# Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations

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## I. INTRODUCTION

The war is over and Delaware has won. The "Delawarization" of bankruptcy law appears complete. The reorganization of a large, publicly held corporation under Chapter 11 of the Bankruptcy Code today will more likely take place in the Delaware

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** Professor of Law, Vanderbilt Law School. We would like to thank Lynn LoPucki for his comments on an earlier draft of this piece, and for generously sharing his bankruptcy database with us. We prepared this reply based solely on Professor LoPucki and Sara Kalin's initial piece. We agreed at the start with Professor LoPucki that we would not modify this piece to attempt to reply to any argument raised in his response.

Bankruptcy Court than in any other jurisdiction.[1] The bankruptcy judges and lawyers in Delaware are no doubt pleased with this state of affairs, while many of their counterparts in other jurisdictions look to Delaware with envy.[2] While few question that Delaware is the preferred forum for public corporations seeking to reorganize, it remains hotly contested whether that is a good thing. In other words, the race is to Delaware; but is it to the top, the bottom, or somewhere in between?

To answer this normative question, one needs a theory explaining why the managers of a firm, advised by their lawyers, decide to file in one jurisdiction as opposed to another. Some have argued that firms prefer to file in Delaware because the Delaware Bankruptcy Court is the fastest and most efficient processor of Chapter 11 cases.[3] Others see a nefarious attempt on the part of managers of firms to shop for a forum that will promote their interests at the expense of shareholders and creditors.[4] Still others view the matter as more complex, suggesting that some of the reasons for going to Delaware are beneficial from the perspective of social welfare, while maintaining that other reasons are suspect.[5] The normative desirability of the stampede to Delaware remains a contested issue.

Lynn LoPucki and Sara Kalin purport to provide the answer in their article in this issue of the *Vanderbilt Law Review*.[6] According to them, Delaware's victory has been something of a mistake. Supposedly, those who took firms to Delaware to reorganize simply did not know what they were getting themselves into. A firm that reorganizes in Delaware, it turns out, is four times as likely to file a second bankruptcy petition as is a firm that reorganizes in another jurisdiction. "[T]he parties who stood to lose in a failed Delaware reorganization simply underestimated the likelihood of

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1. *See* Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 977-82 (1999); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1367, 1372-76 (2000).

2. *See* Rasmussen & Thomas, *supra* note 1, at 1369 (detailing efforts by the Houston bankruptcy judges to induce local attorneys to file in Houston rather than Delaware).

3. *See, e.g.*, David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1 (1998) [hereinafter Skeel, *Bankruptcy Judges*]; David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243 (2000) [hereinafter Skeel, *Lockups*].

4. *See* Eisenberg & LoPucki, *supra* note 1, at 1001-03.

5. *See* Rasmussen & Thomas, *supra* note 1, at 1382-86.

6. Lynn M. LoPucki & Sara Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231 (2001).

failure."[7] The conclusion that the players in the reorganization game did not understand the risk inherent in choosing the Delaware bankruptcy court leads directly to LoPucki and Kalin's policy prescription—give the market more information. They endorse the proposition that competition among bankruptcy courts can lead to desirable results,[8] and seek to promote competition by providing the relevant actors with more information.

LoPucki and Kalin have increased our understanding of bankruptcy practice in Delaware. Firms that reorganize there often need a subsequent reorganization. We have no quarrel with their factual findings. Naked facts, of course, do not generate conclusions. What one needs is a theory that explains the facts. We maintain that LoPucki and Kalin's facts do not necessarily lead to the conclusions that they draw, especially the conclusion that market players are unable to assess legal regimes.[9] This assertion, if true, would have impact well beyond bankruptcy law and even corporate law. The data that they generate, however, does not justify their sweeping conclusions.

In this Reply, we proceed as follows. First, we set forth our theory of venue choice in bankruptcy law, suggesting why competition among bankruptcy courts is likely to be efficient as to prepackaged bankruptcies, but may not be efficient as to traditional Chapter 11 cases.[10] Given that there are theoretical reasons to distinguish between these two types of proceedings, we question LoPucki and Kalin's failure to separate fully the data into one set consisting solely of prepackaged bankruptcies and another set consisting solely of traditional Chapter 11 proceedings. We then examine the question, not studied in detail by LoPucki and Kalin, of what refiling rates can tell us. In particular, LoPucki and Kalin have looked at one type of capital restructuring after an initial reorganization—a second bankruptcy—but have neglected to scrutinize the reasons

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7. *Id.* at 236.

8. We also endorse competition among bankruptcy courts, so long as the decision of where to file is made at a time when the interests of the firm's managers coincide with the goal of maximizing firm value. *See* Rasmussen & Thomas, *supra* note 1, at 1400-01.

9. We recognize that market actors do need information to make sound decisions. Delaware, however, has been the forum of choice for over five years. We believe that this period of time, coupled with the relatively small nature of the reorganization bar—which allows for rapid dissemination of reorganization practice—is sufficient to provide the parties with accurate information about the consequences of deciding to file in Delaware.

10. Competition in this setting does not necessarily require bankruptcy judges to alter their behavior in order to attract cases. To be sure, they very well might. *See* Rasmussen & Thomas, *supra* note 1, at 1400-01. Even if the prospect of attracting a large Chapter 11 case does not affect judicial behavior, there is still competition in the sense that firms will select from available jurisdictions the one they believe best suits their needs.

why a large number of firms, well over half, dropped out of their study. Their conclusion that market players do not understand the effect of filing in Delaware depends upon "failure" being defined exclusively as the initiation of a second bankruptcy proceeding.

Moreover, their focus on the costs of a second bankruptcy proceeding fails to consider the possibility that there is an optimal, non-zero amount of refilings. Embedded in their analysis is the assumption that reorganization costs are the same across jurisdictions. The fact that Delaware seems to handle its cases more quickly than other jurisdictions provides a potential reason why it may be rational to file for bankruptcy in Delaware, even if one assumes that having to undergo a second bankruptcy proceeding is costly.

Finally, we show that, even if refiling rates were significant in and of themselves, LoPucki and Kalin's statistical analysis, which rests on bivariate rather than multivariate analysis, may fail to disclose other, more plausible explanations for the disparity in refiling rates. In the end, the tantalizing data that LoPucki and Kalin produce forces us to focus squarely on how one measures the success of any bankruptcy regime.

