105 of the Bankruptcy Code in 1986, authorizing bankruptcy judges to take any action and make any determination necessary to enforce a court order or rule or to prevent an abuse of process on a sua sponte basis.[78] In addition, in 1994 § 105(a) was amended to authorize bankruptcy judges to conduct status conferences regarding any case or proceeding after notice to the parties in interest.[79] Despite these increases

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73. H.R. REP. NO. 95-595, at 4 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 5966.

74. Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 431 (1995).

75. *Id.*

76. H.R. REP. NO. 95-595, at 4, *reprinted in* 1978 U.S.C.C.A.N. 5963, 5966.

77. Miller, *supra* note 74, at 432 (citing H.R. REP. NO. 95-595, at 235, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6194)).

78. *See* Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, § 203, 100 Stat. 3088, 3097 (1986) (codified as amended at 11 U.S.C. § 105(a) (2000)).

79. *See* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 104(a), 108 Stat. 4106, 4108 (1994) (codified as amended at 11 U.S.C. § 105(d) (2000)).

in the power and prerogative of bankruptcy judges under Chapter 11, the Bankruptcy Code has generally preserved their isolation from the active administration of cases.

In contrast to the spirit of Chapter 11, Professor LoPucki argues that bankruptcy judges should play a more active role administering cases—a philosophy that was rejected by the Reform Act. Had Congress wanted bankruptcy judges to play the role now espoused by Professor LoPucki, Congress would not have eliminated the ability of the SEC or another entity of equal expertise to review each plan of reorganization independently. Nonetheless, Congress did exactly that and left the bankruptcy court with no mechanism to evaluate the feasibility of plans of reorganization.

In light of the legislative history of Chapter 11, the Delaware Bankruptcy Court conforms closely to the spirit of the Reform Act when it hears Chapter 11 cases. The court permits the debtor and its creditors to negotiate a plan of reorganization that is acceptable to both. Once there is consensus and compliance with the Bankruptcy Code provisions, the court will confirm the plan and allow the debtor to be relieved of the constraints of Chapter 11, subject to the plan provisions. That confirmation is the result requested by the parties in the great majority of Chapter 11 cases and always in prepackaged reorganizations.

Therefore, it is not appropriate to blame the Delaware Bankruptcy Court for conducting its cases in accordance with the congressional mandate under the Reform Act. As expressly stated in the legislative history, the Reform Act sought to remove the bankruptcy judge from "managing bankruptcy cases."[80] Since Congress effectively divested bankruptcy judges of the ability to manage cases, critics of the Delaware Bankruptcy Court should be hard-pressed to castigate the court when reorganizations fail. Their criticism should be directed at other causes, not the Delaware Bankruptcy Court.

In addition, critics must take into account the incredible pressure imposed upon a bankruptcy court to confirm a plan that has already been accepted by the requisite majorities of impaired classes of claimants. The pendulum of public opinion has swung against debtors, and there has been increased criticism of allegedly "debtor-friendly" bankruptcy courts. Permitting the debtor to retain exclusivity for plan filing and thus to remain within the protection of Chapter 11 for an excessive period of time is purportedly evidence of a court being "debtor-friendly." Consequently, the stigma of being labeled debtor-oriented for resisting creditor pressure to bring the Chapter 11 to an

80. H.R. REP. NO. 95-595, at 4, *reprinted in* 1978 U.S.C.C.A.N. 5963, 5966.

expeditious close almost compels a bankruptcy court to succumb—to confirm a plan of reorganization even though the debtor may not have had the opportunity to test the viability of a business plan and to build the plan of reorganization around an established and sound business operation.

Because Chapter 11 provides no role for the court to participate in the formulation of a plan and only gives the court a limited ability to determine the feasibility of a plan, no court, including the Delaware Bankruptcy Court, can be faulted for "reorganized" debtors' recidivism. The real problem lies not in the Delaware Bankruptcy Court, but in the conference rooms across the country where the debtors and creditors create and agree to reorganization plans. In those conference rooms, a bankruptcy judge has no control or influence, and the parties themselves may bind each other to dubious reorganization plans. Despite the debtor's lack of commensurate bargaining leverage, once the debtor and the creditors' committee have committed to a plan, a bankruptcy court will usually defer to the professed expertise of the parties' financial advisors, investment bankers, and other plan advocates, and confirm the proposed plan.

