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TIMING MATTERS: PROMOTING FORUM SHOPPING BY INSOLVENT CORPORATIONS

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INTRODUCTION

Timing is everything. We all know people who, when making similar choices at different points in their lives, have made different decisions each time. A young man who chose to pursue professional advancement, even though it took him away from his family, may when he is older choose to spend more time with his family instead of seeking another promotion. Similar situations occur in legal settings. This is not irrational conduct: even economic decision makers, acting in a calculating self-interested manner,[1] care about timing.

Law and economics scholars explain that timing matters because the incentives that actors face change over time. These variations in context explain what might otherwise appear as logical anomalies. For example, corporate law scholars claim that corporate charter provisions drafted at the time of incorporation tend to be efficient, yet if those same provisions are offered as amendments to a pre-existing charter, these scholars argue that

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[1] This is the standard assumption of traditional economic analysis. A growing literature enriches this assumption by delineating the ways in which actual decisionmaking deviates from this ideal. *See, e.g., Symposium, The Legal Implications of Psychology: Human Behavior, Behavioral Economics, and the Law,* 51 VAND. L. REV. 1495 (1998); Christine Jolls et al., *A Behavioral Approach to Law and Economics,* 50 STAN. L. REV. 1471 (1998). These deviations are, in some situations, counteracted through structural mechanisms. *See, e.g.,* Robert K. Rasmussen, *Behavioral Economics, the Economic Analysis of Bankruptcy Law, and the Pricing of Credit,* 51 VAND. L. REV. 1679, 1687-1702 (1998) (explaining mechanisms in banks designed to increase the rationality of lending decisions).

they are wealth decreasing.[2] In a similar vein, many courts and commentators decry forum shopping.[3] At the same time, however, they applaud the use of forum selection clauses.[4]

The common explanation for these apparent contradictions is that the parties' incentives were different at the earlier point of time than they were later on. Thus, in both the charter and forum-selection situations, what changes is not the decision to be made—in the former it is the terms of the charter, in the latter it is where a dispute will be litigated—but rather the incentives the actor faces when the decision is made. Initial corporate charter provisions will be tested in the market in a way in which midstream amendments will not. Similarly, parties agree to forum selection clauses at the time of contract formation, when they are attempting to maximize the contract surplus, as opposed to the litigation setting, where one party is attempting to gain an advantage over the other party.

This insight—that timing matters—can be applied to analyze corporate bankruptcy reform initiatives.[5] In this article, we demonstrate that timing is

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[2] *Compare* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 1-39 (1991) (arguing that initial charter terms tend to be efficient) *with* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,* 102 HARV. L. REV. 1820, 1822-29 (1989) (midterm charter amendments should be limited); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role,* 89 COLUM. L. REV. 1618, 1674-78 (1989) (similar); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract,* 89 COLUM. L. REV. 1416, 1443-44 (1989) (similar).

[3] *See, e.g.,* Hanna v. Plumer, 380 U.S. 460, 474 (1965) (Harlan, J., concurring); Schultz v. Boy Scouts of Am., Inc., 480 N.E.2d 679, 686-87 (N.Y. 1985); Kevin M. Clermont & Theodore Eisenberg, *Exorcising the Evil of Forum-Shopping,* 80 CORNELL L. REV. 1507 (1995); Henry H. Friendly, *Averting the Flood by Lessening the Flow,* 59 CORNELL L. REV. 634, 641 (1974); Kimberly Jade Norwood, *Shopping for a Venue: The Need for More Limits on Choice,* 50 U. MIAMI L. REV. 267 (1996).

[4] *See, e.g.,* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 590-95 (1991); The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972); Linda Mullenix, *Another Choice of Forum, Another Choice of Law: Consensual Adjudicatory Procedure in Federal Court,* 57 FORDHAM L. REV. 291 (1988); Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure,* 25 CORNELL INT'L L. J. 51 (1992).

[5] For example, several economically-oriented bankruptcy scholars have argued that firms should be allowed to select their own bankruptcy regime, so long as such selection is done prior to the onset of financial distress. *See* Robert K. Rasmussen, *A New Approach to Transnational Insolvencies,* 19 MICH. J. INT'L L. 1 (1997); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Reorganization,* 71 TEX. L. REV. 51 (1992) [hereinafter Rasmussen, *Debtor's Choice*]; Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy,* 107 YALE L.J. 1807 (1998) [hereinafter Schwartz, *Contract Theory Approach*]; Alan Schwartz, *Contracting About Bankruptcy,* 13 J.L. ECON. & ORG. 127 (1997) [hereinafter Schwartz, *Contracting*]; *see also* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy,* 45 STAN. L. REV. 311 (1993) (arguing that current bankruptcy law should be replaced by a regime that enforces contractual priority). Just as in the corporate chartering and forum shopping examples above, they claim that the time at which the decision is made has efficiency implications. Initial charter provisions, or contractual clauses, are value enhancing, whereas the same choices made when insolvency looms imminent are not.

However, our proposals in this article, while directed toward increasing the efficiency of the bankruptcy law and applying a law and economics methodology, are quite distinct from the earlier literature. Unlike the proposed bankruptcy law reforms discussed above, our proposal could be implemented within the existing legal system with little or no change to current legal rules. Such an incremental approach to law re-

the key to unraveling the controversy surrounding one of the most hotly contested aspects of current bankruptcy law, forum shopping by corporations seeking to reorganize under Chapter 11. Examining this problem in light of the incentives that the relevant actors face reveals two novel propositions.

First, we argue that, despite the widespread criticisms of forum shopping, the Bankruptcy Code would be more efficient if the law were to facilitate *more* forum shopping by companies for bankruptcy venue. Such legal reform is warranted by the importance of timing and the different incentives corporate managers face at different times. If the law were to allow companies to commit to a particular bankruptcy venue prior to the onset of financial distress, managers would have strong incentives to select the forum that would maximize the value of the firm.[6] We would forbid subsequent unilateral changes of this choice of forum, particularly if the firm becomes insolvent, because managers' interests are likely to diverge from those of the firm as a whole at that time.[7]

Second, we contend that such a shift will do more than ensure that bankruptcy cases are handled by the jurisdiction which best promotes firm value; it will actually provide incentives for bankruptcy judges to increase their efficiency in handling Chapter 11 cases in order to attract these cases. Bankruptcy court judges seem to derive significant nonpecuniary benefits from handling these high profile, newsworthy cases. To the extent that these rewards lead bankruptcy judges to compete for cases, as they seem to do now, our proposal will lead them to seek to devise more efficient methods of resolving them.

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form has the virtue of not requiring wholesale legislative action and the attendant uncertainties that usually accompany such changes. *See, e.g.*, Robert G. Hansen & Randall S. Thomas, *Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance*, 18 INT'L REV. L. & ECON. 159 (1998) (proposing implementing an auction system for bankrupt companies through slight modifications in application of existing bankruptcy rules). This increases the likelihood that our proposal will be legislatively enacted.

[6] As we explain more fully below, we would allow managers to insert such a forum selection clause into the company's certificate of incorporation at the request of the company's creditors, without shareholder approval, even as the company approaches insolvency, in order to maximize the value of the firm. However, once such a forum is selected, this choice could not be changed by the firm's management without the creditors' consent. We argue that this provision will make the choice of bankruptcy forum more salient to the firm's financial investors and sharpen managers' and creditors' incentives to use it as a method of maximizing firm value. *See infra* Part III.C.

[7] Our proposal to permit companies to preselect a bankruptcy forum has many of the same virtues that forum selection and choice of law provisions have in contractual settings. As other scholars have noted, if the parties to a contract are allowed to preselect the forum in which they will litigate any potential disputes and the applicable law, they can insure that the most efficient forum and legal rules will be applied. *See* Michael Klausner, *A Comment on Contract and Jurisdictional Freedom*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 349 (Francis H. Buckley ed., 1999); Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT, *supra*, at 325. Conversely, the existing system of bankruptcy venue selection suffers from the same infirmities that arise in ex post litigation contexts, where the parties choose the venue most likely to maximize their individual gain, irrespective of its impact on their joint welfare. *See* Harold G. Maier & Thomas R. McCoy, *A Unifying Theory for Judicial Jurisdiction and Choice of Law*, 39 AM. J. COMP. L. 249, 266-67 (1991).

We develop our arguments concerning these points as follows. Part I begins in subpart A with a discussion of the practice of forum shopping for bankruptcy venue under the current Bankruptcy Code. The Code generally provides a firm seeking to reorganize under Chapter 11 with a number of permissible filing venues. Firms filing for bankruptcy, especially large firms represented by high-quality counsel, choose to file in the venue that best promotes their interests as debtors. Most large Chapter 11 cases are not commenced in the judicial district where the firm's corporate headquarters is located.[8] Rather, firms take advantage of the Bankruptcy Code's venue provisions to file in debtor-friendly jurisdictions, frequently thousands of miles away. In short, forum shopping is rampant.

We next trace the evolution of venue choices over time. During the first decade after the passage of the Bankruptcy Code, publicly traded companies filing for Chapter 11 tended to steer their cases to the Southern District of New York.[9] In the second decade after the Code's enactment, however, there has been a dramatic shift in filing patterns so that the Delaware bankruptcy courts have become the venue of choice.[10]

In Part B, we explain how these bankruptcy venue patterns developed. This history shows that large, publicly held corporations have engaged in strategic bankruptcy venue selection.[11] Moreover, debtors appear to be engaged in judge shopping[12] within their preferred venues. While a few commentators endorse forum shopping in limited circumstances,[13] none condones judge shopping. Thus, the widespread speculation that case assignments were not random in the Southern District of New York during its peak years as the preferred venue for debtors added fuel to the furor over companies' choices to file there.[14]

A similar complaint has been made about Delaware. In the early 1990s, firms deciding to file there knew which judge would hear their case because Delaware only had one bankruptcy judge. Now Delaware has two

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[8] *See* Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in the Bankruptcy Reorganization of Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967 (1999).

[9] *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, 26-29.

[10] GORDON BERMANT ET AL., CHAPTER 11 VENUE CHOICE BY LARGE PUBLIC COMPANIES 38-42 (Federal Judicial Center ed., 1997).

[11] See *infra* text accompanying notes 38-49.

[12] By judge shopping, we mean the practice of attempting to select a particular judge as opposed to just a particular forum. *See* Norwood, *supra* note 3, at 292-99.

[13] *See, e.g.*, Friedrich K. Juenger, *Forum Shopping, Domestic and International*, 63 TUL. L. REV. 553 (1989); Note, *Forum Shopping Reconsidered*, 103 HARV. L. REV. 1677 (1990). Much of this debate has been clouded by a lack of consensus on what constitutes forum shopping and how much forum shopping actually occurs. *See* Michael E. Solimine, *The Quiet Revolution in Personal Jurisdiction*, 73 TUL. L. REV. 1 (1998) (trying to ascertain the level of forum shopping).

[14] *See* Eisenberg & LoPucki, *supra* note 8, at 983-84.

judges.[15] But this judicial expansion did not eliminate the problem because these judges shared similar views,[16] and debtors could call the chief judge before filing their case to learn which of the two bankruptcy judges would handle it.[17]

Subpart C of Part I examines the recent criticisms of bankruptcy venue. Widespread concerns over the practice of choosing to file in Delaware led the Federal Judicial Center to commission a study of the "problem,"[18] the National Bankruptcy Review Commission to propose an amendment that would narrow the venue provision of the Bankruptcy Code, [19] and the District Court of Delaware to remove from the Delaware Bankruptcy Court the authority to hear all Chapter 11 cases automatically.[20]

We begin our analysis of these events by showing that not all critics are motivated by concerns for the virtues of the rule of law. Rather, an examination of the complaints offered, and the identity of those who offered them, reveals that many complaints are generated by a baser motive: greed. In the legal market today, widespread competition exists for clients and the attorneys' fees they generate. Chapter 11 cases generate millions of dollars in fees, and thus bankruptcy lawyers compete to handle these cases.[21] While attorneys from outside the district where the bankruptcy petition is filed can, and often do, represent parties in a bankruptcy proceeding, parties often retain local counsel.[22] Thus, when a large firm files a bankruptcy petition in a certain district, this filing directly increases the wealth of the bankruptcy attorneys who practice in that district. Given this rule, it is not surprising that many of the vocal opponents of the shift toward Delaware have been bankruptcy attorneys in states other than Delaware,[23] and that the most strident de-

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[15] *See* Ann Davis, *Too Much Bustle in Bankruptcy Court?*, WALL ST. J., Feb. 5, 1997, at B1 (explaining that Judge Balick was the only bankruptcy judge in Delaware until the 1993 appointment of Judge Walsh, who, until his appointment, was a member of the Delaware bankruptcy bar).

[16] *See* Mark D. Collins, *Why Delaware?*, 15 DEL. LAW. 38, 40 (Fall 1997).

[17] *See* BERMANT ET AL., *supra* note 10, at 40-41.

[18] *See id.* at 7 (report stemmed from request of Committee on the Administration of the Bankruptcy System in June 1996).

[19] *See* REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 770-87 (October 20, 1997) [hereinafter NATIONAL BANKRUPTCY REPORT].

[20] *See* James Agger, *Delaware Bankruptcy Order Unsettles Local Practitioners*, THE LEGAL INTELLIGENCER 1 (Jan. 28, 1997); *Delaware District Court Withdraws Reference of All Ch. 11 Cases to Bankruptcy Court*, Bankr. L. Rep. (CCH), at 123 (Jan. 30, 1997).

[21] *See, e.g.*, Alexander L. Paskay & Frances Pilaro Wolstenhome, *Chapter 11: A Growing Cash Cow, Some Thoughts on How to Rein in the System*, 1 AM. BANKR. INST. L. REV. 331 (1993); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 285-89 (1990).

[22] Indeed, the local rules of the Delaware Bankruptcy Court *require* the retention of attorneys licensed by the Delaware Supreme Court. *See* BANKR. D. DEL. R. 23.

[23] *See, e.g., Delaware's Withdrawal of the Reference: What It Means*, 30 BANKR. CT. DEC. (CCR) No. 4 (Feb. 11, 1997) ("You will recall that, for at least the past five years, much of the bankruptcy bench and bar (outside of Delaware and possibly New York) has been complaining about the fact that many large corporations file Chapter 11 in the District of Delaware. . . ."); William B. Sullivan, *Shaking*

fense of the current venue provisions has been issued by the Delaware Bar Association.[24] A similar alignment has occurred in Congress, with legislators from outside of Delaware supporting an anti-Delaware amendment to the Code, and those from Delaware trying to block such a change

Yet there is more substance to the current debate than just a squabble over money. After all, many of the participants are not bankruptcy attorneys; they include various scholars and those charged with reforming existing law.[25] Moreover, despite the apparent pecuniary interests of those objecting to current practice, the evils that they identify—forum shopping and judge shopping—have been the subject of concern well beyond the domain of bankruptcy law. It is one thing to show that a particular argument is motivated by economic interests; it is quite another thing to show that the argument is fallacious.

In Part II, we set the stage for our theoretical analysis of forum shopping by reviewing the arguments made in the "race to the top" corporate law scholarship. This literature argues that public companies incorporate in Delaware for efficiency reasons.[26] It claims that Delaware, through its reliance on charter revenue and its judicial selection process, has committed itself to provide corporate laws that enhance firm performance, and that market forces lead firms to adopt these value-enhancing laws.[27] The linchpin of the "race to the top" argument is that managers select their firm's state of incorporation before they enter the capital markets. If managers select a state of incorporation with inefficient legal rules, the firm pays a higher cost for capital. The threat of this higher cost creates an incentive for the firm's managers to select a jurisdiction that maximizes firm value.

Part III extends this argument to the bankruptcy context. We first examine the incentives that managers face to show that current law generates efficient venue choice for less contentious, voluntarily agreed to, prepack-

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the Jurisdictional System; Will Revocation of Automatic Reference Become the Norm?, 14 BANKR. STRATEGIST 1, 6 (March 1997) ("most lawyers, accountants and other bankruptcy professionals located in other states look upon Delaware's loss as their gain"); Ann Davis, *Delaware Bankruptcy Lawyers to Meet with Judges on Overhaul of Procedures*, WALL ST. J., Jan. 29, 1997, at B8 ("[l]awyers and judges from other states have complained about Delaware's dominance").

[24] *See* Report of the Delaware State Bar Association to the National Bankruptcy Review Commission in Support of Maintaining Existing Venue Choices (Oct. 3, 1996), *reprinted in* NATIONAL BANKRUPTCY REPORT, *supra* note 19, at App. D-3; *see also* Davis, *supra* note 23 ("Delaware lawyers have fought fiercely against the proposal.").

[25] *See, e.g.*, Eisenberg & LoPucki, *supra* note 8; David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1 (1998); NATIONAL BANKRUPTCY REPORT, *supra* note 19, at 770-87.

[26] *See infra* text accompanying notes 129-40. David Skeel, drawing on this same literature, has argued that bankruptcy law should be returned to the states. *See* David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471 (1994). We do not address the merits of Skeel's proposal in this article because, as we mention below, we restrict our focus here to reforms that can be implemented within the extant bankruptcy system.