## II. THE RACE TO DELAWARE

The debate over the Delawarization of bankruptcy law parallels a more general debate about the behavior of publicly traded firms. The most enduring debate in corporate law over the last three decades is whether the well-known tendency of large, publicly traded firms to incorporate in Delaware increases or decreases social welfare. Some scholars see a competitive market that generates a race to the top, others suspect a blatant attempt by states to cater to the whims of corporate managers that produces a race to the bottom, while still others find a more ambiguous state of affairs.[11] Not surprisingly, numerous studies have attempted to answer this question empirically. In our reading of the literature, the best evidence indicates that incorporating in Delaware adds value to a firm.[12]

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11. For a summary of these positions, see generally ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993), and Rasmussen & Thomas, *supra* note 1, at 1382-86.

12. The most recent and comprehensive study finding positive value from incoporations in Delaware is ROBERT DAINES, DOES DELAWARE LAW IMPROVE FIRM VALUE? (article draft, on file with authors). LoPucki and Kalin claim that the extant studies only show that investors *believe* that firms incorporating in Delaware are worth more than firms incorporating elsewhere. There

Bankruptcy practice and scholarship have followed a similar course. Today, large publicly held corporations are more likely to file for Chapter 11 in Delaware than in any other jurisdiction. This tendency is of more recent vintage than the preference to incorporate in Delaware. While the dominating presence of Delaware in the corporate setting dates back eighty years, the rise of Delaware in the bankruptcy setting has occurred within the last ten.[13] Nevertheless, bankruptcy scholars have been quick to catch up with the more established debate. Indeed, they have borrowed heavily from it.[14] As in the chartering context, the debate in the bankruptcy context has been over whether the race to Delaware is to the top, to the bottom, or somewhere in between. As with the debate over incorporation, empiricists are trying to select among theories by measuring reality.[15]

LoPucki and Kalin's source for their attempt to find a yardstick by which to measure the competing theories is LoPucki's database, which consists of all large, publicly traded firms that have filed for bankruptcy since the adoption of the Bankruptcy Code. Analyzing this data, LoPucki and Kalin claim to have resolved the issue of how well Delaware performs in the bankruptcy context, and perhaps to have shed light on the debate in the corporate arena as well. The variable that they have examined is the propensity of firms to file for a second reorganization. They find that firms reorganizing in Delaware are four times as likely to file for bankruptcy a second time as are firms reorganizing elsewhere.[16] They conclude that this tendency proves that the current system has failed.

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are, of course, a number of measures by which one can attempt to evaluate firm performance. One can look at sales, profits, or cash flows. If LoPucki and Kalin were correct, one would expect that firms with similar financial characteristics would be valued differently based on where they were incorporated. They have not attempted to make such a showing. Moreover, to the extent that LoPucki and Kalin explain the preference for Delaware bankruptcy courts as the result of a lack of information, it is hard to imagine how this explanation could carry over to the incorporation setting. The effect of incorporating in Delaware has been the subject of intense scrutiny for the past three decades.

13. *See* Eisenberg & LoPucki, *supra* note 1, at 983-87; Rasmussen & Thomas, *supra* note 1, at 1372-76; Skeel, *Bankruptcy Judges*, *supra* note 3, at 18-19; Skeel, *Lockups*, *supra* note 3, at 1274.

14. Our debt in this regard is obvious. *See* Rasmussen & Thomas, *supra* note 1, at 1382-85.

15. LoPucki has been a leader in detailing the changing pattern of venue selection for large, publicly held bankruptcies over the past fifteen years. He co-authored both the first study on venue selection, see generally 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, and one of the first studies detailing the emerging preference for Delaware, see generally Eisenberg & LoPucki, *supra* note 1.

16. LoPucki and Kalin also discuss the refiling rate of firms that filed for bankruptcy in the erstwhile forum of choice, the Southern District of New York. LoPucki & Kalin, *supra* note 6, at

Alas, while we are fans of empirical analysis and applaud LoPucki and Kalin's effort, we cannot agree. Our response to LoPucki and Kalin's finding requires that we first summarize our theory of what is going on in Delaware. We have not offered a simple "Delaware Good" or "Delaware Bad" story. Our theory is a bit more complex. We have argued that, in ascertaining whether the preference of firms to file for reorganization in Delaware is beneficial or not, one has to look at the incentives facing those who make the filing decision—the firm's managers and their lawyers. The incentives that they face differ according to the type of bankruptcy proceeding being initiated.

There are two general types of Chapter 11 proceeding initiated by large, publicly held companies—prepackaged bankruptcies and traditional, full-blown Chapter 11 bankruptcies. A prepackaged bankruptcy hinges on agreement. The managers of a firm in financial distress negotiate with the firm's main creditors over a plan of reorganization prior to the filing for bankruptcy. A bankruptcy petition is filed only after agreement among the creditors has been reached on the new debt structure. The benefit of a prepackaged bankruptcy, as opposed to an out-of-court restructuring, is that it eliminates the holdout problem endemic in out-of-court restructurings. Absent bankruptcy, debt holders cannot have their claims reduced without their consent. This creates a collective action problem. When a firm needs to alter its capital structure, individual creditors may opt not to participate in a restructuring that benefits the creditors as a whole. They hope that, although they refuse to reduce their own claims, other creditors will reduce theirs.[17]

A prepackaged bankruptcy eliminates this incentive for strategic behavior. Chapter 11 begins by placing creditors in classes according to the type of claim that they hold.[18] It then allows a majority of creditors in each class who hold over two-thirds of the debt to bind the dissenters in that class.[19] Prepackaged bankruptcies are

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248-51, 266-67. We limit our focus in the main text to Delaware, the current venue of choice. As to the Southern District of New York, we have expressed our doubts as to whether it advanced overall welfare when it was the venue of choice. *See* Rasmussen & Thomas, *supra* note 1, at 1372. For the reasons that we state in the text, however, we do not believe that LoPucki and Kalin's finding of elevated refiling rates necessarily supports the conclusion that the preference for the Southern District was socially detrimental.

17. For an extended discussion of this point, see generally Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189 (1991), and Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

18. 11 U.S.C. § 1122(a) (1994).