The causes of recidivism may flow from the "consensual" plan often imposed by creditors exercising their economic leverage and ability to terminate exclusivity or withdraw financing. The causes of further debtor relief may be multiple, as noted above in the case of Continental Airlines. Similarly, unanticipated economic recessions or acts of terrorism such as September 11, 2001 may disturb sensitive capital or operating arrangements. Such occurrences are beyond the control and authority of the particular bankruptcy judge, especially when the parties in interest have arrived at a consensual plan.[81]

B. The Uneven Playing Field

The reorganization process is intended to strike a balance between the debtor and its creditors. One of the debtor's primary bargaining tools is the statutory grant of an exclusive period in which to formulate and propose a plan. Once the debtor's exclusivity expires, creditors and other parties in interest will craft plans that may adversely impact the debtor's ability to operate.

There has been a steady diminution of the debtor's exclusivity power since the enactment of the Bankruptcy Code. In the Bankruptcy Code's formative years, administration of Chapter 11 cases largely mirrored cases under Chapter XI of the Act, and the interpretation

81. *See supra* note 58 and accompanying text.

and construction of the legislative language in the Code gave the benefit of any doubt to the debtor.[82] The debtor's exclusive right to file a plan was zealously guarded by debtors and respected by creditors' committees.[83] Consequently, extensions of the debtor's exclusive periods for purposes of filing a plan and soliciting acceptances were routinely granted, enabling debtors to retain exclusivity often for a period of several years.[84]

For example, the Chapter 11 cases of Johns-Manville Corporation and its affiliates and subsidiaries were commenced in July 1982.[85] The debtors filed their first proposed plan in November 1983 after numerous extensions of their exclusive periods had been granted.[86] Subsequently, the debtors obtained a string of orders extending their time to solicit acceptances of a filed plan.[87] The debtors' joint amended plan was confirmed in December 1986, nearly four-and-a-half years after the commencement of the cases, at a time when exclusivity was still extant.[88]

Nevertheless, courts began to restrict the debtor's exclusivity. In *In re Lake in the Woods*, a seminal case, the district court reversed the bankruptcy court's order granting the debtor its seventh extension of its exclusive period and automatic extensions thereafter (ad infinitum).[89] The district court found,

> The desire to allow other interested parties to file a plan was grounded in the philosophy that there should be a relative balance of negotiating strength between debtors and creditors during reorganization of an enterprise. . . . Rather than enforcing a relatively equal relationship between the debtor and its creditors, as the Code's drafters envisioned, the bankruptcy court's finding of cause leaves Lake's creditors in the disadvantageous position that Chapter 11 was designed to remedy. . . . Although Congress intended Section 1121 as a device to promote a more equal relationship between debtors and creditors it has been applied by the court here as a means of allowing debtor to drag

82. Miller & Marcus, *supra* note 60, at 122 (citing *In re* Inforex, 1 C.B.C. 2d 159 (D. Mass. 1979); *In re* Mansfield Tire & Rubber Co., Case No. 679-01238 (Bankr. N.D. Ohio)).

83. *Id.* at 130.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. Miller & Marcus, *supra* note 60, at 130-31; *see also* LTV Corp. v. Valley Fid. Bank & Trust Co. (*In re* Chateaugay Corp.), 961 F.2d 378 (2d Cir. 1992) (noting that the LTV Corporation was in Chapter 11 for over six years); *In re* Manville Forest Prods. Corp., 31 B.R. 991, 995 (S.D.N.Y. 1983) (affirming the bankruptcy court's order granting the debtor's fifth extension of its exclusive period even though the debtor was solvent, faced no liability for asbestos claims, and had operations which were separate from those of Manville and its other subsidiaries, and holding that "[t]he sheer mass, weight, volume and complication of the Manville filings undoubtedly justify a shakedown period"); *In re* Ravenna Indus., Inc., 20 B.R. 886, 890 (Bankr. N.D. Ohio 1982) (refusing to grant debtor's request for a ninth extension of the exclusive period, because the debtor had already had the benefit of 435 days of exclusivity).

89. 10 B.R. 338, 342-43 (E.D. Mich. 1981).