[27] *See infra* text accompanying notes 129-40.

aged bankruptcies. At the same time, managerial incentives in the case of a more traditional Chapter 11 diverge from the interests of the firm as a whole. Changing the law to allow venue choice before the firm becomes financially distressed would encourage managers to choose bankruptcy venues that enhance firm value in both situations. Our argument is that the firm's managers select the venue that best promotes their own interests. These interests, and the extent to which they are aligned with those of the firm as a whole, will vary over time. Under current law, managers need not decide on the filing venue until after the firm has become financially distressed. By this point, the interests of the managers often diverge from the interests of the firm as a whole.[28] Were the law amended to allow a firm's managers to bind the firm to filing in a particular venue, and were such commitment made before the firm entered the capital markets, then the managers would have an incentive to select the venue that promised to maximize the value of the firm as a whole.

Thus, contrary to the prevailing wisdom, we maintain that forum shopping, and even judge shopping, can increase the efficiency of the Bankruptcy Code. To this end, the current proposals for restricting venue choice are misguided; if anything, venue choices should be increased, subject to one crucial change—the time at which the venue decision is to be made. Firms should be allowed to make a venue choice before they enter the capital markets.

We believe that such a shift will also lead to competition among jurisdictions that will provide an incentive to bankruptcy judges to increase their efficiency in handling Chapter 11 cases. To expand on this point, we first note that judges appear to compete to attract the big, high profile Chapter 11 cases, perhaps to raise their status with their peers, or perhaps because they prefer the intellectual challenges of the complex corporate cases. The Bankruptcy Code grants these judges substantial discretion in administering bankruptcy cases.[29] As we noted above, firms to date have tended to file in "debtor friendly" courts—courts that routinely exercised their discretion in ways that benefited debtors at the expense of creditors. If our proposal were implemented, thereby allowing debtors to make venue choices prior to the onset of financial distress, debtors would have an incentive to select a judge who will exercise her discretion in the most "efficiency enhancing" manner. This incentive arises because our proposal enables creditors to differentiate among debtors based on the jurisdiction in which they have committed to file.

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[28] *See* Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439 (1992); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 101-09 (1984); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994); Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991).

[29] *See infra* note 68.

We recognize that legal reform proposals based on economic insights face formidable obstacles. On the one hand, they have the virtue of conceptual purity and intellectual rigor.[30] On the other hand, they often propose a complete rejection of extant law, and endorse wholesale departures from current practices.[31] While there are benefits to rebuilding the law on solid foundations, lawmakers are normally reluctant to do so unless disaster strikes.[32] We believe that our proposal to restrict bankruptcy venue selections to those made when the firm seeks capital in the market, but prior to financial insolvency, has the virtue of being analytically sound and yet capable of implementation without radical legal reform.

I. THE RACE TO DELAWARE FOR CORPORATE REORGANIZATIONS

Forum shopping and judge shopping are hotly contested practices.[33] Until recently, little attention has been paid to these problems in the area of corporate reorganization.[34] Recent events, however, have focused national attention on the question of where large, publicly held firms file for bankruptcy.

A. Evidence of Forum (and Maybe Judge) Shopping

The Bankruptcy Code provides a firm seeking to reorganize under Chapter 11 a broad choice of potential forums. The Code permits the firm to file its petition in any district where the company has its principal place of business, its principal assets, or its "domicile," that is, the firm's state of incorporation.[35] Moreover, the Code allows a firm to file a petition in any district in which an "affiliate" of the firm has a pending bankruptcy case.[36]

The extent to which these venue provisions provide a meaningful choice to a firm in financial distress will often turn on the size of the firm.

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[30] *See generally* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1998) (comparing the premises of law and economics bankruptcy scholars with those of traditional bankruptcy scholars).

[31] A notable exception to this deficiency is Barry Adler's work on preference law. *See* Barry E. Adler, *Accelerated Resolution of Financial Distress*, 76 WASH. U. L.Q. 1169 (1998) [hereinafter Adler, *Accelerated Resolution*]; Barry E. Adler, *A Re-Examination of Near-Bankruptcy Investment Incentives*, 62 U. CHI. L. REV. 575 (1995) [hereinafter Adler, *Re-Examination*]; *see also* Hansen & Thomas, *supra* note 5 (proposing that existing Chapter 11 rules be enforced to implement an alternative Chapter 11 regime in which companies are auctioned if they fail to reorganize within 180 days).

[32] For example, Congress passed the 1933 Securities Act and the 1934 Exchange Act in the aftermath of the 1929 collapse in the stock market and ensuing chaos and economic hardship that resulted.

[33] A good summary can be found in Solimine, *supra* note 13, at 18-21.

[34] The first academic article on this subject was LoPucki and Whitford's 1991 article. LoPucki & Whitford, *supra* note 9. The current debate over the validity of Delaware as an appropriate forum has generated articles by Eisenberg and LoPucki and Skeel. *See* Eisenberg & LoPucki, *supra* note 8; Skeel, *supra* note 25.

[35] 28 U.S.C. 1408(1) (1994). *See In re* Ocean Properties of Del., Inc., 95 B.R. 304 (Bankr. D. Del. 1988) (holding that state of incorporation is a corporation's residence for purposes of bankruptcy venue).

[36] 28 U.S.C. 1408(2) (1994).

Many smaller firms will have only one venue choice; it is often the case that a firm, which has no affiliates, is incorporated, has its principal place of business, and has its principal assets all located in the same district. Many, if not most, small, privately held firms fit this description.

Large, publicly held firms, on the other hand, will generally have more viable bankruptcy venue choices. These firms are more likely to incorporate in a state other than the one where their headquarters or principal assets are located.[37] Their headquarters may well be in a different jurisdiction than their principal assets. They are also more likely to have affiliates in other jurisdictions, thereby expanding their range of permissible venues.[38] Large, publicly held firms thus normally have a choice over the jurisdiction in which they file a Chapter 11 petition.

Increasingly, critics have scrutinized large, publicly held firms' choices among these potential venues. This forum shopping phenomenon first attracted attention during the 1980s, when a number of large, publicly held firms filed for bankruptcy in the Southern District of New York. Even a casual observer could not help but note that many of these firms had little contact with New York. Indeed, during this period, the list of firms filing in the Southern District read like the "Who's Who" of major 1980s' reorganizations—Johns Manville, Texaco, LTV, and Eastern Airlines.

Eastern Airlines' Chapter 11 filing was the most visible example of venue shopping. Eastern, a Miami-based corporation, was able to steer its reorganization case to the Southern District by having its wholly owned subsidiary—Ionsphere Clubs (which ran Eastern's hospitality suites for its frequent fliers)—file for bankruptcy in the Southern District.[39] Ionsphere Clubs represented only a tiny fraction of Eastern's assets, and was solvent when it filed for bankruptcy.[40] Six minutes after the financially sound Ionsphere Clubs filed for bankruptcy, Eastern filed its own petition in the Southern District, piggybacking on the petition filed by its one hundred percent owned subsidiary.[41] While Eastern's filing was perhaps the most egregious example of forum shopping, most of the other major corporate reorganization filings were based on similarly slight connections with the Southern District of New York.

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[37] *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6 (American Enterprise Institute ed., 1993) (approximately one half of the largest industrial firms are incorporated in Delaware); *see also* Robert Daines, *State Competition in Corporate Law*, draft (reporting that corporations that incorporate in a jurisdiction other than the one in which they are based tend to incorporate overwhelmingly in Delaware).

[38] *See* LoPucki & Whitford, *supra* note 9, at 21 (reporting that of firms that they studied, roughly three fourths were composed of between 3 and 26 entities).

[39] Ionsphere Club was considered an affiliate of Eastern for purposes of the Code. *See* 11 U.S.C. § 101(2) (1994). No one asserted that the Southern District of New York was an improper venue for Ionsphere Club.

[40] *See* LoPucki & Whitford, *supra* note 9, at 22.

[41] *See id.*

These high visibility filings raised eyebrows because debtors were perceived as receiving highly deferential treatment by the bankruptcy court handling them. Moreover, it appeared to many commentators that a single judge handled a disproportionate number of these controversial cases.[42] For example, many commentators were critical of the Johns Manville Chapter 11 reorganization, which paid contract creditors in full, left equity in the hands of pre-bankruptcy shareholders, but created an allegedly inadequately funded trust fund for the victims of asbestos sold by Manville.[43] In the LTV filing, the reorganization process dragged on for over six years. Eastern's reorganization again provided the most grist for the rumor mill: after selling its profitable air routes to gather more than a billion dollars in cash, the firm was permitted to spend all of this money in a futile attempt to reorganize over the repeated objections of its creditors. These cases created a perception that major firms in financial distress were forum (and possibly judge) shopping.[44]

Empirical studies demonstrated that these high visibility cases were part of a trend. Between 1979 and 1988, the Southern District of New York captured roughly thirty percent of the reorganizations of large, publicly held firms.[45] This is a surprisingly large number, especially because the Southern District of New York would not be a permissible venue for many firms. For example, Delaware, not New York, is where most Fortune 500 firms are incorporated. Furthermore, while New York is home to a large number of corporate headquarters, it has no monopoly on them, and few firms have their principal assets located in Manhattan. Nevertheless, in the 1980s, whenever firms had the opportunity to file in the Southern District of New York, they did so.[46] Once again, debtors appeared to be filing in the Southern District because they believed that they would receive better treatment in its bankruptcy court.

Delaware was not a bankruptcy venue of choice in the 1980s. Only one large, publicly traded firm filed a bankruptcy petition in Delaware during this time period, and that firm had both its corporate headquarters and most important assets located in Delaware.[47] In other words, Delaware was

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[42] Not only were a number of major cases filed in the Southern District of New York, a substantial number of them were handled by the same bankruptcy judge, Judge Burton R. Lifland. For example, Judge Lifland handled the Manville, LTV, and Eastern Airlines cases. From 1980 to 1987, Judge Lifland handled over half of the Chapter 11 cases filed in the Southern District involving large, publicly held companies. *See* Eisenberg & LoPucki, *supra* note 8, at n.47.

[43] *See* KEVIN J. DELANEY, STRATEGIC BANKRUPTCY: HOW CORPORATIONS AND CREDITORS USE CHAPTER 11 TO THEIR ADVANTAGE Ch. 3 (1992); Frank J. Macchiarola, *The Manville Personal Injury Settlement Trust: Lessons for the Future,* 17 CARDOZO L. REV. 583 (1996); Thomas A. Smith, *A Capital Markets Approach to Mass Tort Bankruptcy,* 104 YALE L.J. 367, 368-70 (1994).

[44] *See* Seth Lubove, *A Bankrupt's Best Friend,* FORBES, Apr. 1, 1991, at 99.

[45] *See* LoPucki & Whitford, *supra* note 9, at 29.

[46] LoPucki and Whitford's landmark study of forum shopping in 1980s indicates that firms chose to file for reorganization in the Southern District when it was an available venue. *Id.* at 59-63 (listing cases studied and basis for venue in each).

[47] *See id.* at 62.

its only potential venue. Of the many other large, publicly held firms that had the option of filing for bankruptcy in Delaware because they were incorporated there, none did so.

The past decade, however, has seen a dramatic reversal in this trend: large numbers of firms now file for Chapter 11 reorganization in Delaware, while relatively few seek to do so in the Southern District of New York. This shift began in 1990, as firms began to view Delaware as a desirable bankruptcy venue. By 1996, Delaware attracted thirty-one percent of the publicly traded corporations that filed for Chapter 11. Moreover, these were very large firms, collectively owning over seventy percent of the assets of the publicly traded companies filing for bankruptcy during that time period.[48] The 1997 and 1998 figures remained high. For both years, of publicly traded companies filing for bankruptcy, twenty-two percent filed in Delaware; these firms held a substantial portion of the assets of publicly traded firms filing for bankruptcy in those years—thirty-two percent (1997) and twenty-four percent (1998).[49] The past year saw a dramatic increase in these figures. In 1999, forty-one percent of publicly traded companies that filed for bankruptcy chose to file in Delaware. These firms held sixty-nine percent of the assets of publicly traded firms filing for bankruptcy that year.[50] At the moment, Delaware is clearly the venue of choice for large, publicly held firms filing for bankruptcy.[51]

In contrast, in 1996, the Southern District of New York garnered only eight percent of publicly traded firms filing for bankruptcy. In 1997, that figure dropped another percentage point. As a result, the Southern District of New York had declined as a bankruptcy venue to the point where it is only tied with the Southern District of Florida for the third most frequently used corporate venue.[52]

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[48] *See* THE 1997 BANKRUPTCY YEARBOOK AND ALMANAC 68 (Christopher M. McHugh ed., 7th ed. 1997) [hereinafter 1997 YEARBOOK].

[49] *See* THE 1998 BANKRUPTCY YEARBOOK AND ALMANAC 68 (Christopher M. McHugh ed., 8th ed. 1998) [hereinafter 1998 YEARBOOK]; THE 1999 BANKRUPTCY YEARBOOK AND ALMANAC 66 (Christopher M. McHugh ed., 9th ed. 1999) [hereinafter 1999 YEARBOOK].

[50] *See* THE 2000 BANKRUPTCY YEARBOOK AND ALMANAC 66 (Christopher M. McHugh ed., 10th ed. 2000) [hereinafter 2000 YEARBOOK].

[51] *See Chapter 11 Filings Rise—in Delaware!* 36 BANKR. CT. DEC. (CCR) No. 5 (June 27, 2000) (reporting rise in Delaware filings in second quarter of 2000).

[52] The Central District of California had seven publicly held companies file for bankruptcy in that district in 1997, one more than New York did. The Southern District of Florida also had six publicly held corporations file in that time period. *See* 1998 YEARBOOK, *supra* note 49, at 68. In 1998, the Southern District had regained second place, attracting 10 cases, which is roughly 8% of the cases filed. The Central District of California had nine cases, and the Southern District of Florida eight. *See* 1999 YEARBOOK, *supra* note 49, at 66. The Southern District of New York remained in second place in 1999 attracting 10% of the filings; the Central District of California and the District of New Jersey tied for third with 5.5% each. *See* 2000 YEARBOOK, *supra* note 50, at 66.

We turn next to an analysis of the reasons for the initial rise of the Southern District of New York as a preferred venue and the ensuing shift of corporate reorganizations to Delaware.

B. The Motivations for Bankruptcy Forum Shopping

Bankruptcy forum shopping patterns are path dependent. The core idea of path dependence is that past events constrain future possibilities.[53] For example, the decision by IBM to adopt MS-DOS as the operating system for its first PC continues to affect the choice of software run on many computers today.[54] This theory accurately describes the pattern of corporate bankruptcy forum shopping.

To see why the bankruptcy venue selection process is path dependent, we must examine the incentives of the relevant actors who decide where firms file for Chapter 11. State corporate law places the bankruptcy filing decision in the hands of the board of directors, who normally delegate to the company's senior management the choice as to when, and in what district, to file for reorganization.[55] Managers will generally select a jurisdiction that promotes their self-interest, which is frequently to preserve their positions within the firm, although how they further these interests may vary depending on the particular problems facing the firm. Thus, in some situations, managers' incentives will lead them to act contrary to the interests of creditors, while in others these two groups' interests may converge.[56]

Senior management will consult with bankruptcy counsel before initiating the reorganization process. Attorneys advising corporations where to file bankruptcy proceedings base their advice on their experience in different jurisdictions and the other information that they have about the available fora. A forum with a hospitable reputation for debtors will be recommended over one where it is less certain how the debtor will be treated.

Attorneys will also consider how experienced the particular court is in handling bankruptcies of large, publicly held corporations. Courts that handle these cases regularly will gain valuable experience that they would not obtain from working with other forms of bankruptcy filings. Thus, judges and clerks' offices that have previously handled a large corporate bankruptcy, may handle new, major Chapter 11 cases more efficiently than inexperienced ones. If courts gain experience in this way, or at least if

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[53] For a general discussion of path dependence, and the way in which it may provide insights into legal issues, see Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996); Symposium, *Path Dependence and Corporate Governance*, 74 WASH. U. L.Q. 317 (1996).

[54] *See* Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985).

[55] Corporate law generally rests authority in the Board of Directors, who are generally free to devolve this authority onto the managers. *See* DEL. CODE ANN. tit. 8, §§ 141, 142 (1999).

[56] *See infra* Parts III.A. & III.B.

bankruptcy attorneys perceive that they do, this would provide another reason for path dependency in the forum shopping area.[57]

Bankruptcy attorneys advising firms about where to file their case are also influenced by their own financial self-interest. These incentives are a function of how attorneys for the debtor are compensated in Chapter 11. Under the Bankruptcy Code, the debtor's attorneys are paid from the firm's assets, ahead of all prepetition, unsecured creditors.[58] This payment scheme creates an agency problem—the managers hire the attorneys, but then have little incentive to monitor the amount of fees paid by the estate. Instead, the group that pays these fees is the debtor's unsecured creditors.