19. *Id.* § 1126(c).

thus consensual arrangements between managers and the majority of creditors. The requirement of the Bankruptcy Code that all claims in a given class be treated identically reduces the ability to appropriate value from dissenting creditors. A majority can bind the dissent only by agreeing to the same treatment. Indeed, managers have an incentive to ensure that creditors do not complain about their treatment. Any dispute that requires litigation to resolve robs the prepackaged bankruptcy of one of its most attractive features, speed of completion.[20] On average, prepackaged bankruptcies last roughly one month from filing to completion.[21] This is less than ten percent of the time required for a traditional Chapter 11 proceeding.[22]

Given the overriding necessity of having all affected classes of creditors agree to the proposed new capital structure, we have argued that prepackaged bankruptcies tend to promote the joint welfare of the firm's owners.[23] We have also asserted that having a single jurisdiction specialize in prepackaged bankruptcy makes a good deal of sense.[24] We have concluded from the available evidence that, at worst, the Delaware bankruptcy court is doing as good a job as any jurisdiction in handling prepackaged bankruptcies. Delaware undoubtedly handles prepackaged cases faster than any other jurisdiction when measured by both the mean and median times. While one cannot rule out the hypothesis that these faster times are the result of chance,[25] it remains that Delaware appears to be faster. When managers have to select a forum, they must base their decision on available evidence. They cannot wait for statistical significance. To the extent that speed is a virtue, they have a compelling reason to select Delaware. Removing Delaware as an appropriate place for filing prepackaged cases has little to commend it.[26]

We have been more agnostic on whether the preference for firms to file in Delaware when they sought a full-blown reorganiza-

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20. For extended elaboration of the mechanism of a prepackaged bankruptcy, see Rasmussen & Thomas, *supra* note 1, at 1374-76, 1386-91.

21. *Id.* at 1388.

22. Eisenberg & LoPucki, *supra* note 1, at 987-92.

23. Rasmussen & Thomas, *supra* note 1, at 1387-91.

24. *Id.* at 1388-89.

25. Professors Eisenberg and LoPucki found that the quicker mean time in Delaware was not statistically significant, Eisenberg & LoPucki, *supra* note 1, at 990-91, but a second study concluded that the median times were statistically significant, see Maria Carapeto, Does Debtor-in-Possession Financing Add Value?, 24-25 (March 12, 1999) (unpublished manuscript, on file with authors).

26. Given the significant difference between a prepackaged bankruptcy and a traditional Chapter 11 proceeding, it would have been useful if LoPucki and Kalin had analyzed traditional Chapter 11 cases separately rather than lumping them with prepackaged cases.

tion under Chapter 11 promoted overall social welfare. The managers of a firm and the lawyers who advise them will look after their own interests. In the situation of a prepackaged bankruptcy, they have to get the creditors to agree with them. This is not the case in the traditional Chapter 11 bankruptcy. Here, disagreement between managers and creditors is common—both over the deployment of the firm's assets and the treatment of creditors' claims—and proceedings, on average, last over one year.[27] We have assumed that counsel would advise managers where to file, and we have identified three reasons why lawyers would prefer one forum over another: predictability of decisions by the jurisdiction (a notable factor given that jurisdictions often have more than a single bankruptcy judge), a track record of decisions by the bankruptcy judge that favor the firm's managers, and the routine approval of attorneys' fees.

The first of these reasons arguably benefits all of a firm's claimants. Predictability in law, especially in the corporate area, is generally thought to be a good thing.[28] The routine approval of attorneys' fees is a more ambiguous matter. Attorneys' fees are paid from the estate, so managers arguably have little incentive to monitor these fees. Still, there may be other constraints on fees. We know of no evidence suggesting that corporate bankruptcy attorneys are compensated at a greater rate than corporate attorneys generally. It may be that judicial approval of fees pegged at the market rate is necessary to attract the top legal talent. All parties may benefit when the debtor can afford to hire the best attorneys.

Perhaps the most likely reason why managers would not choose the reorganization forum that benefits all those with an interest in the firm is that the interests of managers diverge from those of creditors at the time a traditional Chapter 11 begins. Managers may want to control the Chapter 11 process. Crucial here is the ability to remain in charge and to retain the exclusive authority to file a plan of reorganization. The inability of creditors to file a competing plan can induce creditors to agree to a plan of reorganization offered by management simply to terminate the proceeding. Jurisdictions may also differ in their willingness to replace existing managers during the proceeding. Thus, we have suggested that managers may choose to file in a jurisdiction that promotes their

27. *See* Rasmussen & Thomas, *supra* note 1, at 1388.
28. *See id.* at 1368-69.

interests at the expense of creditors. We have not been able to conclude, on balance, which of the various incentives dominates.

The normative conclusion that we have drawn from this analysis is that prior commentators who have argued for constricting venue choice have gotten the prescription exactly backwards. 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. Bankruptcy judges evidently want to attract these cases to their courts. Competition can be a good thing. The key to our proposal is to change the time at which the selection is made. We have proposed that venue rules be changed so that firms can commit in advance to filing in any particular jurisdiction in the event that a reorganization is necessary.

LoPucki and Kalin's data offer little insight into the validity of our theory. Our theory differentiates between traditional Chapter 11 cases and prepackaged bankruptcies based on the incentives that mangers face when they decide in which venue to file. There is a second reason for differentiating between these two types of proceedings. 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 these firms would subsequently file a second reorganization petition, this one for a traditional Chapter 11 proceeding.[29] Our point is that, on average, one would expect firms that file a prepackaged bankruptcy

29. In this respect, one can view the filing of a prepackaged bankruptcy as an attempt by managers to screen out the cause of the firm's financial distress. If the distress is caused only by a mismatch between the capital structure and the firm's operations, the prepackaged bankruptcy should solve the problem. If the distress is caused by the firm's operations as well, one would expect that a second reorganization proceeding is needed. Note here that this second reorganization proceeding should not be considered a failure of the first bankruptcy proceeding. The first proceeding was designed to separate out those firms that need a full-blown Chapter 11 proceeding from those that do not.

to be less in need of restructuring their operations than firms seeking a full-blown reorganization under Chapter 11. Thus, we believe that, to assess the effects of venue choice, it is necessary to separate prepackaged and traditional Chapter 11 cases.

LoPucki and Kalin fail to adhere to this separation. The first set of data that they report, most prominently in Tables 4 and 5, lumps both types of proceedings together. For the reasons that we have discussed, we believe that such a combination is not justified. Nowhere do they analyze traditional Chapter 11 cases as a discrete data set. This being the case, we see no evidence as to how Delaware is performing in the handling of traditional Chapter 11 cases as compared to all other jurisdictions.