> out the reorganization, continue in operation of the [real estate] complex, and pressure the creditor for concession in the status of its rights.[90]

Consistent with the admonition of the district court in *Lake in the Woods*, the evolving case law indicates an erosion of the debtor's right to maintain a workable period of exclusivity in which to propose a plan.[91] Fearing that the bankruptcy court will no longer grant a once routine extension of exclusivity, debtors now are rushed to propose creditor-friendly, economically deficient plans to garner enough votes to pass a plan during the debtor's exclusivity period.[92]

Under the Bankruptcy Code, a debtor is usually allowed a 120-day period following the order of relief during which it has the exclu sive right to file a plan.[93] The debtor may request that the bankruptcy court grant an extension of exclusivity for cause, but these extensions are not guaranteed and creditors may object to any request for an extension.[94]

The 120 days of exclusivity is hardly enough time for a large complex debtor to formulate a realistic, appropriate, and feasible plan of reorganization. The first few months of Chapter 11 are needed to absorb the initial shock of bankruptcy. In that time, the debtor is preoccupied with addressing the trauma of bankruptcy as it affects employees, suppliers, and customers. The debtor-in-possession must meet challenges to the automatic stay, seizures of property, and countless other problems.[95] After the initial trauma subsides, the debtor must focus on the issues that precipitated the Chapter 11 case. Once the debtor identifies its problems, it must take the necessary steps to address those problems in order to stabilize operations and obtain financing that may involve selling parts of its enterprise, rejecting contracts or leases, or refinancing. Finally, after the debtor implements

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90. *Id.* at 343, 345-46.

91. Miller & Marcus, *supra* note 60, at 132; *see In re* Sharon Steel Corp., 78 B.R. 762, 765 (Bankr. W.D. Pa. 1987) (denying the debtor's first request for an extension of the exclusivity period); *In re* Southwest Oil Co. of Jourdanton, 84 B.R. 448, 450 (Bankr. W.D. Tex. 1987) (denying the debtor's first request for an extension and concluding that extensions of the exclusive period should not be routinely granted). In *In re Texaco Inc.*, 76 B.R. 322 (Bankr. S.D.N.Y. 1987), the bankruptcy court granted the debtor a second extension but also created a mechanism by which the limited extension granted could be modified by the court if it were demonstrated that the general committee of unsecured creditors and the equity security holders' committee, with input from Texaco, supported a proposed plan that had the unconditional agreement of Pennzoil. *See* Miller & Marcus, *supra* note 60, at 136-37. "The bankruptcy court's ruling in *Texaco* is noteworthy because it represents the culmination of the trend away from routine extensions of exclusivity." *Id.* at 137-38.

92. Miller & Marcus, *supra* note 60, at 142.

93. *See* 11 U.S.C. § 1121(b) (2000).

94. *Id.*

95. *See, e.g.*, Katie Anderson, *Retailers' Post-Holiday Blues May Deepen*, DAILY DEAL, Jan. 10, 2002, *available at* 2002 WL 6786213.

changes, it needs a reasonable amount of time to monitor their effects while still within the protection of Chapter 11. It is not unreasonable to conclude that a debtor needs sufficient time to evaluate the effects of changes in its business and operations before it can formulate a plan.

Similarly, § 365(d)(4) provides a debtor with only sixty days to assume or reject an unexpired lease for nonresidential real property.[96] Often this allowance does not provide enough time to make a judgment that is beneficial to all parties in interest. It may result in assumptions that substantially increase the potential administrative expense obligations of the debtor's estate to the detriment of all parties or compel the rejection of potentially valuable leases.[97]

The Bankruptcy Code no longer provides the debtor with bargaining power equal to that of creditors. The proverbial "level playing field" rarely tilts in the debtor's favor. As creditors' powers expand in conjunction with a constant contraction of a debtor's rights, the debtor has become a less potent force in its own reorganization and is often compelled to succumb to the pressure of creditors, who may have other objectives, and to agree to a plan that may not be feasible in the long term.

V. THE RISE OF DISTRESSED DEBT TRADING

In the early days of the Bankruptcy Code, there was a more symbiotic relationship between debtors and creditors than there tends to be between debtors and creditors today. For instance, many of the early debtors were retailers with suppliers as their primary creditors. When the debtor's businesses hit hard times, it was in the interest of the suppliers to keep the debtor's business alive. Those creditors had a self-interest in rehabilitating the debtor as great as the interest of the debtor itself. Creditors were interested in the ultimate emergence of a viable entity and the preservation of a valuable good customer. During that period, financial institutions maintained and supported long-established relationships.