The Bankruptcy Code attempts to address this agency problem by requiring the bankruptcy court to review requests by the debtor's attorneys for fees. Courts differ in their approach to fee applications. These differences include how closely a court is willing to scrutinize the hours claimed and the hourly rate that the court is willing to approve. In particular, one important, recurring issue is whether New York attorneys should be paid at New York billing rates, or at the (invariably) lower rates which prevail in any other jurisdiction where the bankruptcy court handling the petition is located.[59] Not surprisingly, bankruptcy attorneys prefer to file in courts that are more likely to award the fees they request.

Recent developments in Houston highlight the importance of fee awards to venue decisions. The bankruptcy judges in the Southern District of Texas, in an attempt to induce local attorneys to file large Chapter 11 cases in their district, established an advisory committee to produce recommendations on how the bankruptcy judges should handle Chapter 11 cases.[60] The committee was comprised of local bankruptcy judges and local bankruptcy attorneys.[61] Local attorneys complained that the bankruptcy judges were reticent to approve an hourly rate of above $300 an hour. After receiving the report of the advisory committee, one of the local bankruptcy judges stated, "This is the sound bite. The war on fees is over. The bright line of $300 is gone."[62]

Coupled with the concern over fee awards is the fact that the attorneys that represent debtors in large, Chapter 11 cases comprise a small, elite

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[57] *Cf.* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995) (explaining how a similar process involving the Delaware state courts' interpretation of state corporate law may lead to a lock-in effect in the market for corporate charters).

[58] *See* 11 U.S.C. § 507(a) (1994).

[59] *See, e.g.*, Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc., 50 F.3d 253 (3d Cir. 1995) (reversing bankruptcy court's refusal to award New York rates); *In re* Washington Mfg. Co., 101 B.R. 944 (Bankr. M.D. Tenn. 1989) (awarding out-of-state rates); *In re* Wendy's of Mont., Inc., 111 B.R. 314 (Bankr. Mont. 1988) (refusing to award nonlocal rates); *In re* Frontier Airlines, Inc., 74 B.R. 973 (Bankr. D. Colo. 1987) (same).

[60] *See Houston, We Know We Have a Problem (But We're Working On It!)*, 35 BANKR. CT. DEC. (CRR) No. 12, at A1 (Feb. 8, 2000) [hereinafter *Houston*].

[61] *See id.* at A1, A8.

[62] *Id.* at A8.

community. Between 1980 and 1998, only thirty-four firms represented three or more publicly traded companies with assets in excess of $100 million.[63] Of these firms, only six represented more than ten such debtors.[64] The small size of this community explains two important aspects of bankruptcy forum shopping patterns. First, the small number of key players means that information about bankruptcy courts is disseminated relatively efficiently. Since the law firms are repeat players, they have an incentive to monitor the activity of the bankruptcy courts that are likely potential venues. Much of this information is not readily available to the general public. For example, many of the important attributes of the practices in a particular bankruptcy court are not apparent from reading published opinions. Bankruptcy judges have a broad range of discretion, which they exercise in a variety of ways, and only the parties involved in a given case will obtain direct information about how a judge exercises her discretion. This potential private information problem, however, is ameliorated by the small, cohesive nature of the bankruptcy bar.

Second, lawyers are not bound to file in the jurisdiction in which their offices are physically located. Whereas forum shopping in general civil litigation may be limited by the fact that most attorneys practice in the local courts to which they are admitted, and thus have little incentive to have their clients file in another jurisdiction, bankruptcy attorneys are qualified to handle reorganization cases anywhere. Moreover, because fierce competition exists for big cases, firms jealously guard their reputations for providing the most effective representation to debtors. If mishandling a case causes greater harm to a firm's reputation than the reputational benefits accruing from properly handling a case, we would expect the debtor's counsel to be quite risk averse in advising firms on where to file their petitions.[65]

Managers thus prefer a forum hospitable to their interests, and the debtor's attorneys prefer a forum that does not scrutinize fee applications too closely. The degree to which these preferences are satisfied will be directly affected by the behavior of individual bankruptcy judges.

Prior to the enactment of the Bankruptcy Code in 1978, attorneys had little information that they could use to make predictions about any particular judge's behavior under the new law.[66] Chapter 11 was an innovative

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[63] *See Big Case Lawyers/Big Case Firms,* 33 BANKR. CT. DEC. (CRR) No. 5, at chart 2 (Oct. 20, 1998) (reporting findings compiled by Lynn LoPucki) [hereinafter *Big Case Lawyers*].

[64] *See id.* Of these six firms, four had their main offices in New York, one had its main office in Delaware (and this firm, representing 44 debtors, had the most representation of any firm), and one had its main office in Los Angeles.

[65] On the tendency of reputation to lead to overly cautious advice, see Donald C. Langevoort and Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules,* 5 S. CAL. INTERDISC. L.J. 375, 394-99 (1997).

[66] The predecessor to the Bankruptcy Code, the Bankruptcy Act of 1898, contained reorganization provisions, but they differed significantly from those in the Code. *See* J. RONALD TROST ET AL., THE NEW FEDERAL BANKRUPTCY CODE (1979).

feature of the Bankruptcy Code when it was enacted. Moreover, the new Code contained provisions whose effects were unclear ex ante and which required interpretation.[67] Furthermore, some of its provisions expressly vested discretion in the bankruptcy judges.[68] Thus, when the Bankruptcy Code went into effect, lawyers had little information on which venues would best promote the interests of the managers who hired them and which venues would be more permissive towards attorneys fees. In other words, they did not know where to file in order to best satisfy their preferences.

Faced with this uncertainty, it is not surprising that the Southern District of New York received many of the early cases filed under the new Code. A number of firms have headquarters in New York, thus making the Southern District a convenient venue for the firm's managers. Also, several important investment banks and money center banks, often major players in a corporate reorganization,[69] are located in New York City. Finally, New York City has long been home to many leading commercial and corporate lawyers. A high percentage of the most respected lawyers who serve as debtor counsel are based in New York.[70] Thus, convenience was a significant factor in initially making the Southern District an attractive filing venue.[71]

Once the first few Chapter 11 cases were filed in the Southern District, bankruptcy lawyers perceived that its bankruptcy courts were exercising their discretion in "prodebtor" ways and were routinely approving attorney fee requests. As New York developed this reputation, a lock-in effect oc-

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[67] *See, e.g.*, Bank of Am. v. 203 North LaSalle St. Partnership, 119 S. Ct. 1411 (1999) (addressing, but not definitively resolving, the issue of whether "new value" exception to absolute priority survived the enactment of the Bankruptcy Code); United Saving Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988) (resolving the issue of whether "adequate protection" requires compensation for delayed recovery).

[68] For example, see 11 U.S.C. § 105(a) (1994) (bankruptcy court empowered to issue "any order . . . that is necessary or appropriate"); 11 U.S.C. § 362(d)(1) (1994) (bankruptcy court empowered to lift automatic stay for "cause"); 11 U.S.C. § 330(a)(1)(A) (1994) (bankruptcy court can approve payment of "reasonable" attorneys' fees); 11 U.S.C. § 1121(d) (1994) (bankruptcy court may extend exclusivity period for "cause").

[69] Money center banks often provide "debtor-in-possession" financing for Chapter 11 firms. Chemical Bank was the first major bank to create a separate DIP financing unit, and other major lenders include Bankers Trust New York, Citibank, and General Electric Capital Corp. *See* Maria Carapeto, *Does Debtor-in-Possession Financing Add Value?*, at 2 (Working Paper, March 12, 1999). Also, investment banks often provide advice in major Chapter 11 cases, especially concerning the value of the firm's assets.

[70] For example, since 1980, New York attorneys have served as lead counsel in half of the 18 largest bankruptcies of publicly held companies. *See Big Case Lawyers, supra* note 63, at chart 3.

[71] The first "major" case filed under the Bankruptcy Code was the Johns-Manville bankruptcy, which was filed on August 26, 1982 in the Southern District of New York. Counsel were based in New York, but the corporate headquarters were in Denver, and assets were located across the country, though there were none in New York. *See* LoPucki & Whitford, *supra* note 9, at n.56. Manville chose the Southern District because many of the participants were in New York and it viewed the bankruptcy court there favorably. *See id.*

curred.[72] Attorneys advising clients on the appropriate choice of bankruptcy venue could tell them that the Southern District was a favorable, "prodebtor" forum. By comparison, these lawyers would need to be more cautious in forecasting the debtor's fate in other venues where the courts were less predictable. These effects were self-reinforcing: as more and more firms filed in New York, lawyers received further positive reinforcement about the desirability of the Southern District. Thus, by 1988, the Southern District of New York was admittedly the bankruptcy venue of choice for large, publicly traded corporations.

However, that is not the remarkable part of the bankruptcy venue story. Given the path dependent nature of the process, one would expect that, with the enactment of the Code, one jurisdiction would gain a reputation as being debtor friendly, and other firms would file there whenever it was a permissible venue. Nor is it surprising that, early on, some firm would file in the Southern District. Once that happened, and the Southern District gained a reputation as being both debtor friendly and relatively liberal in approving fee requests, it was predictable that other firms would also file there.[73]

What is surprising is that the Southern District lost its position as the preferred venue. Patterns of behavior often become entrenched. Moreover, there were few natural competitors to the Southern District to become the situs of bankruptcy filings. Effective competitors needed to be venues widely available for many firms. Most of the available venue choices were not distributed in a manner that satisfied this criterion. For instance, if we examine all of the major corporations in the United States, their principal assets are not concentrated in any one area of the country. Corporate headquarters, to the extent that one location dominates, tend to be in New York City. This leaves one other permissible venue basis for a potential competitor: the company's state of incorporation. Delaware was the only state that had a decided advantage in this regard, as many of the major corporations in this country are incorporated there. This made Delaware the logical competitor for the Southern District for the position as the pre-eminent bankruptcy venue.

But it was not enough for such a potential competitor to exist. Once people have established patterns of behavior, only an external shock will cause them to switch their way of doing things.[74] Such a shock came in

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[72] For a discussion of the lock-in effect in the terms of corporate contracts, *see* Klausner, *supra* note 57, at 789-812.

[73] Recall that in the 1980s no large publicly traded firm bypassed the Southern District when it was available.

[74] This was not the first time that Delaware had been the beneficiary of another state's loss of its position as a pre-eminent legal center. Prior to 1900, New Jersey had been the home of most of the major American corporations. It enjoyed many of the same advantages that the Southern District did in the 1980s. However, in 1913 New Jersey's then-lame-duck-governor, Woodrow Wilson, decided to break up the oil trusts. Most of these corporations fled south to Delaware and reincorporated there. This shock ultimately led to Delaware becoming the premier state of incorporation and leader in the field of

1990 when the managers of Continental Airlines, which had been through bankruptcy in 1983, decided that the firm needed to seek protection under Chapter 11 again. The bankruptcy venue statute offered Continental three choices: Houston, where its headquarters was located; the Southern District of New York, where Eastern Airlines, an affiliated company, was in Chapter 11; and Delaware, where it was incorporated. Houston was unattractive because Continental had previously filed for bankruptcy there and the case had not gone smoothly.[75] The second option, New York, was also a poor candidate because the Eastern Airlines' bankruptcy had turned into a contentious affair.[76]

This left Delaware. So Continental filed its petition in the Delaware bankruptcy court. At the time, the Delaware Bankruptcy Court had only one judge, Helen Balick.[77] She handled the Continental case proficiently and, in doing so, earned a reputation as being both accessible and prodebtor. Moreover, attorneys perceived that she did not quibble over their fee requests.

After this beneficial precedent was established, Delaware quickly supplanted the Southern District as the preferred bankruptcy venue. The speed of this change was accelerated by the greater certainty about which judge would decide a Delaware bankruptcy case than one filed in the Southern District of New York. For example, in 1990, Delaware had only one bankruptcy judge, whereas there were five bankruptcy judges in the Southern District of New York. Firms thus knew which judge they would get in Delaware. Even when the Delaware Bankruptcy Court added a second judge, he quickly established a similar reputation to that of his senior colleague.[78] After 1988, when the responsibility for case assignments for bankruptcy cases filed in the Southern District was transferred to the Administrative Office of the United States Courts in Washington, D.C., lawyers perceived that there was more variation among bankruptcy judges' treatment of the large corporate filings in the Southern District than in Delaware.[79]

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corporate law. *See* Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677 (1989).

[75] *See* DELANEY, *supra* note 43, ch. 4.

[76] *See* Christi Harlan, *Legal Perspective: Continental's Latest Chapter 11 Flight Lands in Delaware, Could Be Re-Routed*, WALL ST. J., Dec. 6, 1990, at B4; Bill Mintz, *Delaware Debut/Continental Picks Cast of Unknowns for Bankruptcy*, HOUS. CHRON., Jan. 6, 1991, at 1, *available in* 1991 WL 3895553.

[77] *See* Barbara Franklin, *Welcome to Delaware, Wilmington Court Favored for Bankruptcy Filings*, 207 N.Y. L.J., March 19, 1992, at 5.

[78] *See* Agger, *supra* note 20, at 1 ("By having only two bankruptcy judges, there was an element of predictability in terms of how a case would be handled."); *see also Houston*, *supra* note 60, at A8 (bankruptcy attorneys concerned with reliability and consistency).

[79] Eisenberg and LoPucki note that, prior to 1988, it appears that judge assignment may not have been random in the Southern District. Any doubts about the blindness of the assignment process were removed in 1988 when the assignment process was moved to Washington D.C. *See* Eisenberg & LoPucki, *supra* note 8, at 983-84. To the extent that this decreased the value of filing in the Southern District, it made it easier for Delaware to supplant it as venue king; *see also* 6 CONSUMER BANKR. NEWS, No. 10, at 15, 16

At the same time that Delaware was becoming an attractive venue option for large publicly held corporations filing for Chapter 11 reorganizations, the rise of the prepackaged bankruptcy further enhanced Delaware's favorable position. A prepackaged bankruptcy is a hybrid of the options normally associated with financial distress: an out-of-court restructuring and a full-blown Chapter 11. Typically, when a firm is initially faced with financial distress, it first tries to negotiate new payment terms with its existing creditors. Many firms are able to do so and therefore never file for bankruptcy.[80]

In other instances, these negotiations fail, and the firm files for reorganization under Chapter 11 of the Bankruptcy Code. The goal of a Chapter 11 reorganization is to confirm a plan of reorganization which restructures the firm's payment obligations.[81] This plan, often proposed by the firm's managers, is the result of extensive negotiations among the interested parties. These negotiations take place after the firm has filed for bankruptcy.[82]

Perhaps the most crucial difference between a restructuring outside of bankruptcy and a restructuring inside of bankruptcy is the treatment of dissenting creditors. Without resort to the bankruptcy process, a creditor's payment rights can only be modified with that creditor's consent.[83] This creates potentially enormous holdout problems in getting an agreement on the terms of the restructuring. In a bankruptcy proceeding, however, the court has the power to bind a dissenting minority of creditors to modifications approved by a majority of similarly-situated creditors in that class.[84] A class is deemed to approve a plan when at least half of the class members collectively holding at least two-thirds of the amount of debt that the class owns approve the plan.[85] The majority thus binds the dissenters, thereby reducing the holdout problem significantly. This power to bind dissenting creditors comes at a cost, though. Formal bankruptcy reorganizations are

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(quoting an attorney as stating "I've always said: If you want to destroy Delaware, you don't have to pass [a rule about] venue. You only have to add a third judge who is not consistent in the rulings.").

[80] *See* Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189, 1191 (1991) (73 of 156 junk bond issues successfully completed exchanges); Stuart Gilson, *Bankruptcy, Boards and Blockholders*, 27 J. FIN. ECON. 355 (1990) (50 of 111 firms in financial distress restructured without filing a bankruptcy petition); Stuart C. Gilson et al., *Troubled Debt Restructuring: An Empirical Study of Private Reorganization of Firms in Default*, 27 J. FIN. ECON. 315 (1990) (80 of 169 firms in financial distress restructured without filing a bankruptcy petition). For an argument that these out of court restructurings do not reduce debt sufficiently, see Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161 (1997).

[81] *See* 11 U.S.C. § 1129 (1994); DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 240-66 (Rev. ed. 1993).

[82] *See* BAIRD, *supra* note 81.

[83] *See* Trust Indenture Act of 1939, § 316(b), codified at 15 U.S.C. § 77ppp(b) (1994); John C. Coffee, Jr. & William A. Klein, *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. CHI. L. REV. 1207 (1991); Mark J. Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232 (1987).

[84] 11 U.S.C. § 1123(a)(4) (1999).

[85] 11 U.S.C. § 1126(c) (1999).

much more expensive than informal workouts.[86] Not surprisingly, these expenses increase the longer that the firm remains in Chapter 11.

Prepackaged bankruptcies are a hybrid of these two options. In a prepackaged case, the firm negotiates a plan of reorganization with its major creditors prior to filing a bankruptcy petition. The firm need not secure unanimous consent to its proposal, however. Rather, the firm tries to obtain the agreement of a sufficient number of creditors to the plan to ensure that it can be confirmed under the voting procedures of the Bankruptcy Code. The firm then files a bankruptcy petition and, concurrently, its plan of reorganization. The creditors vote on the plan shortly after the filing. This option allows the firm to eliminate any holdouts by dissenting creditors. The prepackaged bankruptcy thus provides the firm with the benefit of class-wide voting to minimize holdout problems, while simultaneously minimizing the time the firm spends in bankruptcy.