LoPucki and Kalin do, however, break out the data for prepackaged bankruptcies. They claim that they get a statistically significant difference between Delaware and other bankruptcy courts in this area, with Delaware prepackaged bankruptcies more likely to need a second reorganization. To get this significance, however, they have to limit their data set in two ways. The first is that they limit their focus to cases filed after 1990. The reason for this focus is that Delaware only became the preferred venue at that time. We understand the reason for this limited focus and do not quarrel with it. We bring it up only to note that the effect of this exclusion is to remove two cases from the data set, neither of which filed in Delaware. One of these two cases eventually resulted in a second petition being filed. Had these two cases been included in the data set, LoPucki and Kalin's results would not have been statistically significant. The fact that such a small change in the data affects whether the results are statistically significant gives us pause in placing too much reliance on the conclusions.

The second limitation that LoPucki and Kalin make is, to our minds, more troubling. They compare Delaware bankruptcy courts to other bankruptcy courts *excluding the Southern District of New York.* This exclusion is significant in that the Southern District had three prepackaged bankruptcy cases, one of which filed for bankruptcy a second time. Given that adding two cases to the data set, one of which refiled, would prevent a finding of statistical significance, it may be that adding these three cases, one of which refiled, would also undo LoPucki and Kalin's finding of statistical significance. Thus, the reason for the exclusion of these cases must be examined. To be sure, in the period *before* 1990, the Southern District of New York was the venue of choice for large, publicly traded firms filing for bankruptcy. Yet we see no logical reason why this would lead to the exclusion from the data set of cases that were filed *after*

the Southern District had lost its status as the venue of choice. If one wants to measure how well Delaware performed in the 1990s, the Delaware court should be measured against *all* of its competitors. We therefore cannot conclude anything definitive about the relationship between venue choice and refiling rates in either the traditional Chapter 11 or prepackaged bankruptcy context.

Though it does not appear to be statistically significant, the LoPucki and Kalin data set is suggestive. We certainly cannot prove that there is no correlation between venue choice and refiling rates in either traditional Chapter 11 cases or prepackaged bankruptcies. It may well be that, as the number of cases in the data set increases over time, a statistically significant correlation will emerge. We thus believe it prudent to address the possible implications of finding higher refiling rates for firms emerging from bankruptcy court in Delaware. In short, we do not believe that higher refiling rates necessarily imply that the Delaware bankruptcy court is performing worse than its peers. First, we do not find refiling rates to be an accurate barometer of the performance of a bankruptcy court. Second, even if refiling were indicative of judicial performance, it may be that a high refiling rate increases overall social welfare. We address these points in turn.

## III. WHY REFILINGS?

LoPucki and Kalin offer two reasons why a second petition should be treated as a failure of the initial bankruptcy proceeding. They argue that such treatment is warranted because the Bankruptcy Code condemns refilings and because refilings are costly.[30] Neither argument supports their conclusion. The Code, in fact, does not condemn refilings. Rather, it only requires that the bankruptcy judge approving a plan of reorganization determine that "confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor."[31] The Code thus does not require that refilings be avoided at all costs. Rather, it only requires that a plan of reorganization is not likely to lead to a second reorganization. Roughly 70% of the firms that file in Delaware do not need a second reorganization. It thus appears to us that this statutory requirement is being met. Indeed, as we show below, there may be an optimal, non-zero rate of refiling. In other

30. LoPucki & Kalin, *supra* note 6, at 235-36.
31. 11 U.S.C. § 1129(a)(11) (1994).

words, the Bankruptcy Code seeks to bar too high a refiling rate; it does not seek to eliminate refilings altogether.

The second reason LoPucki and Kalin offer as to why the filing of a second bankruptcy petition implies that the first proceeding should be considered a failure is that high costs are associated with bankruptcy, and a second petition implies that these costs are incurred a second time.[32] This observation is no doubt true. It does not, however, justify a rigid focus on refiling rates for at least three reasons.

The first problem with focusing exclusively on refiling rates is that a recurrence of financial distress does not necessarily lead to a second bankruptcy proceeding. Financial distress, even when it does not lead to a bankruptcy petition, is costly. A firm in financial distress may be a ripe candidate for a takeover, it may put itself on the auction block, it may initiate an out-of-court restructuring, or it may have to sharply curtail (or even eliminate) its operations. A Chapter 11 proceeding that leaves the firm vulnerable to financial downturns may lead to results other than a second bankruptcy petition.

A quick glance at LoPucki's data highlights the problem. By our count, of 183 firms in LoPucki's data set, only seventy-six (42%) are still being followed. Fifty-eight percent of the firms that emerged from Chapter 11 no longer meet the criteria LoPucki established for being followed. Of the thirty-two firms that emerged from reorganization in Delaware, thirteen (41%) remained in the data set by the cutoff date. For all other jurisdictions, sixty-three of 151 (42%) remained under observation to the end of the period. To be sure, given that Delaware cases, on average, tend to be younger, it may be that Delaware firms are more likely to fail to meet the criterion for being followed. We have not been able to verify this proposition one way or the other from the data we have. Still, it is striking that less than half of the companies reorganized under Chapter 11 fail to meet the standards for being followed, and there is no obvious difference between Delaware and other jurisdictions. Thus, once the focus is on companies that have remained in the data set to the end of the study period, we see no results in the data suggesting that Delaware fares worse than its competitors.

A second reason refiling may not be a fair indicator of a court's performance is that LoPucki and Kalin fail to distinguish adequately between a refiling after a traditional Chapter 11 pro-

32. LoPucki & Kalin, *supra* note 6, at 236.

ceeding and a refiling after a prepackaged bankruptcy. One would expect a higher rate of refiling after a prepackaged bankruptcy than after a traditional Chapter 11. A firm in financial distress may or may not be in economic distress as well. If the firm is suffering from only financial distress, all that is needed is a new capital structure. If it is suffering from economic distress as well, however, it needs to revamp its operations. Yet it may be unclear to those in charge if a firm in financial distress is also in economic distress. Diverting all cash flow to debt service may prevent an accurate assessment of how the firm would operate were some of that cash flow retained in its operations. In this ambiguous situation, it would seem to be a rational strategy to attempt a prepackaged bankruptcy. If in fact the firm is only in financial distress, the prepackaged bankruptcy should relieve that distress. If, however, it turns out that, even with the new capital structure, the firm continues to lose money, the firm is probably in economic distress as well, and a more expansive Chapter 11 proceeding is needed. A prepackaged bankruptcy can be used in this way as a means to ascertain whether the firm is suffering from economic distress in addition to financial distress. The fact that a full-blown Chapter 11 proceeding follows a prepackaged bankruptcy cannot thus be viewed as a failure of the system.