Distressed debt trading and changes in bankruptcy relationships have destroyed the symbiotic relationship of debtor and creditor. Distressed debt traders normally purchase debt claims at substantial discounts. They may have no interest in the debtor's long-term viability; instead, they are usually interested in the return on their investment. Expedition of the Chapter 11 process is necessary to maximize

96. § 365(d)(4).

97. *See In re* Klein Sleep Prods., Inc., 78 F.3d 18, 22-30 (2d Cir. 1996).

the return on investment given the time value of money. Similarly, creditor banks are generally constrained to limit exposure and no longer carry large defaulted loans that must be marked to market. To achieve liquidity and limit losses, banks will often trade away the debt notwithstanding the prior relationship with the debtor.

Distressed debt trading occurs when investors purchase claims and interests in distressed entities. These investors rely on the basic legal principle: "[A] claim or interest in the hands of a purchaser has the same rights and disabilities as it did in the hands of the original claimant or shareholder."[98] Creditors involved in a Chapter 11 process often need to find liquidity, and the sale of their claims to vulture investors offsets the risks posed by the uncertainties of Chapter 11. Chapter 11 distressed debt traders decide to invest in debt claims based on two calculations: (1) that the reorganization will yield a higher return than the cost of the claim, and (2) that the plan of reorganization will be confirmed and consummated before the investor's cost of carrying the investment—the time value of money—consumes whatever profit the investor hopes to make on the discount.[99] Therefore, unlike the symbiotic relationship of the vendor and supplier, "[t]here is a real world difference between the attitude of a longtime creditor and an investor who has just invested its money."[100] Because Chapter 11 is premised upon a symbiotic relationship between debtor and creditor, it is becoming less effective in the context of distressed debt trading.

Although distressed debt trading may produce negative consequences for the debtor, Chapter 11 has enhanced distressed debt trading. This trading now thrives in Chapter 11, especially following the 1991 amendments to Federal Rule of Bankruptcy Procedure 3001(e). Before 1991, claimants had greater access to information that enabled them to make informed decisions on whether they should sell their claims.[101] Bankruptcy Rule 3001(e), amended in 1991, no longer requires the disclosure of the "terms of the transfer" and "the considera-

98. Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 13 (1990) (citations omitted). Claims trading has evolved into a multibillion dollar industry. *See* W. Andrew P. Logan III, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(e)(2)*, 2 AM. BANKR. INST. L. REV. 495, 495 & n.3 (1994) (stating that there was an estimated $13 billion in distressed debt trading in 1993).

99. Fortgang & Mayer, *supra* note 98, at 5.

100. *Id.* at 6. Fortgang and Mayer apparently believe that the benefits of trading in the stock and the claims of a debtor in Chapter 11 outweigh the problems resulting from such trading. *See id.*

101. *See* Logan, *supra* note 98, at 496-99 (citing *In re* Revere Copper & Brass, Inc., 58 B.R. 1, 2 (Bankr. S.D.N.Y. 1985)).

tion therefor."[102] These disclosures were viewed as frustrating the goal of providing a liquid market for the sale of claims. Today, Bankruptcy Rule 3001(e) simply requires the transferee to provide evidence of the transfer to the court.[103] The ease by which an investor can buy claims in Chapter 11 has led to the boom in distressed debt trading and its deleterious effect on reorganization.

Reorganization has evolved from a primarily rehabilitative process to a dual process that stresses, in addition to rehabilitation, enhancing creditors' recoveries. Chapter 11 now provides fertile opportunities for speculators. In that environment, distressed debt traders may sacrifice the long-term viability of a debtor for the ability to realize substantial and quick returns on their investments. Distressed debt trading must be viewed as another cause of recidivism of reorganized entities that subsequently require a return to the bankruptcy court to pursue another Chapter 11 effort.

VI. CONCLUSION

During the 1990s, Delaware became the corporate reorganization capital of the nation. During the same time period, commentators began to criticize the rate of recidivism among Chapter 11 debtors reorganized in Delaware and have concluded that the hurried approval of nonfeasible plans was the price tag of this preeminence. These critics attack the Delaware Bankruptcy Court for the recidivism of Chapter 11 debtors.[104]

However, the recidivism in Delaware between 1990 and 2001 is consistent with the recidivism in the Southern District of New York. Both of these districts attracted large, publicly owned debtors. This fact indicates that there is nothing fundamentally wrong with the Delaware Bankruptcy Court. The true causes of recidivism include the nature of the cases filed, the diminution of the debtor's bargaining power and prerogative to craft a workable plan of reorganization, and outside influences such as the rise of distressed debt trading and the evolution of the banking industry.