This type of bankruptcy filing has become increasingly popular in recent years. In LoPucki and Whitford's study of Chapter 11 bankruptcies ending before 1989, only 2 of the 43 firms in their sample filed prepackaged bankruptcies.[87] More generally, between 1986 and 1990, of 633 publicly held companies which filed for bankruptcy, only 8 (1.2%) were prepackaged bankruptcies.[88] This changed markedly between 1991 and 1997. During that time period, 622 publicly held companies filed for bankruptcy, of which 70 (11.3%) were prepackaged bankruptcies.[89] Roughly half of the prepackaged bankruptcies were filed in Delaware.[90]

This preference for Delaware in the case of prepackaged bankruptcies is greater than the preference for Delaware in more traditional Chapter 11 cases. Delaware's advantage in this area is similar to its advantage in the traditional Chapter 11 setting. Delaware processes its cases a bit quicker than do other venues. Moreover, attorneys know that Delaware has experience in processing this type of case; no other venue has handled nearly as many. Indeed, in many situations, it may be that Delaware is the only venue choice available that has handled this type of proceeding. The

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[86] Chapter 11 contains many procedural devices and often takes a good deal of time to complete. Both of these facts raise the costs of the procedure. The estimates for direct costs in Chapter 11 range from 2.8% to 7.5% of firm value. *See* James Ang et al., *The Administrative Costs of Corporate Bankruptcy: A Note*, 37 J. FIN. 219 (1982); Jerold Warner, *Bankruptcy Costs: Some Evidence*, 32 J. FIN. 337 (1977); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990). The indirect costs of Chapter 11 may even be higher. *See* Weiss, *supra*. While there is no empirical data on the costs of workouts, few would argue that they approach the costs associated with a full-scale Chapter 11 proceeding.

[87] The two firms were Oxoco and Crystal Oil. *See* Letter from Lynn M. LoPucki to Robert K. Rasmussen (July 28, 1997) (on file with the authors).

[88] *See* 1998 YEARBOOK, *supra* note 49, at 144.

[89] *See id.*

[90] *See* Eisenberg & LoPucki, *supra* note 8, at 989, tbl. 1 (Nineteen of thirty-nine prepackaged cases in their study filed in Delaware).

quickness and experience of the Delaware Bankruptcy Court, coupled with its reputation for approving fee requests, makes Delaware an attractive venue for prepackaged bankruptcies.

Today, Delaware is the preferred venue for both traditional Chapter 11 cases and prepackaged bankruptcies. Although it was a traditional case—Continental Airlines—that generated the impetus to move cases to Delaware, statistically the preference for Delaware is stronger with prepackaged bankruptcies than it is for traditional Chapter 11 cases.

C. The Criticisms of the Rise of Delaware

Critics of forum shopping have been quick to note this rapid increase in the Delaware Bankruptcy Court's caseload. Three events have highlighted this concern: a critical report by the Federal Judicial Center attacking certain practices of the Delaware Bankruptcy Court, the Delaware District Court's unprecedented decision to strip the Delaware Bankruptcy Court of its power to hear any Chapter 11 case, and the National Bankruptcy Commission's recommendation that Congress delete a firm's state of incorporation from the list of potential bankruptcy venues. These events, and the ostensible justifications offered for each, are examined below.

The history of bankruptcy law in this country is largely a story about the bankruptcy bar. Bankruptcy lawyers helped to create the law of corporate reorganizations in the absence of federal legislation in the 1800s, and subsequent legislation has been shaped by both these lawyers and those concerned about their power.[91] It is thus not surprising that the debate about venue selection is one driven by the interests of bankruptcy lawyers. Each of the judicial and administrative actions listed above were initiated because bankruptcy attorneys complained about forum shopping.

Bankruptcy venue matters a great deal to these attorneys for a simple financial reason: the parties involved in a bankruptcy proceeding generally hire local counsel. This rule means that the bankruptcy proceeding of a large, publicly held firm, involving numerous parties, will provide jobs for a large percentage, if not all, of a district's bankruptcy attorneys. While this raises the expected wealth of these attorneys, this increase comes at the expense of bankruptcy attorneys practicing in other potential venues.

The competition for the attorneys' fees generated by these bankruptcy cases is a zero-sum game in that the lawyers in the "winning" districts receive exactly the same amount that those in the "losing" district give up. But while a large number of the winners today all come from the same district (Delaware), the losers come from a larger number of jurisdictions.

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[91] *See* Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393 (2000); Eric A. Posner, *The Political Economy of the Bankruptcy Reform Act of 1978*, 96 MICH. L. REV. 47 (1997); David A. Skeel, Jr., *Bankruptcy Lawyers and the Shape of American Bankruptcy Law*, 67 FORD. L. REV. 497 (1998); David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 BANKR. DEV. L.J. 321 (1999).

Although these losing attorneys are geographically diverse, the bankruptcy bar is relatively small, and they can, if they choose, easily form a coalition to protect their interests.[92] Their geographic diversity also strengthens their political power as they have influence with a greater number of friendly legislators, judges, and politicians as a whole than the more concentrated group of winners. Thus, we would predict that the losers in the venue game should be more effective in securing changes to improve their situation than the winners will be in protecting the status quo.

This appears to be exactly what has happened over the last few years. The critics of the current system of forum shopping were primarily attorneys from outside New York and Delaware. As a first step in their attempts to eliminate Delaware as an attractive bankruptcy venue, they were successful in placing the venue selection question on the National Bankruptcy Review Commission's agenda for potential reforms of the federal bankruptcy laws.[93] The Commission's membership, while comprised of well-respected bankruptcy professionals and two prominent federal judges, did not include a single person from Delaware.[94] Its chair and vice-chair were both from Midwestern states.[95]

At the time that the Commission began its work, academics had paid scant attention to the subject of forum shopping by large firms in Chapter 11. Only one empirical study had been published.[96] While this study documented companies' statistical preference for filing in the Southern District of New York in the 1980s, it concluded that the venue provisions of the Bankruptcy Code should not be altered. Rather, the authors suggested, Congress should turn its attention to actual judicial practices that it found objectionable.[97] However, the Commission requested that the Federal Judicial Center further study the matter, in large part because of pressure from its (non-Delaware) attorney members.[98]

Before the Federal Judicial Center had completed its study, the Commission's staff had already proposed drastic reductions in the extant venue provisions: first, that a company's place of incorporation be eliminated as an appropriate venue for filing bankruptcy;[99] and, second, that a firm be

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[92] *See* MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOOD AND THE THEORY OF GROUPS (1971).

[93] This Commission was established by Congress to propose an overhaul of the nation's bankruptcy law. *See* Pub. L. No. 103-394, 108 Stat. 4106 (1994).

[94] *See* NATIONAL BANKRUPTCY REPORT, *supra* note 19, at 55-57.

[95] *See id.*

[96] *See* LoPucki & Whitford, *supra* note 9.

[97] *See id.* at 45-51.

[98] *See* BERMANT ET AL., *supra* note 10, at 7.

[99] *See* National Bankruptcy Review Commission, *Memorandum* (Nov. 19, 1996) <http://www.bankrupt.com/clla/venueml.html> (Proposal to Amend the Bankruptcy Venue Provisions Under 28 U.S.C. § 1408) (on file with authors); *see also* memorandum from Professor Lawrence P. King & Elizabeth I. Holland to the National Bankruptcy Review Commission (Nov. 16, 1996) (on file with author).

prevented from combining its bankruptcy proceeding with that of an affiliated firm, unless the firm that first filed for bankruptcy was the parent of the second filing firm.[100] The first proposal would eliminate the provision on which most Delaware bankruptcy filings have been based, while the second would reduce the availability of venue in the Southern District of New York. The Commission tentatively adopted these recommendations on December 18, 1996 and February 21, 1997, and they were ultimately included in the Commission's final report.[101]

The Federal Judicial Center released its draft report in early January 1997. The Report made no recommendations.[102] Rather, it included a substantial body of evidence that has become a principal focus of the forum shopping debate, consisting of a survey of bankruptcy judges, an empirical analysis of filing trends, and an attempt to quantify the costs of forum shopping to creditors. The judicial survey found that a significant minority of bankruptcy judges (thirty-seven percent) thought that the bankruptcy venue provisions should be amended, but that a roughly equal amount (thirty-four percent) believed that no change was needed.[103] The filing trend analysis chronicled the shift of large, publicly held, corporate bankruptcy filings to Delaware, thereby confirming that Delaware had replaced the Southern District of New York as the preferred bankruptcy venue.

The Report's most startling evidence concerned the Delaware Bankruptcy Court's procedures for handling Chapter 11 filings. It documented that court's informal method of case assignment, the debtor's counsels' ability to find out which judge the case was assigned to before the petition was filed, and these attorneys' practice of engaging in ex parte contacts with the judge prior to filing the petition to inform the judge of the motions they would make the first day of filing.[104]

The Report also made a modest attempt to estimate the cost of forum shopping. These estimates were restricted to calculating the increased airfare to the attorneys involved. The Report determined that, assuming that the creditors' attorneys had to fly from where the creditor was located, the

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[100] *See id.*

[101] *See id.*

[102] The Report made reference to the Commission's earlier tentative recommendation concerning venue, but did not take a position on the merits of that recommendation. *See* BERMANT, ET AL., *supra* note 10, at 10.

[103] BERMANT ET AL., *supra* note 10, at 22-25. Twenty-two percent of the judges responding to the survey thought that there had been cases filed in other districts that should have been transferred to their district. *See id.* at 19-22. Of the 52 cases that the judges identified as "misfiled," 22 were filed in Delaware and 20 were filed in the Southern District of New York. *See id.*

[104] *See id.* at 40-41. These practices have since been roundly condemned by the non-Delaware bankruptcy bar. *See, e.g.*, Davis, *supra* note 23, at B8 (Chicago bankruptcy attorney opining that the process in Delaware Bankruptcy Court "would make a layperson doubt 'the objectivity of the process.'"); *Delaware's Withdrawal of the Reference: What It Means*, 30 BANKR. CT. DEC. (CCR) No. 4, at A16 (Feb. 11, 1997) (non-Delaware bankruptcy judge stating that he "wouldn't tolerate [Delaware's practices] here").

choice of Delaware as a forum would cost each party an additional $270 over what their costs would have been if the case had been filed where the firm's assets were located.[105] The Report did not address the larger question of whether forum shopping increased attorneys' fees.

On January 23, 1997, shortly after the Commission's adoption of its tentative proposal to eliminate the state of incorporation as an appropriate venue, and the Federal Judicial Center's Report detailing the informal practices of the Delaware Bankruptcy Court, the Delaware District Court removed all Chapter 11 cases from the Delaware Bankruptcy Court. To understand why this court had the power to make this change, we must first examine the division of jurisdictional authority between the federal district courts and bankruptcy courts. The federal district courts, which are Article III courts, have original jurisdiction over all cases arising under federal bankruptcy law.[106] By contrast, bankruptcy courts, which were established by Congress under Article I of the Constitution,[107] cannot have the power to adjudicate cases arising under the laws of the United States.[108] Rather, bankruptcy courts are adjuncts to the district courts and can assist the latter when requested to do so.

The district courts have the power to refer any federal bankruptcy case in the first instance to the bankruptcy court.[109] In fact, every district court in the country has issued orders exercising this power, thereby ensuring that all bankruptcy cases commence in the bankruptcy court.[110] The Delaware District Court modified this standing order (called the "reference"), an action never before taken by a district court, to remove corporate reorganization cases from its bankruptcy court's jurisdiction.[111]

The Delaware District Court claimed that such extraordinary measures were needed to relieve the burden on its bankruptcy judges.[112] This expla-

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[105] *See* BERMANT ET AL., *supra* note 10, at 42-55.

[106] 28 U.S.C. § 1334(a) (1994).

[107] Bankruptcy judges are appointed for 14-year terms rather than life tenure. *See* 28 U.S.C. § 152(b) (1999). Having life tenure is a *sine qua non* for being an Article III judge. *See* U.S. CONST. art. III, § 1 ("The Judges . . . shall hold their Offices during good Behavior"); Glidden Co. v. Zdanok, 370 U.S. 530 (1962). For a debate on whether bankruptcy judges should be Article III judges, compare Susan Block-Lieb, *The Costs of a Non-Article III Bankruptcy Court System,* 72 AM. BANKR. L.J. 529 (1998) with Thomas E. Plank, *Why Bankruptcy Judges Need Not and Should Not Be Article III Judges,* 72 AM. BANKR. L.J. 567 (1998).

[108] *See* Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

[109] *See* 28 U.S.C. § 157(a) (1994).

[110] *See* Leif M. Clark & Douglas E. Deutsch, *The Delaware Gap: Exposing New Flaws in the Scheme of Bankruptcy Referrals,* 5 AM. BANKR. INST. L. REV. 257, 258 (1997).

[111] *See id.*

[112] *See* January 23, 1997 Order of District Court ("WHEREAS, the judges of the district court have determined that a significant increase in the number of bankruptcy cases has occurred and that it is appropriate and necessary that judges of the district court participate in the handling of such cases. . . . ").

nation was met with widespread incredulity.[113] Neither bankruptcy judge had complained about the extant caseload, and the Delaware bankruptcy court handled its cases more quickly than most courts.[114] Instead, commentators believed that the district court had been stung by the recent criticisms leveled by the Review Commission and the Federal Judicial Center Report.[115] In the wake of the district court's action, no large publicly held corporation filed for bankruptcy anywhere in the country for more than five months.[116]

On October 20, 1997, the Bankruptcy Review Commission issued its final report to Congress. It recommended eliminating bankruptcy venue based on state of incorporation, and limiting venue based on affiliation to those cases where a subsidiary seeks to file in a district where its parent already is in bankruptcy. Unbelievably, the report claimed that these proposals were not "directed at the bankruptcy courts in the Southern District of New York, those in Delaware, or in any other specific bankruptcy venue."[117] Rather, it stated that the Commission was concerned that under the current Bankruptcy Code large publicly held firms had too many potential forums from which to choose. This overabundance of choices, the report went on, had led firms to engage in forum shopping,[118] which was harmful to small creditors.[119] Despite the report's stated rationale, the history of the Commission and its venue discussions make it abundantly clear that it was the (non-Delaware) lawyers, and not small creditors, who were behind these recommendations.

Small creditors were not interested in these proposals. Their lack of enthusiasm, however, did not stem from collective action problems; several effective organizations represent the interests of small creditors, especially the National Association of Credit Management. More likely, as we show in Part III below, small creditors are indifferent because current venue

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[113] *See* Davis, *supra* note 15, at B1 ("But some observers believe [the district court] is trying to counter critics who contend that the Delaware court is too easy on corporate debtors and who want to yank state of incorporation as a place to file bankruptcy."); *Delaware District Court Withdraws the Reference in Chapter 11 Cases*, 30 BANKR. CT. DEC. (CRR) No. 3 (Feb. 4, 1997) ("No one believes the reference was withdrawn because of the heavy caseload."); Claudia MacLachlan, *Ex Parte Contact Behind Delaware Bankruptcy Shakeup?*, NAT'L L. J., Feb. 10, 1997, at A10 ("Bankruptcy lawyers say the real reason for the change was the Jan. 10 Judicial Center report and the growing controversy over whether debtors should be allowed to file in Delaware—where they are incorporated—instead of where they do business.").

[114] The Federal Judicial Center Report, issued shortly before the district court's order, confirmed the speed of the Delaware Bankruptcy Court. *See* BERMANT, ET AL., *supra* note 10, at 37.

[115] *See supra* note 113.

[116] *See* Eisenberg & LoPucki, *supra* note 8, at 986. The Delaware bankruptcy court saw its first Chapter 11 case, large or small, in April 1997, when it was assigned the case of Grossman's Inc. *See Delaware Bankruptcy Judge Gets First Significant Case Since District Court Took Over*, 30 BANKR. CT. DEC. (CRR) No. 15, at A1 (Apr. 29, 1997) [hereinafter *Delaware Bankruptcy Judge*].

[117] NATIONAL BANKRUPTCY REPORT, *supra* note 19, at 779.

[118] *Id.* at 776-79.

[119] *Id.* at 776-77.

shopping practices impose only small costs on them.[120] Yet, even if the current law possibly unduly burdens small creditors, they were not the ones aggressively lobbying for change.

The Commission's Report did not lead directly to bankruptcy legislation. Rather, individual members of Congress, who viewed the Commission's recommendations concerning the reform of consumer bankruptcy as too generous to consumers, introduced their own legislation seeking to restrict consumer access to bankruptcy.[121] While this legislation did contain some provisions that applied to corporate reorganizations, it did not include any proposed amendments to the Bankruptcy Code's venue provisions. The House and Senate failed to reach agreement with the White House in the closing days of the 105th Congress.