The third reason the cost of a second refiling does not justify focusing on refilings is that there may be an optimal, non-zero refiling rate. Bankruptcy proceedings are costly affairs, but they do not have a fixed cost. An unstated premise of LoPucki and Kalin's article is that the initial bankruptcy proceeding costs the same regardless of the jurisdiction handling the case. Once one relaxes that assumption—and there is empirical evidence justifying such a relaxation—the benefits of a cheaper, less extensive Chapter 11 proceeding may exceed the costs of increasing the necessity of a second reorganization.

We start with the proposition that Delaware processes its bankruptcy cases more quickly than other jurisdictions do. There is empirical support for this proposition.[33] Bankruptcy proceedings have direct costs and indirect costs. Direct costs include the fees paid to various professionals such as lawyers, advisors, and accountants. These fees may be correlated roughly with the length of the bankruptcy proceeding. The longer the proceeding, the greater the fees. The indirect costs of bankruptcy, which may well exceed

33. *See* Eisenberg & LoPucki, *supra* note 1, at 989.

the direct costs,[34] stem from the distraction caused by Chapter 11. The firm's managers must focus on the reorganization proceeding rather than running the firm. Creditors may be hesitant to deal with a firm in bankruptcy. It seems fair to assume that these indirect costs are directly correlated with the length of time that a firm remains in bankruptcy. It logically follows that quicker bankruptcy proceedings will, on average, be cheaper affairs.

To be sure, there is a cost attached to quickness. Speed may indicate a less thorough-going examination of the needs of the reorganized entity. As LoPucki and Kalin intimate, enough questions may not be asked, or managers may be retained when they should be shown the door.[35] Operating plans may be approved that, on reflection, should have been jettisoned. Thus, there may be a trade-off between the cost of a procedure and the results. Such tradeoffs are ubiquitous in law.[36]

The fact that one has to make tradeoffs gives us no insight as to what the appropriate balance is. It may well be the case that all the owners of a firm benefit from a quicker proceeding even though such a proceeding is more likely to lead to a subsequent refiling. To be concrete, assume there is a 70% chance that a firm filing for reorganization in Delaware will emerge as a healthy company that will not need to refile. Filing in another jurisdiction leads to a 90% chance that the firm will emerge as a healthy company. These numbers roughly approximate those generated by LoPucki and Kalin. LoPucki's prior work in this area, done with Ted Eisenberg, shows that Delaware processes a traditional Chapter 11 case, on average, in 510 days. Other jurisdictions (excluding New York, which needs, on average, 765 days to conclude a case) process a case in 620 days.[37] Stated differently, Delaware processes a case in roughly 80% of the time as do other jurisdictions. Assume, for the sake of argument, that the overall cost of bankruptcy, which includes both direct costs and indirect costs, is directly proportional

34. *See generally* Edward I. Altman, *A Further Empirical Investigation of the Bankruptcy Cost Question*, 39 J. FIN. 1067 (1984); Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress: Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443 (1998).

35. LoPucki & Kalin, *supra* note 6, at 264.

36. *See, e.g.*, Mathews v. Eldridge, 424 U.S. 319, 334-35 (1976) (concluding that, in procedural due process cases, the Supreme Court must consider "three distinct factors: First, the private interest . . . affected by official action; second, the risk of an erroneous deprivation of such interest through the procedures used[;] . . . and finally . . . the fiscal and administrative burdens that the additional or substitute procedural requirement would entail").

37. *See* Eisenberg & LoPucki, *supra* note 1, at 989.

to the amount of time spent in bankruptcy. Thus, the cost of proceeding in Delaware would be 80% of the cost of proceeding in another jurisdiction.

These numbers would lead one to hope that the managers would choose to file in Delaware, even though a subsequent refiling is three times as likely. The expected cost of proceeding in Delaware is given by the cost of the first proceeding plus the expected cost of any future proceeding, discounted to present value. Symbolically, $c_\delta = D + pD$, where D is the cost of a Delaware proceeding, $\delta$ is the firm's discount rate, and p is the probability of refiling in Delaware.[38] For filing the first reorganization case in another jurisdiction, the cost is given by $c_o = O + \delta qO$, where O is the cost of proceeding in the other jurisdiction, and q is the likelihood of having to refile in that jurisdiction. Recall that $p = 0.3$ in Delaware and $q = 0.1$, and that $D = 0.8[O]$. Plugging these values in, we get a cost of filing in Delaware of $0.8[O] + \delta.24[O]$ and a cost of filing in other jurisdictions of $O + \delta.1[O]$. When one subtracts the cost of filing in Delaware from the cost of filing in another jurisdiction, filing in Delaware is less expensive, even considering the cost of being three times as likely to need a subsequent reorganization, so long as $0.2[O] - \delta.14[O] > 0$, or $1.43 > \delta$. Thus, filing in Delaware will be cheaper as long as the firm's discount rate is less than 143%. Given that it is impossible to imagine a firm having such a high discount rate—it would mean that $1.00 in the future is worth $1.43 today—it is easy to see that filing in Delaware may be the cost-effective choice.

To be sure, our simple formula may not include all costs of refiling, and there may be a more complicated relationship between the time in bankruptcy and the cost of bankruptcy.[39] More complex models could be developed. Our basic point is not that we have correctly captured the costs of refiling; rather, it is that, even if one assumes refiling to be costly in the abstract, one cannot be sure that Delaware's higher refiling rate is inefficient. When evaluating any product, price is always an attribute to be considered. Given that we know that Delaware is faster, before condemning the Dela-

38. We are assuming here that only two filings are possible. To extent that a second bankruptcy would have a 30% chance of leading to a third (an issue on which we have no data), this would affect the numbers slightly, though the general point would follow through.

39. For example, our model implicitly assumes that all refilings occur after a single period. A more complete model would discount the cost of refilings based on the number of periods between the first bankruptcy and refiling. Such a refinement would, of course, reduce even further the expected cost of a second bankruptcy proceeding.

ware refiling rate, we need to know more about the price at which Delaware is selling its product.

It follows from all of this that refiling rates, in and of themselves, do not necessarily provide a benchmark for measuring reorganization practice. This observation exposes perhaps the most crucial problem with LoPucki and Kalin's project: it fails to offer a robust definition of what constitutes a successful Chapter 11 proceeding.