The percentage of large, publicly traded corporations filing for Chapter 11 reorganization in Delaware reached its peak in 1996 at 87%.[105] That number dipped to 50% in 1997 and further to 43% in

102. FED. R. BANKR. P. 3001(e).

103. *Id.*; *see also* Logan, *supra* note 98, at 501.

104. *See supra* Part III.

105. *See* WebBRD, *supra* note 23, *at* http://lawlibfs.lawlib.ucla.edu/LoPucki/query1.asp (last visited Sept. 12, 2002).

1998.[106] In 1999, the number rose to 65% but decreased to 57% in 2000 and 50% in the first six months of 2001.[107] There is evidence that other bankruptcy courts are beginning to attract filings. In 1996 and 1997, only one large corporation per year that chose to commence a Chapter 11 case in a venue other than the venue of its principal offices chose a venue other than Delaware.[108] Nevertheless, the number of large corporations selecting a venue outside of Delaware increased to four in 1998, four in 1999, eleven in 2000, and five by June 2001.[109] The Northern District of Georgia, the Northern District of California, the District of Arizona, and the District of Nevada were disproportionately represented in this list. Furthermore, the Northern District of Ohio, the Eastern District of North Carolina, and the Eastern District of Virginia have recently been praised for offering alternative fora for Chapter 11 cases.[110] Commentators cite these courts' increased expertise, efficiency, and judicial temperament.[111] Significantly, these courts are attracting Chapter 11 cases by adopting procedures that were developed by the Delaware Bankruptcy Court. In September 2001, a commentator writing about the Southern District of Texas's attempt to dislodge Delaware from its throne of bankruptcy supremacy stated that "courts want to emulate Delaware."[112]

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. Deeper analysis reveals that there is no endemic defect in the Delaware Bankruptcy Court's administration of reorganization cases. Delaware remains an appropriate venue in which to commence a large, complex Chapter 11 reorganization. Although it has a statistically proven higher rate of

106. *See id.*

107. *See id.*

108. *See id.* (noting that Kenetech Corp. filed in the Northern District of California in 1996 and that RDM Sports Group, Inc. filed in the Northern District of Georgia in 1997).

109. *Id.*

110. *See* David Marcus, *Man of Steel*, DAILY DEAL, Oct. 11, 2001, *available at* 2001 WL 25883328; Chris Serres, *Slow Economy Leads to More Filings at U.S. Bankruptcy Court in Raleigh, N.C.*, KNIGHT-RIDDER TRIB. BUS. NEWS, Aug. 28, 2001; *Virginia Courts Becoming a Venue of Choice for Large Bankruptcy Cases; Eastern District U.S. Bankruptcy Court Hosting Several Large Cases That Could Have Been Filed in Delaware or Elsewhere*, PR NEWSWIRE, Aug. 29, 2001.

111. *See* Marcus, *supra* note 110 (noting the availability and expertise of Judge William T. Bodoh of the Northern District of Ohio); Serres, *supra* note 110 (asserting that the United States Bankruptcy Court for the Eastern District of North Carolina resolves Chapter 11 cases 20% faster than the national average); *Virginia Courts Becoming a Venue of Choice for Large Bankruptcy Cases: Eastern District U.S. Bankruptcy Court Hosting Several Large Cases That Could Have Been Filed in Delaware or Elsewhere*, *supra* note 110 (asserting that the efficiency and judicial temperament of judges in Eastern District of Virginia attracts increased filings).

112. Rovella, *supra* note 13.

recidivism than other jurisdictions, its rate of recidivism is generally consistent with that of the other venue choice of large, complex debtors—the Southern District of New York.[113] The consistency of recidivism rates for large, publicly owned debtors reorganized in the experienced venues of Delaware and the Southern District of New York demonstrates that the cause of recidivism in Delaware does not lie with the Delaware Bankruptcy Court, but rather with the evolution of the process. That evolution may include the debtor's loss of bargaining power and external pressures on the reorganization process. After absorbing the initial trauma of filing, a debtor must be given a reasonable amount of time in Chapter 11 to formulate, test, and adjust a business plan before proposing a plan of reorganization. That process may be inimical to the profit motives of speculators in debt. The rate of recidivism in Delaware is beyond the Delaware Bankruptcy Court's control, and it will probably continue until the playing field is level once again.

113. *See supra* Part III.