The reform legislation was reintroduced in the 106th Congress. As introduced, it did not affect the corporate bankruptcy venue provision. During the House Judiciary Committee's mark-up session on the bill, Representative Howard L. Berman, from Los Angeles, inserted an "anti-Delaware" amendment in the bill on a voice vote.[122] This amendment, which differs from the one offered by the Commission, provides that a corporation is deemed to be a citizen of the state in which its principal place of business is located. In other words, a corporation would no longer be a citizen of the state in which it was incorporated. The amendment did not affect the "affiliate" rule, which, in the past, has allowed many firms to file in the Southern District of New York. The House passed the bill containing this amendment.

The response from Delaware was swift, with both of Delaware's senators vowing to protect the status quo. Senator William V. Roth, Jr., stated, "I will do everything I can to ensure that Delaware-incorporated businesses can continue to have their bankruptcy reorganizations adjudicated in Delaware."[123] Senator Joseph R. Biden Jr.'s office issued a statement that, "This is a huge issue for the Delaware bar. . . . Sen. Biden is committed and determined that it will not be in the final bill."[124] The bankruptcy bill passed by the Senate did not contain an "anti-Delaware" amendment.[125]

Regardless of how this legislative issue is resolved, one thing is vividly clear. The one group most affected by current venue practices that would benefit most from the changes proposed by the Commission is bankruptcy

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[120] *See infra* notes 181-86 and accompanying text.

[121] *See* Jacob M. Schlesinger, *Card Games: As Bankruptcies Surge, Creditors Lobby Hard to Get Tougher Laws*, WALL ST. J., June 17, 1998, at A1.

[122] *See* Celia Cohen, *Sneak Attack: Delaware Delegation Battles Back Against Congressional Bill that Would Curb Bankruptcy Practice*, 2 DEL. L. WKLY., May 4, 1999, at 1.

[123] *Id.*

[124] *Id.*

[125] Interestingly, the corporate reorganization provision enacted in 1934 allowed firms to file in Delaware due in large part to the efforts of a senator from Delaware. This provision was removed when the law was revamped in 1938. By that time, this senator had been replaced. *See* Skeel, *supra* note 25, at 8-14.

attorneys from outside of Delaware and the Southern District. It is not surprising, therefore, that they are the ones who have lobbied to remove the place of incorporation and "affiliate in bankruptcy" provisions from the list of permissible venues. They have been opposed by the Delaware bar.

II. THE RACE TO DELAWARE IN CORPORATE LAW

The debate over the propriety of financially distressed firms filing for Chapter 11 reorganization in Delaware recalls the long-standing academic battle over the propriety of healthy firms incorporating in Delaware. The current evidence suggests that, in general, the "race" to Delaware produces some efficiency gains. That debate has relevance to the problem of bankruptcy forum shopping because the mechanisms that the "race to the top" theorists claim produce efficiency gains provide insights into the problems with the current venue provisions, and suggest ways in which those provisions can be amended so as to increase the efficiency of the Bankruptcy Code.

As every student of American corporate law knows, a disproportionate number of publicly held firms are incorporated in Delaware. The reasons for this phenomenon and its efficiency implications are hotly debated. In 1974, William Cary argued that the preference for Delaware resulted from managers of firms seeking out the jurisdiction which best protected their interests, often at the expense of shareholders.[126] Cary saw a race to the bottom. The engine propelling this race was the claim that managers controlled the decision about which state to incorporate in, that managers would act selfishly to select a jurisdiction with laws favorable to their position, and that shareholders lacked the ability to influence this decision.[127] This argument was an application of the story of American corporate law told by Berle and Means in the 1930s: the separation of ownership and control allows managers to run the firms for their own benefit, often at the expense of shareholder interests.[128]

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[126] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). He claimed that if management has unfettered discretion, they will adopt laws that maximize their personal benefits rather than those to shareholders. States want to maximize their revenues from incorporation fees and other taxes on companies to try to entice the parties in control of incorporation or reincorporation decisions to select their state for incorporation. *See id.* at 668. The competition among states to attract companies leads them to adopt pro-management corporate codes.

This competition does not stop when a company initially selects its state of incorporation. Corporate managers can subsequently elect to reincorporate in another state subject to shareholder approval. *See* Bebchuk, *supra* note 2, at 1836-40 (claiming that even though management needs shareholder consent to reincorporate, shareholders will rationally remain ignorant and even consent to a reincorporation that reduces shareholder value). Therefore, these authors argue that a state can best attract a corporation and ensure that it remains in the state by selecting corporate laws that are favorable to management.

[127] Cary argued that the national government should intervene and adopt a federal corporate law to remedy this problem. *See* Cary, *supra* note 126, at 701.

[128] *See* ADOLF BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).

Ralph Winter responded that the race to Delaware was actually a race to the top that increased firm value.[129] The thrust of his argument was that the need to obtain capital at the cheapest cost forced managers to select the state that provided the most efficient corporate laws that maximized firm value. Firms whose managers selected inefficient jurisdictions to further their own self-interest at the expense of the shareholders would be at a competitive disadvantage and would suffer depressed share prices.[130] The market for corporate control would punish these managers by removing them from power.

The linchpin of the theoretical argument for the race to the top is that managers make the incorporation decision at a time when their interests are generally convergent with those of the shareholders. At the time of incorporation, the future wealth of the managers is directly correlated with the future wealth of the firm. If the firm does well, the managers will prosper; if the firm does poorly, the managers will fare less well. For the firm to do well, it must be able to finance its projects. For most firms, such financing comes from outside investors, either through debt or additional sales of equity. Outside investors are quite capable of ascertaining the possibility of managers taking actions that benefit themselves at the expense of the firm as a whole. Thus, they will charge higher interest rates on debt and pay a lower price for equity to compensate for this risk. These actions make it more expensive to finance the firm's projects, and thus more likely that the firm's projects, once they are undertaken, will fail to produce sufficient revenue. Managers, in turn, anticipate this result, and thus have an incentive to incorporate in states that provide corporate laws that best promote the interests of the firm as a whole. In short, Winter's argument rejected the Berle and Means conception of the corporation as incomplete. Corporations function in markets, and these markets provide constraints on the ability of managers to further their interests at the expense of shareholders.

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[129] Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) [hereinafter Winter, *State Law*]; *see also* RALPH K. WINTER, THE GOVERNMENT AND THE CORPORATION (1978).

[130] Winter claimed that market forces from the capital, product, and corporate control markets lead corporate managers to select a state of incorporation that will maximize firm value and deter them from reincorporating in states with laws that are detrimental to shareholders. *See* Winter, *State Law*, *supra* note 129, at 256. He wrote that:

> (1) If Delaware permits corporate management to profit at the expense of shareholders and other states do not, then earnings of Delaware corporations must be less than earnings of comparable corporations chartered in other states and shares in the Delaware corporations must trade at lower prices. (2) Corporations with lower earnings will be at a disadvantage in raising debt or equity capital. (3) Corporations at a disadvantage in the capital market will be at a disadvantage in the product market and their share price will decline, thereby creating a threat of a takeover which may replace management. To avoid this result, corporations must seek out legal systems more attractive to capital. (4) States seeking corporate charters will thus try to provide legal systems which optimize the shareholder-corporation relationship.

Id.

The debate over incorporation in Delaware has been extended and refined over the past twenty years.[131] Recent work explores the mechanisms by which Delaware retains its status as the leader in the incorporation arena. These mechanisms, which we discuss below, tend to produce efficient law. Empirical research has shown that reincorporating in Delaware does not decrease the value of the firms' shares, thus supporting the race to the top position.[132] Recently, Professor Robert Daines has compared the value of firms incorporated in Delaware to the value of firms incorporated elsewhere. He found that Delaware firms have higher values, thus bolstering the race to the top argument.[133]

Yet few believe that Delaware produces optimal laws. There are situations where managerial self-interest departs from the interest of shareholders. As Lucian Bebchuck has pointed out, mid-stream amendments to the corporate charter have the potential for enriching management at the expense of shareholders.[134] Also, managers have been able to persuade most states, including Delaware, to pass laws that inhibit hostile takeovers. Such laws protect incumbent managers and reduce the wealth of shareholders.[135] These

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[131] See generally ROMANO, *supra* note 37, for a discussion of this debate.

[132] In particular, several event studies have been conducted to see if corporations reincorporating in Delaware suffer a reduction in their share price. None of these studies finds a significant decrease in stock price associated with reincorporation in Delaware, while some find significant price increases. *See id.* at 17-18 (stating that none of the five event studies she analyzed found that reincorporation in Delaware had a negative effect on stock price); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance,* 75 IOWA L. REV. 1, 48 (1989) (same, although for firms incorporated in Delaware, the passage of § 102(b)(7) of the Delaware corporate code had a significant decrease in their stock value); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: 'Unhealthy Competition' vs. Federal Regulation,* 53 J. BUS. 259, 281 (1980) (concluding that shareholders were not hurt by reincorporation to Delaware); Roberta Romano, *Law as a Product: Some Pieces of the Reincorporation Puzzle,* 1 J.L. ECON. & ORG. 225, 280 (1985) (same); *see also* Allen Hyman, *The Delaware Controversy-The Legal Debate,* 4 J. CORP. L. 259 (1979); Jeffery Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience,* 18 FIN. MGMT. 29 (1989). These results support the claim that states are racing to the top, not to the bottom. Bebchuk offers three alternative explanations for the results. *See* Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law,* 105 HARV. L. REV. 1435, 1448 (1992). First, he argues that the negative effect on share prices from reincorporating in Delaware could have been outweighed by management's announcement of other information that was favorable to the shareholders. Second, reincorporation to Delaware might not have a negative effect on share prices if the original state of incorporation had corporate laws similar to Delaware. Third, the pro-shareholder rules of Delaware might outweigh the anti-shareholder rules. Romano disagrees with these criticisms. She argues that if Bebchuk is correct, then there should be a difference in the stock price reactions of firms that reincorporate in Delaware for pro-manager purposes (no offsetting positive event) as opposed to pro-shareholder purposes (positive offsetting event). *See* ROMANO, *supra* note 37, at 18. No such effect is observed, which suggests that there is no negative effect on stock prices from the reincorporation.

[133] *See* Robert Daines, *Does Delaware Law Improve Firm Value?* (draft).

[134] *See* Bebchuk, *supra* note 2, at 1836-40 (claiming that even though management needs shareholder consent to reincorporate, shareholders will rationally remain ignorant and consent to a reincorporation that reduces shareholder value).

[135] The problem with these statutes is that they protect inefficient management by reducing the chance of hostile takeovers, and limit the effectiveness of the corporate control market to act as a constraint on the

developments rebut the assertion that any state, even Delaware, produces optimal corporate law. Nevertheless, Delaware's corporate law appears to be more efficient than that of its competitors. For present purposes, we want to spell out the mechanism by which Delaware tends to produce such laws.

As Winter recognized, managers have an incentive, at least at the time of incorporation, to select the jurisdiction providing the most efficient legal regime. This is the demand side of the equation. But what about the supply side of the equation? Part of the theory of the race to the top is not only that managers will select the most efficient legal rules available, but that states will compete for incorporation business, thus producing more efficient laws. The literature has identified three crucial ways in which Delaware has committed itself to produce laws favored by managers.

One mechanism is that Delaware has structured its finances so that it relies heavily on the income produced from corporate charters. With some minor variations, roughly seventeen percent of Delaware's total revenues are derived from its corporate chartering business.[136] Politicians thus know that to the extent they pass legislation which leads to a decrease in the number of firms incorporating in Delaware, they will either have to slash the state's budget or find replacement sources of revenue.

A second mechanism is the creation of an experienced judiciary. The Delaware Chancery Court is nationally recognized for its expertise in corporate law.[137] Moreover, the selection process of judges is designed to maintain a high level of judicial competence. This long history of able judges has produced a detailed and consistent body of precedent on which firms can rely.[138]

Perhaps underlying all of these mechanisms is the interest of Delaware lawyers.[139] Delaware lawyers earn a significant amount of income based on their knowledge of Delaware corporate law. They thus have an incentive to ensure that firms retain the preference to incorporate in Delaware. To this end, they control the selection process for judges, and would lobby hard against legislative changes that would cause firms to by-pass Delaware.

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divergence of management's interests from those of shareholders. Winter believes that in order to make the corporate control market a more effective deterrent, one might have to make an exception to the state corporate system and allow federal regulation to preempt state takeover statutes. *See* Winter, *State Law*, *supra* note 129, at 289. However, Winter notes that Congress's past legislation regarding the corporate control market, *i.e.* the Williams Act, has not been favorable to shareholders. *See id.* at 291.

[136] *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 490 (1987).

[137] *See* Klausner, *supra* note 57, at 845.

[138] *See id.* at 845-46. Ehud Kamar, while agreeing as to the quality of the Delaware bench, has suggested that it produces indeterminate laws that have the effect of enhancing its competitive advantage. In short, this indeterminacy, while it reduces the value of Delaware's laws, reduces the value of the laws of other jurisdictions to an even greater extent by making them incompatible with Delaware law. This observation is consistent with both race to the top and race to the bottom theories. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998).

[139] Macey & Miller, *supra* note 136, at 503-06.

In short, these mechanisms commit Delaware to producing corporate law that, on balance, increases efficiency. In the next Part, we first analyze the normative desirability of the current bankruptcy venue provisions, and then, drawing on the general corporate law literature recounted above, suggest a crucial amendment to align managers' interests with those of the firm and improve the efficiency of the bankruptcy laws.

III. THE NORMATIVE IMPLICATIONS OF THE RACE TO DELAWARE FOR CORPORATE REORGANIZATIONS

A. The Social Desirability of Current Law for Prepackaged Bankruptcies

The efficiency implications of the current practice of filing for bankruptcy in Delaware are, at first glance, unclear. While a firm's managers and attorneys who select its bankruptcy venue undoubtedly select the venue that best promotes their interests, it does not necessarily follow that their venue choice will be value-decreasing for the firm's owners. In other words, when agents act selfishly that does not mean that their principals necessarily incur agency costs—many times the two groups' interests coincide. For our purposes, we must first distinguish between prepackaged bankruptcy cases and more traditional Chapter 11 cases in order to assess whether agency costs are prevalent in corporate reorganizations. We discuss prepackaged bankruptcies in this subpart, and traditional Chapter 11 proceedings in the two subsequent subparts.

Delaware has become the venue of choice for firms filing prepackaged bankruptcies.[140] One recently completed empirical study of venue choice in large Chapter 11 cases, conducted by Professors Eisenberg and LoPucki, attempted to measure the extent to which prepackaged bankruptcies are filed in Delaware. This study found that in cases filed between 1989 and 1997, nineteen of the thirty-nine prepackaged bankruptcies involving large, publicly held corporations were filed in Delaware.[141] The study further demonstrated that while Delaware is the preferred venue for both traditional Chapter 11 filings and prepackaged cases, forum shopping is more preva-

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[140] *See* BERMANT ET AL., *supra* note 10, at 39-41.

[141] *See* Eisenberg & LoPucki, *supra* note 8, at 989. In this subpart of the article, the numbers reported for prepackaged bankruptcies differ slightly depending on which data set we use. The Eisenberg & LoPucki data set includes only Chapter 11 cases filed by publicly traded firms with assets, as measured in 1980 dollars, that exceed $100 million. *See id.* at 973-74. The numbers reported in the 1997, 1998 and 1999 Bankruptcy Yearbooks and Almanacs include the filings of all publicly traded firms. *See* 1997 YEARBOOK, *supra* note 48, at 45; 1998 YEARBOOK, *supra* note 49, at 43; 1999 YEARBOOK, *supra* note 49, at 38. The numbers from the Federal Judicial Center Report are themselves drawn from the 1997 Bankruptcy Yearbook. *See* BERMANT ET AL., *supra* note 10, at 31. While these two sets of data thus differ slightly in the number of firms that they contain, they both illustrate the same general patterns.

lent in prepackaged cases. Indeed, since 1990, prepackaged bankruptcies make up 38.8% of the large bankruptcy cases filed in Delaware.[142]

What normative implications does this forum shopping of prepackaged bankruptcies have? If prepackaged bankruptcies increase the efficiency of bankruptcy law, and Delaware plays a crucial role in facilitating such bankruptcies, then the trend toward more such filings in Delaware should be applauded. We claim that prepackaged bankruptcies do, in fact, promote efficiency.

If a firm is in financial distress, but is still economically viable, then creditors would favor revamping the firm's capital structure if they were able to act collectively outside of bankruptcy.[143] Yet, at this point in time, the (nonbankruptcy) law forbids altering a creditor's repayment contract without that creditor's consent.[144] Thus, while as a group creditors may favor debt renegotiation, individual creditors may balk at a proposed renegotiation in the hopes that the firm will pay it off in full. In other words, debt restructurings outside of bankruptcy suffer from holdout problems.