In attempting to assess Chapter 11 practice, LoPucki and Kalin focus only on firms that have emerged from Chapter 11 as operating companies. Yet this focus seems unduly narrow. Recall, for example, that LoPucki's sample began with 240 cases, and over 21% of these firms were liquidated[40] rather than reorganized. Do these cases represent a success or failure of Chapter 11? Were one to view the goal of Chapter 11 as reorganization at all costs, this 21% would be a failure. But a sale of the assets can often be viewed as a success. Indeed, academics have argued strongly that an auction, as opposed to a reorganization, is the best way to resolve the financial distress of large, publicly held companies.[41] To be more concrete, consider the case of ICO Global Communications Ltd.[42] ICO filed for bankruptcy in Delaware in August of 1999. In October of 1999, Craig McCaw in essence agreed to buy 80% of the firm for $1.2 billion. ICO emerged from bankruptcy on May 17, 2000, and was immediately merged with another firm owned by McCaw. By all accounts, this was a much better outcome than most anticipated when ICO filed for bankruptcy.[43] Yet this case, had it ended prior to LoPucki and Kalin's cutoff date, would not have been included in the data set because it was not an independent firm after bankruptcy.

Ultimately, success in a Chapter 11 proceeding is measured by whether the assets were deployed to their highest valued use, whether the firm had a capital structure consistent with its reve-

40. Liquidation in this context includes sales of assets as going concerns, not just piecemeal liquidations.

41. *See* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986); *see also* Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523 (1992); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Robert D. Hanson & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance*, 18 INT'L REV. L. & ECON. 159 (1998).

42. The timing of the ICO Global bankruptcy is such that it is not included in Professor LoPucki's data set.

43. *See* Scott Thurm & Paul M. Sheer, *Deals & Deal Makers: ICO, Wasserstein Clash in Battle over Hefty Bailout Fee*, WALL ST. J., Aug. 29, 2000, at C1.

nues, and whether these two objectives were achieved in the most cost-effective manner.[44] To be sure, refiling is evidence that this may not have occurred. As we discuss more fully below, a firm may need a second reorganization because it may have failed to reduce its debt load sufficiently in the first reorganization, it may have retained a suboptimal business strategy, or it may have done both. Perhaps these firms should have had a different plan of reorganization, or perhaps they should have been auctioned off. Yet it may be that some firms emerging from Chapter 11 and not refiling should have been sold during bankruptcy. Before condemning or condoning Delaware, one needs a robust theory of what constitutes a successful Chapter 11 proceeding. A narrow focus on refiling rates simply will not do.

## IV. THE DIVERGENCE BETWEEN DATA AND CONCLUSIONS

While a focus on refiling rates cannot tell us whether the stampede to Delaware for corporate reorganizations should be applauded or opposed, we could still learn something from the data LoPucki and Kalin have generated. In particular, we could discern what it is about reorganization in Delaware that leads to a higher refiling rate.[45] If we knew the causes of the refiling rate, we would be in a better position to assess its normative impact. This would require a multivariate analysis of the causes of refiling rates.

Statistical analysis of multivariate empirical data normally proceeds in two steps. First, the researcher formulates a well-articulated theory about what they are trying to prove or disprove. For example, if the scholar wishes to test whether increases in variable X lead to increases in variable Y, then she must provide a theory of why this should be true. In this case, LoPucki and Kalin have assumed the burden of providing us with a theory explaining why more companies making bankruptcy filings in Delaware (variable X) leads to a disproportionately high number of bankruptcy refilings by those companies (variable Y). As we discuss below, LoPucki and Kalin have not fully explained why there may be a causal relationship between these two variables. A theory of causality is crucial; without it, the researcher suffers from the "omitted variable

44. *See* Robert K. Rasmussen, *The Ex Ante Effect of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1160-61 (1994).

45. In this Section, we are assuming for the sake of argument that the differences in refiling rates between Delaware and other jurisdictions for both prepackaged bankruptcies and traditional Chapter 11 cases are statistically significant.

problem," in which a different, unmeasured variable is actually driving the results that one sees.

The second step in empirical analysis is to generate a model to test the hypotheses that the researcher derives from her theory. The type of model that she employs will depend upon the relationship that she is trying to capture and the number of factors that influence it. Here, LoPucki and Kalin have a wide variety of possible models that they could have used to test for the purported causal connection between bankruptcy filings in Delaware and the refiling rate. A number of variables that might affect this relationship would also need to be incorporated into such a model, suggesting that LoPucki and Kalin should have incorporated some form of multivariate analysis. They do not employ such a model, nor do they examine all possible variables. LoPucki and Kalin's simple bivariate testing raises more questions than it answers. As they themselves acknowledge, none of their results does more than suggest avenues for future researchers to investigate.

### *A. What is the Relationship Between Bankruptcy Filings in Delaware and the Refiling Rate?*

Unanswered by LoPucki and Kalin is the question of what causes a firm to file a second bankruptcy, or, more precisely, what did or did not happen in the first bankruptcy that left the firm vulnerable to a second bankruptcy proceeding. One can imagine at least three possibilities. The first is that there was not sufficient debt reduction to alleviate financial distress. Stuart Gilson suggests this possibility in his study of firms that adjust their capital structure, both in and out of bankruptcy.[46] Gilson shows that firms leaving a bankruptcy proceeding are more highly leveraged than most firms in their industry. The more leverage, the more likely a firm is going to run into financial difficulties in the future. Confirming this positive correlation between leverage and bankruptcy, Professor Gilson also shows that firms undergoing out-of-court restructuring are likely to remain more leveraged, and are more likely to undergo a second restructuring, than firms going through Chapter 11. In other words, Gilson finds that firms reduce more debt in Chapter 11 than they do in out-of-court restructurings, but they still do not reduce sufficient debt to inoculate themselves from a second bout with financial distress.

46. See generally Stuart C. Gilson, Transaction Costs and Capital Structure Choice: Evidence from Financially Distressed Firms, 52 J. FIN. 161 (1997).

The second reason that a firm may need to visit Chapter 11 a second time is that the firm did not change its operations enough to alleviate its economic distress. Some bankrupt firms simply need a new capital structure. Their operations are sound in that they generate operating revenues that exceed operating costs, but they cannot service their debt load. They are suffering financial distress but not economic distress. Cases such as *Johns Manville* and *Texaco* fall into this category.

Other cases, in contrast, involve firms that need to restructure not only their capital structure but also their operations. The firm, absent dramatic change, is not economically viable. It cannot make up in volume what it loses in each transaction. It may need to shed assets and focus on its core business. If a bankruptcy proceeding only addresses the firm's capital structure but fails to correct defects in its operations, a second trip to the tank will be inevitable. Perhaps firms filing in Delaware alter their operational focus to a lesser extent than firms filing elsewhere.

In either of these scenarios—the firm remains too highly leveraged, or the firm remains too highly leveraged and with inefficient operations—one could surmise that bankruptcies in Delaware leave firms more leveraged than those in other jurisdictions. Delaware practice may lead firms to reduce debt less than other jurisdictions.[47] Creditors, understandably, resist what they view as an unwarranted reduction of their claims. Perhaps managers in Delaware buy the peace by not antagonizing creditors through aggressive debt reductions. This effort at appeasement could result from managers' desires to retain their positions, to end the proceeding as quickly as possible, or to craft a reorganization plan that gives a portion of the reorganized firm to the equity holders of the pre-bankruptcy firm.

The third possible 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. Whether this cause of refiling for an individual firm can plausibly explain the difference in refiling rates be-

47. LoPucki and Kalin note Gilson's work in passing, but make no attempt to use their data to look at the leverage ratios of the firms in their study. Moreover, they offer no reason as to the incentives that managers may have to steer their firm to a jurisdiction that permits plans of reorganization with higher than average leverage ratios.

tween Delaware and the rest of the country is a difficult question. If the firms filing in Delaware were a random subset of firms filing nationally, the risk of external shocks would be randomly distributed across the sample, and that risk could not plausibly explain the differing refiling rates. Given that there seems to be a great variation in the types of firms that file for bankruptcy, however, there may be something about the nature of the firms ending up in Delaware that left them more vulnerable to unexpected changes. While this explanation is plausible, we view it as the least likely of the three.

We thus have three possible reasons as to why the bankruptcy practice in Delaware may lead more firms filing there to seek a second reorganization. Which reason or combination of reasons is true affects what policy prescriptions one endorses.

LoPucki and Kalin do not consider any of these explanations for Delaware's refiling rate. Instead, they identify four scenarios they claim might explain their refiling rate data: the "potential for huge gains" from a risky reorganization plan;[48] the possibility that Delaware handles "a disproportionate share of the most difficult cases;"[49] the potential for differences in the size of the firms filing in Delaware;[50] and finally, the possibility, based on anecdotal information about three cases, that "the Delaware court did not appear to be making informed decisions on which risks to undertake."[51] While they claim to test each of these factors' importance as alternative explanations, the authors pay little attention to the first three, and leave little doubt that they believe the only explanation is that the Delaware court "abdicates its statutory obligation to determine whether the proposed reorganization is feasible."[52] Yet they offer no definitive data for this conclusion. Given the other explanations that we offer above, the cause of Delaware's higher refiling rate remains open to speculation.

48. Lopucki and Kalin, *supra* note 6 at 255.
49. *Id.* at 257.
50. *Id.* at 257-59.
51. *Id.* at 259. This last explanation may be consistent with Delaware's speed in processing cases.
52. *Id.* at 264.

### *B. How Should We Test a Theory Suggesting That Increases in Bankruptcy Filings in Delaware Lead to Increases in the Refiling Rate?*

Despite their failure to articulate a comprehensive theory about the nature of a bankruptcy practice in Delaware that supposedly causes higher levels of bankruptcy refilings, LoPucki and Kalin push ahead to analyze their data set using bivariate analysis. The heart of their analysis is reproduced in Tables 5 and 7, where they present data showing the bankruptcy refiling rates for all bankruptcies and bankruptcy refiling rates for prepackaged bankruptcies only.[53] They find that the refiling rates for all bankruptcies—traditional Chapter 11 and prepackaged bankruptcies combined[54]—filed in Delaware are statistically significantly higher than for all bankruptcies filed in all other jurisdictions. They make a similar, but much weaker, finding that refiling rates for prepackaged bankruptcies are higher for Delaware compared to all other jurisdictions excluding the Southern District of New York.[55]

These are interesting results, but simply comparing the average refiling rates of different courts only tells us whether there is a significant difference between them. It does not tell us much about the reasons for the difference and whether the difference is solely attributable to the court handling the case. To answer that question, we need to control for the other factors that may affect refiling rates for bankruptcy proceedings.

It is here that LoPucki and Kalin speculate about what those factors might be. While we explore the tests that LoPucki and Kalin employ of the effects of these variables below, it is worth pausing to ask whether they have controlled for the most important factors that influence bankruptcy refilings. In this regard, we think that the answer must be no. As we noted above, refilings could stem from a failure to alter the capital structure so as to relieve financial

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53. No separate statistics are presented for Chapter 11 bankruptcies only. While it is unclear from looking at the data presented in the article if the deletion of the prepackaged bankruptcies from the whole sample would alter the significance of the basic bivariate result, it would clearly result in different rates of refiling for Chapter 11 proceedings from those presented for all filings. It would be useful, therefore, to discuss refiling rates for Chapter 11 proceedings in a separate table from those for prepackaged bankruptcies, rather than lump those rates together as LoPucki and Kalin have. At the least, the article ought to present the results of testing for statistical significance of refiling rates for Chapter 11 proceedings in Delaware and other jurisdictions so that the reader can see if the bivariate results hold up.

54. For our criticism of this combination, see *supra* text accompanying notes 17-26.

55. Again, we are puzzled by the exclusion of the Southern District. *See supra* text at pages 292-93.

distress, a failure to revamp the operations of the firm to relieve economic distress, or from external shocks that affect those firms emerging from Delaware as opposed to some other jurisdiction. We would think that it would be important to determine if, for example, leverage ratios differed between companies filing in Delaware and those filing in other jurisdictions, and how the bankruptcy proceeding in the different courts affected them. Similarly, one could compare operating revenues and expenses in the period before filing with the period after completion of the initial reorganization to ascertain the extent to which the firm has shed assets in Chapter 11.

Moreover, to truly assess the performance of Delaware, LoPucki and Kalin should have considered dispositions other than emergence after Chapter 11. Chapter 11 often results in the sale of all or substantially all of a firm's assets. Indeed, the auctioning off of assets upon the filing of a Chapter 11 petition seems to be a growing trend,[56] perhaps because it may well be the most efficient means of resolving the financial distress of large, publicly held companies.[57] If what LoPucki and Kalin worry about is refiling, they should rejoice when the assets of a firm are sold to a healthy third party. Short of a complete sale, a bankruptcy proceeding could sell off a substantial portion of a firm's assets. In fact, if Delaware were more likely to auction off valuable assets than other jurisdictions, this could explain its higher failure rate. The valuable assets are sold to a third party, and the firm tries to make a go with the more risky assets for which there is less of a market.