Strategic holdouts by disgruntled creditors will often force firms to file Chapter 11 proceedings. This is confirmed by empirical studies showing that out of all the firms in financial distress only one half are able to renegotiate their debt outside of bankruptcy.[145] Bankruptcy law overcomes such strategic holdouts through the use of class-wide voting procedures.[146] Prepackaged bankruptcies achieve a similar result by allowing the firm to implement a value-increasing plan of reorganization with the consent of the majority of creditors, despite the protests of those minority of creditors who may be seeking to capture more than a proportionate share of the gain for themselves. Moreover, they achieve this result at a lower cost than a traditional Chapter 11 proceeding.[147]

Creditors' interests as a group are advanced by this procedure. To understand this point, recall that in a prepackaged bankruptcy the firm must obtain the agreement of a sufficient number of creditors to ensure that the plan can be confirmed under the voting procedures of the Bankruptcy Code. The Bankruptcy Code groups creditors into classes. The claims in each

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[142] *See* Eisenberg & LoPucki, *supra* note 8, at 992-93.

[143] On the now standard distinction between financial distress—inability to pay debts—and economic distress—inability of revenues to cover costs—see Baird, *supra* note 30; Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1165-67 (1994). The seminal work identifying the collective action problem that bankruptcy responds to is Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

[144] *See supra* note 83 and accompanying text.

[145] *See supra* note 80 and accompanying text.

[146] *See* 11 U.S.C. § 1126 (1994).

[147] *See* Elizabeth Tashjian et al., *Prepacks: An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FIN. ECON. 135, 144, tbl. 2 (1996) (explaining that the mean cost of a prepackaged bankruptcy is 1.8% of firm value; the mean cost of a Chapter 11 bankruptcy is 2.8% of firm value).

class must be substantially similar.[148] A class is deemed to approve a plan when at least half of the class members collectively holding at least two-thirds of the amount of debt that the class owns approve the plan.[149] Finally, we assume that when creditors consider whether to support a plan of reorganization their primary concern is their ultimate payout.[150]

In this situation, creditors in a given class may vote differently on a plan of reorganization for one of two reasons. First, they may disagree over which course of action promises the greater return to creditors. In cases where such uncertainty exists, the more efficient rule is to let a majority of the claims, as measured by dollar amount, bind the class.[151] Alternatively, a creditor may disagree for strategic reasons. The dissenter may know that the proposed plan of reorganization is in the best interests of creditors as a group, but nevertheless vote against it in an effort to gain more of the value of the reorganized firm for itself. Little social gain stems from such behavior, and therefore the Bankruptcy Code's provisions should (and do) override such dissent. We conclude that prepackaged bankruptcies are efficiency-enhancing when compared to creditors' other options.

Despite their social welfare increasing nature, prepackaged bankruptcies remain relatively rare phenomena. There were a total of eight prepackaged bankruptcies from 1986 to 1990. This increased to seven in 1991 alone, and seventy-nine from 1992 to 1999.[152] Even during this last period, only one out of every ten bankruptcies of a publicly held firm involved a prepackaged bankruptcy. Statistically, the number of bankruptcy courts in the country outnumber the sum of prepackaged bankruptcies filed in the past decade.

There are efficiencies to be gained from handling many of these cases in one jurisdiction. An experienced court could handle these cases more quickly, which would enhance the attractiveness of a prepackaged bankruptcy to a firm. Indeed, part of the attractiveness of a prepackaged bankruptcy is its speed, which reduces its costs. For example, the average prepackaged bankruptcy proceeding ends in less than two months.[153] Traditional Chapter 11 cases take more than a year longer to complete.[154] Attorneys would also prefer courts that have demonstrated an ability to expeditiously process a prepackaged bankruptcy case. Having convinced the firm's managers that a prepackaged bankruptcy will be a relatively

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[148] *See* 11 U.S.C. § 1122(a) (1994).

[149] *See* 11 U.S.C. § 1126(c) (1994).

[150] *See* Schwartz, *Contract Theory Approach*, *supra* note 5, at 1836.

[151] *See* Kevin A. Kordana & Eric A. Posner, *A Positive Theory of Chapter 11*, 74 N.Y.U. L. REV. 161, 168-69 (1999). Kordana and Posner show that the efficiency of current voting rules is more ambiguous when they allow for strategic voting. *See id.* at 169-220.

[152] *See* 1999 YEARBOOK, *supra* note 49, at 152. Again, the difference in numbers here and those we cited earlier are due to the source from which they are drawn. *See supra* note 141.

[153] *See* Eisenberg & LoPucki, *supra* note 8, at 989.

[154] *See id.*

quick (and therefore cheap) endeavor, attorneys have the incentive to steer that bankruptcy to the forum that will best vindicate their prediction.[155]

This efficiency rationale is consistent with the Delaware Bankruptcy Court's experience. After it competently handled its first prepackaged bankruptcy case, it began to receive more of these cases. Many public firms contemplating a bankruptcy filing had Delaware as an option either because they were incorporated there, or had an affiliated entity incorporated there. Indeed, Delaware was the most common venue option for firms. As more and more of these firms filed prepackaged bankruptcies in Delaware, bankruptcy attorneys routinely recommended Delaware as the venue of choice for prepackaged bankruptcies.[156]

Professors Eisenberg and LoPucki take issue with our analysis. They argue that while Delaware is a bit quicker at handling prepackaged bankruptcies than other courts, the difference is not statistically significant.[157] They contend that other courts are just as effective as the Delaware courts in handling prepackaged bankruptcies, and thus the Delaware court's relative expertise is not the real reason that firms prefer Delaware.[158]

Professors Eisenberg and LoPucki fail to consider the choices that debtors' attorneys face when advising their clients on where to file. These attorneys will confront one of two situations: either the firm can file in only one jurisdiction (Delaware) that has handled a prepackaged bankruptcy, or the firm has a choice among experienced jurisdictions. In the first situation, it is easy to see why Delaware would be chosen. Attorneys tend, on average, to be risk averse when advising their clients.[159] This risk aversion would lead them to shy away from untested courts. When it is coupled with the fact that Delaware is at least as fast on average as other jurisdictions, this will lead bankruptcy attorneys to advise their clients to file in Delaware. While no one has determined how many of the prepackaged cases fall into this category, there are undoubtedly some because only eighteen other bankruptcy courts have processed a prepackaged bankruptcy.[160]

Even where the firm can select another experienced venue, Professor Eisenberg and LoPucki's argument that there are no advantages to filing in Delaware misses the mark. Speed is a crucial advantage in handling a prepackaged bankruptcy. While the mean time for Delaware is a bit quicker

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[155] *See* Langevoort & Rasmussen, *supra* note 65, at 394-99.

[156] This trend may be an example of herd behavior. Herd behavior occurs where a decision rationally relies on the past actions of others rather than making its own independent calculus. *See* Abhijit Banerjee, *A Simple Model of Herd Behavior,* 107 Q. J. ECON. 797 (1992).

[157] Eisenberg and LoPucki are careful to note the limits on their empirical analysis. It is simply that they have not been able to prove the hypothesis. Given the limited number of cases in the sample, it would have taken a relatively large effect to have been statistically significant. *See* Eisenberg & LoPucki, *supra* note 8, at n.78.

[158] *See id.* at 989.

[159] *See* Langevoort & Rasmussen, *supra* note 65.

[160] *See* Eisenberg & LoPucki, *supra* note 8, at 994.

than for other jurisdictions, the median time is much quicker.[161] While LoPucki and Eisenberg failed to find statistical significance for this quicker median in the sample that they studied, a second study which included more firms found that the quicker medians were statistically significant.[162] This is an important distinction because, by definition, one half of the cases filed in Delaware must have been resolved more quickly than the median case. If the median in Delaware is statistically significantly shorter than that in other jurisdictions, then filing in Delaware is a good defense against having an unusually long bankruptcy proceeding. Faced with this choice, we are not surprised that lawyers would advise their clients to choose Delaware. From an efficiency perspective, there is a benefit from increased certainty about the time it will take to resolve a bankruptcy case that should not be jettisoned unless it were associated with a greater cost.[163]

We have trouble identifying any such cost. Managers are unlikely to file prepackaged bankruptcies in Delaware in an attempt to enrich themselves at the expense of creditors. A majority of creditors must consent for a prepackaged bankruptcy to succeed. Creditors, as a group, are unlikely to agree to being shortchanged. Moreover, in a prepackaged bankruptcy, debtors cannot be filing in Delaware to obtain the benefit of "pro-debtor" case law. Prepackaged bankruptcies, by their nature, are not as contentious as traditional Chapter 11 cases. Courts have not found issues of interpretation about which to differ. Thus, debtors' preference for Delaware cannot be explained as an attempt to obtain a more pro-debtor interpretation of the Code.[164]

Professors Eisenberg and LoPucki argue that Delaware's speed in resolving prepackaged bankruptcies prevents dissenting creditors from objecting to improperly obtained consents, and that this benefits debtors.[165] Their argument is rife with problems. First, as noted above, they have claimed that Delaware is no faster than other jurisdictions in handling these cases. Now they assert that the preference for Delaware is based on such an advantage. They cannot have it both ways: Delaware is either faster than other jurisdictions or it is not.

Second, Professors Eisenberg and LoPucki overstate the likelihood that creditors will dissent in prepackaged bankruptcies. Under the Code, a class of creditors must consist of substantially similar claims. These creditors

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[161] *See id.* at 989.

[162] *See* Carapeto, *supra* note 69, at 24-25.

[163] It is unclear the extent to which Delaware will maintain this advantage in the future. Inevitably, other forums will have the chance to handle prepackaged bankruptcies. Given this, it is possible for other forums to develop reputations similar to Delaware. In such a situation, a lawyer's advice may well be to file in the more convenient forum.

[164] This state of affairs differs significantly from that existing when the Southern District of New York was the venue of choice in Chapter 11 cases. In that situation, it was easy to identify a practice of the local courts—the routine continuation of the exclusivity period—that provided the debtor with an advantage over its creditors.

[165] *See* Eisenberg & LoPucki, *supra* note 8, at 995.

tend to have similar preferences—maximizing the recovery on their claims.[166] While the potential gains from holdout can induce small creditors to act strategically, the Code is designed to prevent this type of behavior. Indeed, Professors Eisenberg and LoPucki fail to identify a single case where creditors were hoodwinked by a prepackaged plan.

In summary, the Delaware court specializes in handling a relatively infrequent type of bankruptcy proceeding, which is, when appropriate, advantageous to both firms and their creditors.[167] The Bankruptcy Commission's proposal would disable Delaware (or any other court) from specializing in prepackaged bankruptcies, and thereby make prepackaged bankruptcies a more uncertain proposition. This increases the risks associated with filing these cases[168] and decreases social welfare. We believe that this portion of the Commission's proposal should be rejected.

The Commission recommended venue reform because of the current system's claimed inconvenience to small creditors. Even if this is true in traditional Chapter 11 cases (an issue discussed below), it has almost no relevance in prepackaged cases.[169] Less litigation takes place in a prepackaged case than in a normal Chapter 11 proceeding. Indeed, the advantages which a prepackaged plan offer a debtor make it unattractive for that debtor to file a plan which it believes would be contentious. For example, if a prepackaged plan provided a creditor with a legitimate complaint about the amount of its claim, or how it was classified, that creditor could delay confirmation of the plan while it litigated its complaint. Managers contemplating a quick trip through Chapter 11 via a prepackaged bankruptcy therefore try hard not to provide creditors with individual objections. Given this reality, small creditors rarely need to appear in bankruptcy court over contested matters in prepackaged bankruptcies.

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[166] *See* Schwartz, *Contract Theory Approach*, *supra* note 5, at 1807.

[167] It has often been stated that the Delaware Chancery Court creates similar benefits for firms and shareholders because of its advantage in deciding important corporate law cases. One leading commentator has summarized this argument as follows:

> In Delaware, corporate law cases are heard in the chancery court rather than in courts of general jurisdiction as in other states. The court's small size and continuity in membership facilitate the development of judicial expertise in business law and enhance the predictability of corporate law decisions. Judges are appointed to twelve-year terms by the governor, from a list submitted by a judicial advisory council, with the consent of the senate, and they often have a background in business law.

ROMANO, *supra* note 37, at 39-40.

[168] Indeed, after the Delaware District Court withdrew the reference, attorneys were hesitant to file a Chapter 11 petition in Delaware. *See Delaware Bankruptcy Judge*, *supra* note 116, at A8; William B. Sullivan, *Shaking the Jurisdictional System; Will Revocation of Automatic Reference Become the Norm?*, 14 BANKR. STRATEGIST 1 (March 1997) ("No responsible debtor's counsel would want his client's Chapter 11 case to serve as a learning experience or training vehicle for a Delaware district judge.").

[169] Unfortunately, the Commission's Report did not consider prepackaged bankruptcies separately from traditional Chapter 11 cases.

B. Criticisms of Delaware's Role in Traditional Chapter 11 Filings

Having demonstrated that prepackaged bankruptcies are efficiency-enhancing, and that the Delaware bankruptcy court appears to handle them efficiently, we next analyze the criticisms of current venue rules and the Delaware court's handling of traditional Chapter 11 cases. As we discussed above, Delaware became the venue of choice for traditional Chapter 11 proceedings in the 1990s. Traditional Chapter 11 cases have been the predominant part of the Delaware Bankruptcy Court's docket: in 1996, of the twenty-six publicly traded companies that filed for bankruptcy in Delaware, the majority were traditional Chapter 11 cases.[170]

Venue, as we noted above, is chosen by the firm's management in consultation with their attorneys. Attorneys, all else being equal, prefer jurisdictions that routinely approve fee requests as compared to those that pare back such requests.[171] Managers prefer jurisdictions that give them an advantage in the negotiations with creditors, which are the hallmark of a traditional Chapter 11 proceeding.

Delaware offers these benefits to both debtors and their attorneys.[172] The Delaware Bankruptcy Court's unique practice of allowing the debtors' counsel to inform a judge as to when they will file the case, and what first day motions will be made, gives the debtor a strategic advantage over creditors. For example, first day motions, which often include requests to approve financing arrangements for the debtor while it remains in bankruptcy, are often critical to the success of a reorganization.[173] In addition,

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[170] Although we cannot precisely breakout the numbers for prepackaged and Chapter 11 filings, we know that nationwide there were only nine prepackaged bankruptcies filed that year. *See* 1997 YEARBOOK, *supra* note 48, at 149. By comparison, in 1996, the Southern District of New York, the former venue champion, had only nine Chapter 11 cases filed. *See id.* at 68. By 1997, the figure had declined even further. *See* 1998 YEARBOOK, *supra* note 49, at 68 (explaining that 6 out of the 82 cases that year were filed in the Southern District of New York).

[171] *See* LoPucki & Whitford, *supra* note 9, at 31-33.

[172] Skeel argues that the rise of Delaware may be an example of specialization—prepackaged cases go to Delaware and traditional Chapter 11 cases go to the Southern District. *See* Skeel, *supra* note 25, at 39. While we agree with Skeel that Delaware has become the forum of choice for prepackaged bankruptcies, and that this is a positive development, we disagree with the suggestion that firms are sorting themselves out by types. We see no residual preference for the Southern District. Moreover, given that the preference for the Southern District seems to have been driven by pro-debtor rulings, we are less than sanguine about the conclusion that the use of the Southern District is a positive development.

[173] Indeed, empirical studies have shown that approval of debtor-in-possession financing is positively correlated with a successful reorganization. *See* Carapeto, *supra* note 69; Sandeep Dahiya et al., The Dynamics of Debtor-in-Possession Financing: Bankruptcy Resolution and the Role of Prior Lenders (March 2000) (unpublished manuscript, on file with authors); Upinder S. Dhillon et al., Debtor-in-Possession Financing and the Resolution of Uncertainty in Chapter 11 Reorganizations (Working Paper, 1996); Fayez A. Elayan & Thomas O. Meyer, Market Reaction to Announcements of Debtor-in-Possession Financing: An Empirical Investigation of Bankruptcy Outcome, Duration and Loan Characteristics (Working paper, January 1999).

Delaware has developed a reputation as a debtor-friendly forum.[174] Finally, and most importantly for attorneys, the Delaware court has routinely approved their fee requests.[175] All of these factors have contributed to Delaware's success in becoming the new venue capital.

Of course, any jurisdiction that gives debtors and their attorneys significant benefits in Chapter 11 proceedings will attract bankruptcy cases. This analysis yields no direct policy prescriptions, other than our earlier suggestion regarding prepackaged bankruptcies. Critics of the existing system have complained that it encourages forum shopping practices and therefore should be changed. Yet simply recognizing that forum shopping exists does not, in and of itself, yield any policy prescriptions. Our legal system generally tolerates a good deal of forum shopping. For instance, plaintiffs in federal civil cases who sue corporate defendants can choose to file in any jurisdiction in which they can get personal jurisdiction over the corporation.[176] While many, but not all, commentators condemn forum shopping, little consensus exists about how to determine the "appropriate" venues for filing litigation of any type.[177]

We have doubts about the wisdom of some current practices that encourage debtors to file in certain jurisdictions. However, we believe that these concerns are best addressed through changing existing substantive laws, rather than tinkering with the venue procedures. For example, if some bankruptcy courts are too quick to extend the debtor's time for exclusively proposing a plan of reorganization, we would argue that amending the relevant provision of the Bankruptcy Code to bar such practices is a better solution than gerrymandering firms' ability to select some jurisdictions. Similarly, if the problem is ex parte contacts between judges and attorneys prior to the filing of a bankruptcy petition, appropriate legislation can forbid that practice.[178]

Indeed, if legal reform efforts focus on fiddling with the venue rules, rather than addressing these problems directly, they will create only poor second-best solutions. No matter how legislators draft the venue statute, *some* firms will be eligible to file bankruptcy proceedings in an offending jurisdiction, and thereby benefit from the objectionable practice. Moreover, these offensive acts will rarely occur in only a single venue. Many courts outside of the Southern District of New York routinely extend the debtor's

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[174] *See* Ann Davis, *Delaware Court's Actions in* Marvel *Case Viewed as Message to Corporate Debtors*, WALL ST. J., June 30, 1997, at B11 (Delaware bankruptcy court "had been criticized . . . by some judges and lawyers around the country for being overly sympathetic to companies operating under Chapter 11 protection.").