Furthermore, LoPucki and Kalin make no attempt to list any other important variables that might need to be considered, if data on them were available. For instance, the central theme of LoPucki and Kalin's critique of Delaware bankruptcy courts is that they fail to scrutinize the agreement that creditors and management reach. What is the direct evidence of this? Are Delaware bankruptcy filings leading to lower levels of debt reduction, on average, across the companies in the sample? Are managers at companies filing for bankruptcy in Delaware, on average, deriving some benefits that managers filing elsewhere are not? These variables are critical to testing the thesis of their article.

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56. *See* Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 104-06 (1995).

57. *See generally* Baird, *supra* note 41. A related trend is the use of bankruptcy to consummate a sale of the firm that has been agreed to prior to the bankruptcy filing. TWA and American Airlines are currently using this strategy to enable American to purchase TWA. TWA's bankruptcy petition, not surprisingly, was filed in Delaware.

Finally, much of the criticism of the rise of the Delawarization of bankruptcy law centered on one judge, Helen Balick.[53] Rightly or wrongly, detractors of Delaware have pointed to her as the cause of Delaware's failures. Judge Balick has since left the bench, but Delaware continues to be the preferred bankruptcy venue for large, publicly held corporations to file for bankruptcy. Judge Balick's cases dominate LoPucki and Kalin's data set. According to the data that they have generously shared with us, of thirty-two cases filed in Delaware, Judge Balick handled twenty-five, the other bankruptcy judge (Judge Walsh) handled six, and the two judges together handled the one remaining. To be sure, the refiling rate between the two judges appears roughly similar. Seven of Judge Balick's cases (28%) ended up going through Chapter 11 twice, two of Judge Walsh's cases (33%) needed a second Chapter 11 proceeding, and the one case with which they were both involved ended up refiling. Nevertheless, given the large presence of a single judge in the data, it bears watching how the refiling rate changes—if at all—as cases handled by other Delaware bankruptcy judges are added to the mix.

More generally, the effect of all of the variables affecting bankruptcy refiling rates, including the ones discussed by LoPucki and Kalin, can only be sorted out if a multivariate form of statistical analysis is used. For instance, economists commonly use multiple regression analysis to model linear multivariate relationships to determine the contributions, if any, of the different variables to the hypothesized causal relationship.

Turning to LoPucki and Kalin's efforts to control for the effects of other variables on bankruptcy refiling rates, it is important first to note that these are all bivariate "tests" of the significance of these variables. While perhaps indicative of things to look for in a multivariate analysis, bivariate tests can be misleading. Variables that often seem important in bivariate analysis often have no significance in multivariate testing. Thus, we might find that the court hearing a bankruptcy case, while apparently important in determining refiling rates in a bivariate analysis, is statistically unimportant once multivariate statistical techniques are employed.

Finally, even as a bivariate analyses, LoPucki and Kalin's efforts to examine the effect of the factors that they identify as potentially important fail to provide much guidance. For example, LoPucki and Kalin claim that they wish to determine if Delaware's

58. LoPucki & Kalin, *supra* note 6, at 267.

high refiling rate is caused by its having received a disproportionate share of the most difficult bankruptcy cases.[59] To test this proposition, they try to determine the types of businesses most likely to file for bankruptcy using one digit SIC codes as a method of classifying firms by type, and then comparing how many of these cases are handled by the different courts. They find that Delaware does not receive a disproportionate number of manufacturing and retail trade bankruptcies, which appear to be the single SIC code categories with the highest refiling rates. This is an interesting result that needs to be further explored, despite the obvious problems created by their small sample size for statistical testing.

The basic problem is that single digit SIC codes are an overbroad measure for determining which firms are most likely to file bankruptcies, as they group together a broad range of businesses that have very little in common.[60] Even though they find statistically significant differences in the types of single digit SIC businesses filing for bankruptcy, it is difficult to interpret this finding for comparative purposes when such a broad range of firms falls within each category.[61] We suggest that LoPucki and Kalin could enrich their analysis by adding further comparisons of the firms within the manufacturing and retail trade categories to try to generate further details about these comparisons.

The remaining efforts to control for the effects of other variables are also unpersuasive. For instance, LoPucki and Kalin test for differences in the size of companies that file for bankruptcy in Delaware versus other jurisdictions. It is unclear why they believe that size should make a difference in refiling rates. Perhaps there are good reasons to think it should, but they are not spelled out in the article.

LoPucki and Kalin also claim to test whether Delaware receives a disproportionate share of high-risk bankruptcies. Here it would seem that we would want to define a high risk bankruptcy using measures of economic distress or financial distress, so that a higher risk company would be one that is deeper in the hole and

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59. *Id.* at 257.

60. For example, the one digit SIC code 2, which includes retail stores of various kinds, also includes automobiles and auto parts, building materials, hardware and tools, hotels, household furnishings, publishing, the gaming industry, textiles, advertising services, and commercial and consumer services.

61. Given the small number of observations in the sample, it may well be impossible to generate meaningful statistical comparisons using two digit SIC code categories. This lack of data does not negate our basic point that the measure used is a very imprecise one for the test that the authors are trying to conduct.

less likely to emerge than a lower risk company. Instead of using this measure, LoPucki and Kalin tell us that, based on their "casual examination" of the data, there do not appear to be any dramatic successes.[62]

## V. CONCLUSION

These limitations on LoPucki and Kalin's theory and results argue strongly in favor of modesty about the implications of their current work. They also present a challenge to both defenders and critics of the current system to produce stronger theories and better tests to prove them. We think that such attention to the potential defects of the current venue system are well-deserved. Indeed, despite our arguments that LoPucki and Kalin's data do not prove that traditional Chapter 11 practice in Delaware is suspect, we remain open to that possibility. LoPucki and Kalin have highlighted the need to search for empirical answers to the Delawarization question.

To finish this reply with a reminder of where we started, our proposal to reform the existing venue selection system argues that the current system is not working as well as it could, and that allowing companies to precommit to the venue in which they will seek reorganization, if it should become necessary, will be an improvement over the existing system. Our proposal would align the economic incentives of those making the decision with the overall welfare of the firm. Theory gives us reason to believe that alignment of managers' incentives with the goal of maximizing firm value will nudge the venue choice toward the socially optimal one. LoPucki and Kalin's data do not suggest otherwise.

62. LoPucki and Kalin, *supra* note 6 at 255 & n.57. The other "tests" on this point do not discuss any measures of company-specific risk. *See id.* at 255-56.