[175] *See* Skeel, *supra* note 25, at 21.

[176] *See* 28 § U.S.C. 1391 (1994).

[177] *See* Larry Kramer, *Rethinking Choice of Law*, 90 COLUM. L. REV. 277, 313 n.117 (1990); Solimine, *supra* note 13, at 55-56.

[178] *See* LoPucki & Whitford, *supra* note 9, at 45-51 (arguing that it is better to fix objectionable practices directly rather than manipulating venue provisions).

exclusivity period, and many courts outside of Delaware allow some ex parte contacts between judges and lawyers.[179] We believe that it is better to eliminate these problems entirely rather than to try to suppress them indirectly.[180]

Critics of the current system have instead chosen to label the venue rules as the source of the problem. For example, the Bankruptcy Commission recommended restricting firms' venue choices because it believed that present law unduly burdens small creditors. At first blush, this claim seems plausible. Unlike defendants in civil cases who can only be haled into a jurisdiction with which they have minimum contacts,[181] in bankruptcy proceedings there is no such limitation. Even trade creditors selling on credit to a firm in California, who have no contact with Delaware whatsoever, could find themselves in a bankruptcy proceeding in Delaware.

How can we determine if these theoretical concerns are of practical consequence? One important question is how to weigh the interests of the firm's different creditors. Publicly traded companies will have creditors located all over the country. Our California-based firm in the preceding paragraph may have outstanding loans from a major New York bank. If we want to measure which forum is most convenient to creditors—Delaware, the Southern District of New York or the Southern District of California—should we: weigh all creditors' interests equally?; distinguish among creditors based on the dollar amount of their claims?; or differentiate among creditors based on the likelihood of payment?

Even if we focus solely on small creditors, who are presumably more heavily concentrated in the area where the firm's assets are located, what is the cost to such creditors of having to press their claims in a more distant forum? We suggest that, upon closer examination, the cost to such creditors must be small. To understand this point, recall that all creditors face a collective action problem in a bankruptcy proceeding. Each creditor holds only a claim to a portion of the firm's assets, and each creditor will receive only a fraction of the total benefits of participating in the reorganization. The Bankruptcy Code's solution to this collective action problem is to place the drafting of a large, publicly held company's reorganization plan in the hands of creditors' committees. Each secured lender is placed in a class by

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[179] *See* MacLachlan, *supra* note 113, at A10 .

[180] To our mind, the best justification for restricting venue would run along the following lines. Debtors will always choose the forum that favors their interests. At the time of a bankruptcy petition, the firm's managers are engaged in a battle with the creditors. In most situations, a ruling that benefits the current managers hurts the creditors. Thus, any choice by definition would be exercised in a way that benefited managers at the expense of creditors. Restricting venue to one single location—say, where the principal's assets are located—would reduce such behavior. We do not press such as argument because, as we show below, it is better to redirect the incentives of managers by making them precommit to file in a particular venue, and thus create competition among bankruptcy courts to promote efficiency.

[181] *See* Asahi Metal Indus. Co. v. Superior Court, 480 U.S. 102 (1987); International Shoe Co. v. Washington, 326 U.S. 310 (1945); Lea Brilmayer, *Related Contacts and Personal Jurisdiction*, 101 HARV. L. REV. 1444 (1988).

itself. The unsecured general creditors, including the small creditors, are represented by a committee consisting of the largest seven general unsecured creditors.[182] These committees tend to be dominated by large creditors,[183] and their expenses are paid out of the bankruptcy estate.[184] This unsecured creditors' committee should safeguard the interest of the small, unsecured creditors. Its objective is to maximize the value of all the unsecured claims, which will further the interests of the smaller claimants as well as the larger ones. In other words, the small, unsecured creditors to a large extent are able to free ride on the efforts of the larger unsecured creditors.

If it is true that small creditors are not directly involved in negotiating the plan of reorganization, what are their costs of participating in a Chapter 11 proceeding? We can think of only two relatively small costs, hardly enough to merit the sweeping changes recommended by the Bankruptcy Commission's report. The first cost is that a small creditor will need to retain local counsel to file its claim. This is a small expense as filing these claims is a ministerial act that does not consume an inordinate amount of time. It does not require the creditor's principal attorney to travel to the court where the case is filed. The magnitude of this cost thus does not vary with the distance between the creditor and the bankruptcy forum. This cost is a fixed cost, which must be paid any time that the creditor's attorney cannot file a proof of claim herself in the selected forum.

The second cost that forum shopping imposes on small creditors arises only for disputed claims. In that subset of all situations, the bankruptcy court must value the claim.[185] If the dispute can be resolved by the court on the papers without oral argument, the small creditor should not incur any additional costs. Where the small creditor's attorney must travel to the bankruptcy court to argue the motion, however, the creditor will need to pay its attorney's airfare. The creditor's largest expense, its attorney's time investigating the dispute and litigating the issue, would remain the same.[186] While there are no thorough empirical studies of the net increase of travel costs that might arise from the bankruptcy venue provisions, we are hard pressed to see how it could be so big that creditors would be routinely discouraged from pressing their claims.

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[182] *See* 11 U.S.C. 1102(b) (1994). The bankruptcy judge has the discretion to expand the number of creditors on the committees as she deems appropriate. For an insightful analysis as to how this discretion should be used to facilitate reorganization, see Daniel J. Bussel, *Coalition Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. Rev. 1547 (1996).

[183] *See* Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 155 (1990) (noting that large, unsecured creditors control the committee process).

[184] 11 U.S.C. § 1103(a) (1994).

[185] *See* 11 U.S.C. § 502(b) (1994).

[186] Of course, an attorney's fee can increase if the attorney bills for travel time during which she performs no work for the client. Our sense is that while such billing may in fact occur, it is by no means universal, and those who actually do it tend not to publicize it.

We thus conclude that the Bankruptcy Commission's proposal to eliminate place of incorporation as an appropriate venue is harmful in the case of firms seeking to file a prepackaged bankruptcy, and would provide little if any benefit in the case of a traditional Chapter 11 proceeding. Thus, Delaware should remain as an appropriate venue in reorganization cases, even if its only relation to the debtor is that it is the state of incorporation.

C. The Efficiency Benefits of Reforming Current Venue Rules: Importing the Race to the Top into Bankruptcy Law

If, however, we reexamine the corporate law race to the top arguments in Part II, we find a much sounder basis for reforming current bankruptcy venue rules. To briefly summarize these points, recall that the race to the top analysts have made compelling arguments that allowing firms to select their state of incorporation (or reincorporation) increases social welfare.[187] In the traditional Chapter 11 case, by contrast, the firm has an incentive to select a forum that favors its interests over those of its creditors, which may not increase economic efficiency.[188]

What is the difference between these two decisions by the firm? Under state corporate law, a firm selects its initial state of incorporation at the time of its formation, when its future is usually rosy. If it should choose to reincorporate, this generally occurs to facilitate a particular transaction that can be undertaken more cheaply under a different legal regime.[189] In neither scenario is the firm experiencing financial or economic distress, and the firm's managers expect to retain their jobs for the foreseeable future.[190] These managers have incentives to choose value-maximizing jurisdictions for their (re)incorporation because they know they will need to persuade investors to make later investments in the firm, either by buying equity or by lending money.

By contrast, when a bankruptcy petition is filed, the firm's future is unclear—it is experiencing financial distress and possibly economic distress as well. The managers' job tenure is insecure.[191] In this final period situa-

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[187] *See supra* Part II.

[188] Finally, in prepackaged bankruptcies, there are good reasons to believe that the firm's selection of venue may increase social welfare by decreasing the costs of the reorganization. *See supra* notes 136-48 and accompanying text.

[189] *See* ROMANO, *supra* note 37, at 32. Romano points out that these transactions usually take one of three forms: a public offering of stock, a mergers and acquisitions program, and anti-takeover defensive tactics. Under state corporate law, shareholders need to approve a corporation's decision to reincorporate in a different state.

[190] Even if management is seeking to reincorporate to strengthen the corporation's anti-takeover defenses, managers are likely to retain their jobs because they will only seek shareholder approval for the reincorporation when the corporation has yet to be directly attacked. If they should wait until a hostile bidder has appeared, they are unlikely to persuade shareholders to approve a defensive reincorporation.

[191] The turnover rate for managers in Chapter 11 is quite high. *See* Stuart Gilson, *Management Turnover and Financial Distress*, 25 J. FIN. ECON. 241 (1989) (29% of senior managers remain over a

tion, managers will seek to preserve their control of the firm despite the costs to investors, even if they only are able to delay their own day of reckoning by a few months.

How does the difference in the timing of when managers select their firm's state of incorporation and when they choose their bankruptcy venue impact on economic efficiency and the appropriate choice of bankruptcy venue rules? We argue that while letting a firm's managers select its state of incorporation is value-maximizing for its owners, permitting managers to select their bankruptcy venue once the firm is financially distressed creates important inefficiencies in bankruptcy law because managers' interests diverge from the firm's interests as a whole. However, if we could instead force managers to precommit to the firm's bankruptcy venue at the time when the firm seeks capital in the financial markets prior to the arrival of financial distress, then managers would have an incentive to select the venue which promises to maximize the value of the firm as a whole.

We begin by reiterating an important lesson of our earlier discussion of the Delaware Bankruptcy Court: forums matter, especially in the bankruptcy context. Bankruptcy judges have substantial discretion in implementing the Code. For example, they must approve post-petition financing[192] and all transactions outside of the ordinary course of business,[193] they must decide whether or not to lift the automatic stay so that a secured creditor can foreclose on its collateral,[194] and they must determine whether or not to allow creditors to propose plans of reorganization,[195] which can often include a liquidation of the firm.[196] Not surprisingly, these judges exercise their discretion differently: some will make prodebtor choices, while others may be more procreditor. Under current law, managers will choose the bankruptcy venue that is the most debtor friendly in order to maximize their own welfare.

Such a choice may not be in the firm's long-term interests. For solvent companies, investors understand the costs of various legal regimes.[197]

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four-year period beginning two years before filing); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 723-37 (1993) (reporting similarly high turnover rate).

[192] 11 U.S.C. § 364 (1994).

[193] 11 U.S.C. § 363 (1994).

[194] 11 U.S.C. § 362(d) (1994).

[195] 11 U.S.C. § 1121(d) (1994).

[196] *See* Robert K. Rasmussen, *The Efficiency of Chapter 11*, 8 BANKR. DEV. L.J. 319, 322 (1991) (liquidating plans of reorganization account for between 20% and 30% of all plans); Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 601-02 (1993) (approximately 25% of reorganization plans effectively liquidate the assets of the firm).

[197] The contractarian school of corporate law is best known for the argument that the capital market is effective in pricing charter terms. They argue that professional investors, whose job it is to price stocks, will scrutinize the charter terms and be able to price them relatively effectively. *See* EASTERBROOK & FISCHEL, *supra* note 2, at 15-22. We need not accept this strong a version of market valuation in order to make the

When creditors decide to lend money to the debtor, they price the cost of the operative legal regime. Creditors' ability to increase the cost of capital to firms that promote the interests of managers over the interests of debt and equity holders acts as a substantial constraint on managers' behavior.

The same rules apply in bankruptcy to determine the costs of a bankruptcy regime.[198] Whenever a bankruptcy regime reduces a creditor's payout, perhaps by shifting firm assets away from the creditor in the bankruptcy proceeding itself, or by allowing managers to take unwarranted gambles once the firm encounters financial distress, the creditor will demand a larger payment at the time it lends money.[199] While lenders may not be able to price these increased costs for every provision in a lending agreement, debtor opportunism will increase the costs of loan transactions generally. Raising costs on creditors ultimately raises costs for debtors.

In the corporate law context, these potential costs are constrained by the threat to the firm of increased capital costs if it picks a legal regime that fails to maximize firm value. The firm will continue to operate in the future and to raise funds after it makes the (re)incorporation decision. This is particularly true for firms about to make an initial public offering because they will be immediately raising funds. Moreover, the managers making the incorporation decision expect to continue to hold their current jobs when these effects are felt. Furthermore, these managers will normally either hold stock or stock options in their company and thus have a direct financial interest in obtaining the highest possible price for the company's shares.

Compare this to the situation facing a firm when it decides to file a bankruptcy petition. The firm's immediate concern is its short-term survival. Managers face an immediate loss of their jobs. They seek the most hospitable prodebtor forum to preserve their jobs. If this means extra costs for creditors, they will increase their charges and the firm will ultimately pay these costs.

But when will the firm pay these additional costs? When creditors loan funds they will anticipate that, once the firm encounters financial distress, its management will opportunistically seek the bankruptcy forum which provides the managers the greatest benefits. The creditors will price this cost into their loans up-front. Thus, at the time that the managers are making their decision about where to file, the firm has already paid the price for their choice. This will be true for all firms that seek to borrow capital in the financial markets.

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proposition stated in the text. Any pricing of the terms will push toward the selection of the efficient market. In other words, we do not have to assume perfect markets; we only have to assume some market.

[198] *See* Frank H. Easterbrook, *Is Corporate Bankruptcy Law Efficient?*, 27 J. FIN. ECON. 411, 414 (1990); Rasmussen, *Debtor's Choice*, *supra* note 5, at 55-59.

[199] *See* Rasmussen, *Debtor's Choice*, *supra* note 5, at 55-59. Rasmussen has argued that this pricing occurs even when the insights of behavioral economics are incorporated into the analysis. *See* Rasmussen, *supra* note 1, at 1687-1702.

This creates a social welfare problem because each firm is paying increased capital costs so that, if the firm files for bankruptcy, their managers can make a value-decreasing decision. Creditors anticipate that managers will act in their self-interest, and price their loans accordingly. When the time for the bankruptcy decision arrives, managers act in their self-interest. They pay no subsequent penalty if their selection deviates from the socially optimal one.

Furthermore, not all firms will file for bankruptcy. However, creditors price their loans anticipating that all managers will act opportunistically if the firm files for bankruptcy. Thus, each firm pays the expected cost of their managers' self-interested choice of venue, with the expected cost being higher than the actual cost for those firms who never file, and lower for those firms which end up in bankruptcy. This results in a wealth transfer from firms who pay extra for credit and do not file for bankruptcy to those firms who actually do file for bankruptcy.

This problem can be eliminated if we force firms to make their venue selection when they seek to raise funds in the credit market before they are in financial distress. Firms should thus be allowed to commit, in advance of financial distress, to filing in a certain jurisdiction when a bankruptcy petition is warranted. If our proposal were enacted, the debtor would have the appropriate incentive to pick the bankruptcy jurisdiction which best maximizes firm value.

Our argument rests on the same principles that apply to solvent corporations selecting their state of incorporation. In that situation, if we disregard market constraints, economic theory tells us that managers will pick a state of incorporation whose law maximizes their private interests, irrespective of its effect on the firm's creditors and shareholders. Introducing market constraints into these markets reduces the divergence of manager and investor interests. Firms compete for capital. If their managers pursue policies promoting their own interests at the cost of suppliers of capital, suppliers will raise their prices for providing the firm's capital. Managers thus face a trade-off: choose a legal regime which entrenches them in power, or select one that lowers the firm's cost of capital. The latter regime will enrich managers by increasing the likelihood that the firm will succeed. The more successful the firm, the more successful the managers.

The same story can be told about bankruptcy venue selection. If we view bankruptcy venue selection without consideration of market constraints, managers will select that venue which maximizes their private value at the time of insolvency by picking the most prodebtor jurisdiction that is available so as to preserve their jobs. The firm will, however, pay the higher cost for capital discussed above.

However, once we permit firms to precommit to a particular bankruptcy venue, this situation changes. Firms can now guarantee their creditors about where they will file any potential bankruptcy proceeding and thereby assure creditors about what kind of treatment they will receive if the

firm files for bankruptcy. Creditors could choose to price the firm's potential bankruptcy in this jurisdiction and agree to such a term in exchange for a lower interest rate. Alternatively, creditors could propose a different venue or other arrangement. In either event, creditors would be more accurately assessing the costs of lending to the firm and charge a more suitable rate.

This strategy will also reduce the divergence between the managers' interests and the interests of the firm. Managers have an interest in obtaining capital at the lowest cost so long as they believe at the time they are negotiating for additional capital injections that obtaining more capital will preserve the value of their jobs (and stock options) better than the alternative of filing for bankruptcy. This will generally be true where management believes that the additional capital will enable the firm to reverse its financial decline.

We hypothesize that it would generally be value maximizing for firms and managers if, at any time that a firm seeks credit from the capital markets before insolvency, they would offer to commit to filing any future bankruptcy proceeding in a procreditor jurisdiction in order to persuade potential lenders to offer more favorable terms on their loans. However, we need not define the exact moment when managers and creditors will believe that they are better off striking such a deal. If such an option were available, the parties to the firm's debt contracts could decide when it was value maximizing to exercise it.

Once firms are allowed to commit to the jurisdiction in which they would file for bankruptcy, the flaw in the current venue proposals becomes not that they are overly expansive, but rather that they are unduly restrictive. Bankruptcy courts differ on the ways in which they exercise their discretion. Under current law, a firm cannot select among all bankruptcy courts. Thus, the most efficient court for that firm may not be an available selection. In fact, under current law a firm may have only one venue choice, which may offer a regime far from its optimal selection.

To remedy this situation, we would suggest that, for firms preselecting the forum in which they would file at any time prior to insolvency, they be allowed to designate any bankruptcy court in the country. This would maximize the range of choices available to firms and their creditors for negotiating a value-maximizing choice for a bankruptcy forum. Thus, our proposal would, at a minimum, allow firms to select the most efficient bankruptcy court available.

This preselection will also create incentives for bankruptcy judges to run more efficient courts. Many bankruptcy judges like to handle important Chapter 11 cases because they generate a lot of attention and often raise complex and interesting legal issues.[200] Moreover, most of the other cases

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[200] See statement of Bankruptcy Judge Robert E. Ginsberg in Davis, *supra* note 23, at B8 ("Judges clearly enjoy handling the mega-cases because all the theory comes together."); *see also* RICHARD A. POSNER, OVERCOMING LAW 118 (1995) ("prestige is unquestionably an element of the judicial utility function").

that fill a bankruptcy judge's docket involve neither significant amounts of money nor difficult legal issues. To the extent that bankruptcy judges prefer to handle high profile cases with interesting legal issues, they will affirmatively desire handling the reorganization of large, publicly traded companies. These claims are supported by some bankruptcy judges' complaints that the problem with the rise of Delaware as the venue of choice is that it deprives other judges of the opportunity to have their fair share of these cases.[201] Indeed, as we described earlier, the bankruptcy judges in the Southern District established a committee for the express purpose of advising the judges how they could attract more Chapter 11 cases to their courts.[202]

Under our proposal, bankruptcy judges would be free to compete for Chapter 11 cases, albeit more subtly than states compete for revenues from corporate charters. In the current regime, the way to attract large Chapter 11 cases is to gain a reputation as a prodebtor forum. If firms were to select the forum prior to the onset of financial distress, however, there is reason to think that they would choose the forum that maximizes firm value. Bankruptcy judges would then have to compete for the desirable cases by handling Chapter 11 cases in a manner that maximizes firm value and thereby leads firms and creditors to prefer that forum. In other words, if we allow firms to precommit to the venue in which they would file, this will create an incentive for bankruptcy judges to interpret the Bankruptcy Code in a way that best maximizes firm value. The race to the top in corporate law would thus be replicated in bankruptcy law.[203]

Our proposal raises a number of obvious questions. First, we need to be clear about the mechanism that a firm would use to make the commitment that we advocate. Second, we must ask if creditors would adjust their behavior if firms did in fact commit to file for bankruptcy protection in a value-maximizing venue. Finally, we look at whether a bankruptcy court can commit to be consistent in its rulings over time. We address each question in turn.

How are firms going to commit to filing for Chapter 11 in a specific venue? Firms receive capital from a number of sources. Many firms have long-term debt secured by real estate, short-term debt secured by personal property, unsecured operating loans, short-term trade debt, employees who are owed for their services, and shareholders. These parties all contribute

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[201] *See* sources cited *supra* note 197; *see also* NATIONAL BANKRUPTCY REPORT, *supra* note 19, at 779 ("[c]ourt competition for cases could distort analysis of legal problems").

[202] *See Houston*, *supra* note 60.

[203] LoPucki and Whitford have also reached the conclusion that bankruptcy judges compete for Chapter 11 cases. *See* LoPucki & Whitford, *supra* note 9, at 37-38. They believe such competition is beneficial under current law because it promotes specialization. *See id.* at 40-41. They overlook, however, the fact that the managers' interests diverge from that of the owners of the firm at the time that the bankruptcy petition is filed, and thus bankruptcy courts will cater to the former at the expense of the latter. Our proposal solves this problem by forcing managers to make a decision at a time when their interests are more aligned with the interests of the owners of the firm.

capital to the firm and do so at varying times. What is needed is a mechanism to ensure that all suppliers of capital are assured that the firm has committed to a single venue choice. If a firm can promise one creditor that it would file in one venue and a second creditor that it would file in another, neither promise is credible.

The easiest way to allow the firm to commit to a particular venue is through a provision in the firm's corporate charter specifying that in the event of bankruptcy the firm will file in a particular jurisdiction.[204] The firm will thus commit itself in a public document that is available to all creditors who view such information as relevant.[205] By placing the commitment in a single place, the problem of multiple, inconsistent commitments—and the lack of credibility that it implies—is eliminated.[206]

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[204] Both Schwartz and Rasmussen have endorsed the proposal that firms should choose, prior to the onset of financial distress, the entire bankruptcy reorganization process from a menu of choices, but have disagreed over whether this choice should be made in the corporate charter or in the individual contracts between the firm and its creditors. *Compare* Rasmussen, *Debtor's Choice*, *supra* note 5 (proposal having choice in charter); Robert K. Rasmussen, *Free Contracting in Bankruptcy at Home and Abroad*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT, *supra* note 7, at 311 (responding to Schwartz) *with* Schwartz, *Contract Theory Approach*, *supra* note 5 (bankruptcy terms should be in individual contracts); Schwartz, *Contracting*, *supra* note 5 (same); *see also* Adler, *supra* note 5 (arguing that extant bankruptcy law should be replaced by a regime that enforces contractual priorities to a firm's assets).

However, our proposals in this article, while directed toward increasing the efficiency of the bankruptcy law, are quite distinct from the earlier literature. Unlike the proposed bankruptcy law reforms discussed above, our proposal could be implemented within the existing legal system with little or no change to current legal rules. Such an incremental approach to law reform has the virtue of not requiring wholesale legislative action and the attendant uncertainties that usually accompany such changes. This increases the likelihood that our proposal will be legislatively enacted.

[205] Our proposal could be implemented by changing current bankruptcy law to permit corporations to include a forum selection provision in their charter that could only be amended by a majority vote of the creditors both in number and by the amount of the claims they hold. This would slightly impinge on existing state corporate law by restricting shareholders' right to amend the certificate. We believe that this restriction would only have a very slight effect on shareholders, however, if it was implemented before the corporation was in financial distress.

[206] Two related issues arise with respect to affiliated companies and mergers. First, we would treat affiliated companies as separate and distinct entities for bankruptcy venue purposes and allow them to have distinct venue provisions from each other. This would mean that each would be required to file for bankruptcy in the venue in which it had precommitted to do so. From an efficiency perspective, this would give each entity an incentive to seek to maximize value through the appropriate selection of its bankruptcy venue and avoid any collusive side deals by one firm in order to shift value from its affiliate's creditors.

Second, with respect to mergers, we also need to address the question of whether the surviving firm or disappearing firm's venue selection provision governs. In the event of a conflict between the venue selection provisions of the two concerns, we would first look at the terms of the debt to see if such a change of control constituted a default that would require a renegotiation of the terms of the loans. In this situation, the creditors affected would be free to reject the assumption of their loans by the merged company. However, in the case where there was a conflict of venue provision, and the creditors had failed to bargain to protect themselves in such a change of control situation, we would apply the venue provision of the company with a greater amount of outstanding debt. We would argue that this choice would be more likely to maximize value for all debt-holders and minimize sham transactions designed to curtail creditors' rights.

The firm, however, cannot be allowed unfettered change in its choice of venue. Otherwise, the benefits from ex ante selection may well evaporate. This is because managers would have an incentive to switch the charter choice to a prodebtor jurisdiction as soon as a bankruptcy filing appears to be a realistic possibility. Such opportunistic charter amendments have long been a concern in corporate law generally.[207] Indeed, the inability to make credible commitments on *R*'s score may be one reason we do not see firms attempting to commit to a particular jurisdiction today.[208] To guard against opportunism, such amendments should only be allowed if approved by a majority of creditors, both in number and dollar amount, as well as the firm's shareholders. Presumably, creditors will not sanction a change that is designed to enrich management at the expense of these owners of the firm. Indeed, as we explained above, it is just such a commitment to creditor determination which underlies the Code's current rules for voting on reorganization plans.[209]

A second objection to our proposal might be that even if firms could make binding commitments, creditors will not be interested in bargaining over these commitments when they extend credit. In the case of a firm entering the capital markets for the first time, well before the onset of financial distress, it may be that few creditors would pay attention to the venue to which the firm has committed.[210]

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[207] *See* Lucian Arye Bebchuk, *Forward: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1399 (1989) ("The questions of contractual freedom in the initial charter and in midstream . . . are different and require separate examination."); Bebchuk, *supra* note 2; Coffee, *supra* note 2, at 1674-76; Easterbrook & Fischel, *supra* note 2, at 1442-44; Melvin Avon Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1471-1515 (1989); Ronald J. Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775 (1982); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-85 (1989).

[208] Other reasons may include an uncertainty over whether courts would enforce restrictions on access to bankruptcy courts and the fact that the issue of bankruptcy venue has come to the fore relatively recently.

[209] *See supra* text accompanying notes 146-47. Another possible solution to the problem that jurisdictions may not be constant in their interpretation of the Bankruptcy Code would be for the firm to vest control of the venue decision in the hands of the creditors. After the bankruptcy petition is filed, any creditor would be allowed to file a motion to change venue. The bankruptcy judge would not rule on this motion. Rather, the creditors would vote on the motion, with each creditor having a vote equal to the value of its claim.

The problem with this proposal is that creditors may not always vote for the value-maximizing jurisdiction. At the time a petition is filed, creditors are not a monolithic group. Secured creditors with adequate security would often favor immediate liquidation of the firm. Unsecured creditors, on the other hand, especially in situations where most of the firm's assets have been pledged to senior creditors, may favor a jurisdiction with a bias toward continuing the firm's operations in hopes for a turnaround. While creditors may have, on average, better incentives than managers in this regard, the inevitable conflicts that arise during financial distress make this proposal less attractive than contracting for venue via the corporate charter.

[210] By contrast, many firms reincorporate because they intend to engage in some specific transaction in the near future. In this situation, the consequences of choosing Delaware law instead of their home state will be manifest in the near future.

We offer three responses to this argument. The first is that good reasons exist for the market to price these terms. While the probability of default may be small for many firms, bankruptcy is a common occurrence. Rational investors know that a given percentage of firms fail, and they have incentives to take this into account when they make their lending decisions, especially if the firm is experiencing financial distress at the time of the negotiations. Indeed, even if the parties do not anticipate a bankruptcy filing in the near future, potential creditors are likely to view a public commitment that a firm would file in a jurisdiction known for its value-enhancing interpretation of the Bankruptcy Code as a positive signal that its managers are not going to act opportunistically.

The second response is that, at some point, the possibility of financial distress will become patent. In this situation, the firm may well have to obtain additional credit. In this transaction, if a firm commits to filing for bankruptcy in a value-maximizing jurisdiction, it will have a lower cost of credit. Although we would allow firms to make its initial venue commitment at any time up until the point of filing a bankruptcy petition, they have an incentive to do so much earlier to gain a lower cost of credit ex ante.

Third, as a firm approaches insolvency and seeks more capital, creditors will need to determine whether to negotiate for a more favorable forum, or risk winding up in a prodebtor forum. In other words, creditors will need to pay more attention to venue selection options as the risk of insolvency grows. They will be very interested in bargaining with firms at this point, if they have not earlier, to avoid prodebtor jurisdictions.

One final concern with our proposal that we need to address is that bankruptcy courts may change their positions over time, decreasing the value of earlier commitments. In other words, although a certain jurisdiction may have procreditor bankruptcy judges at the time that the debtor negotiates for its selection, there is no assurance that judges will have the same dispositions when it comes time for the firm to file.

At first glance, there appears to be ample justification for such concerns. Bankruptcy judges do not have life tenure; rather, they serve for a period of fourteen years, though reappointment is a possibility.[211] A procreditor bankruptcy judge may thus be replaced by a prodebtor bankruptcy judge. While the State of Delaware has credibly committed itself to corporate policies and courts that maximize shareholder wealth,[212] the selection

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[211] *See* 28 U.S.C. § 152(a)(1) (1994).

[212] Delaware's commitment to retain a value-maximizing corporate law stems from a variety of sources. First, its highly knowledgeable judges, corporate lawyers, and legislature are capable of making changes in the law that are responsive to the changing needs of corporations. Second, Delaware's constitution requires a two-thirds vote by the legislature to change the corporate laws. Third, the most important reason to believe that Delaware will make the necessary changes in its corporate law is its dependence on charter fees. Approximately 17% of its tax revenue is from charter fees. *See supra* note 136 and accompanying text. If Delaware fails to respond to changing corporate circumstances, it could lose a sizable portion of its state revenue from corporations deciding to reincorporate in more value-maximizing states.

process for bankruptcy judges may not contain similar mechanisms. For example, bankruptcy judges are appointed by the United States court of appeals for the governing circuit.[213] There is no apparent reason to believe that these federal appellate court judges have committed to any particular interpretation of the Bankruptcy Code. If there is no continuity in judicial attitude, pre-committing to file bankruptcy proceedings in a particular jurisdiction may offer few benefits.

We believe that this concern with judicial commitment is easily assuaged. Initially, we note that, in many cases, creditors have little to worry about. If the term of their loan is shorter than the remaining term of the bankruptcy judges in the district, creditors need not fear a reversal in policy. Indeed, the choice of jurisdiction matters most when the firm is close to financial distress. For example, where Microsoft would file for bankruptcy does not enter the calculations of those who contribute capital to that firm today. By contrast, current lenders to Phillip Morris are probably well aware of what would happen were Phillip Morris to file for bankruptcy. Similarly, when a firm attempts a workout with its creditors because it is having financial difficulties, it is much more important which jurisdiction would administer the Chapter 11 case if the out-of-court restructuring fails to ameliorate the firm's financial distress. Thus, long-term changes in the nature of various venues may not loom large.

Another reason why this concern is not significant is that, under our proposal, judicial regimes may remain constant for two reasons. One, as we noted earlier, is that bankruptcy judges tend to prefer Chapter 11 cases. This preference creates an incentive for a new bankruptcy judge not to deviate from the attitude of her predecessor in a way that favors the interests of the firm's managers. A new judge's colleagues may well attempt to socialize her to the governing attitude in the district so as to maintain consistency within the district. Indeed, one of the recommendations by the panel advising the bankruptcy judges in the Southern District of Texas was to be more consistent in their handling of Chapter 11 cases.[214]

A second reason that a drift toward a debtor-friendly attitude may not occur post selection is that our proposal may alter the selection process for bankruptcy judges so that it will produce more judges who maximize firm value. While the appointment power lies with the court of appeals, bankruptcy attorneys can have a large influence on this process. To fill a vacancy on the bankruptcy bench, the court of appeals receives a recommendation from the judicial council for the circuit, which has the responsibility for screening all applicants.[215] In practice, screening is often done by local bankruptcy practitioners. To the extent that the local bar had an interest in ensuring that its bankruptcy courts interpreted the Bankruptcy

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[213] *See* 28 U.S.C. § 152(a)(1).

[214] *See Houston, supra* note 60, at A8.

[215] *See* Pub. L. 98-353, § 120(b) (1984).

Code so as to maximize firm value, and thereby attract more lucrative filings to the district, the bar would have an interest in being involved in the selection process. While it is always dangerous to predict the future course of events, it may well be that a system that regards jurisdictions that handle corporate reorganizations efficiently would generate judges committed to such outcomes.

Support for this supposition comes from the experience in Delaware. After Delaware had become the venue of choice, a new bankruptcy judge was added to the court, increasing the total from one to two. Were a judge appointed to this new position who differed significantly from the current judge, this would have increased the uncertainty of filing in Delaware, and thus made Delaware a less attractive alternative. In fact, the person who was selected for the new position was a member of the Delaware bankruptcy bar, and soon demonstrated that he would act consistently with his colleague on the bench. This consistency between judges is one factor to which attorneys point when explaining the attractiveness of Delaware. While one should always hesitate before drawing conclusions from a single event, the Delaware experience suggests that our hope that the local bar will assist in producing efficiency-minded bankruptcy judges is not farfetched.

A third solution to the problem of changes in the predilections of various venues is to allow for changes to the corporate charter. When a jurisdiction which had been selected by the firm in its corporate charter becomes less attractive from the creditors' standpoint, the firm could amend the charter to choose a venue which is now the most desirable. To the extent that the firm anticipates that it will have to enter the credit markets in the future, it has an incentive to change its venue selection to a more appropriate jurisdiction. As we discussed above, however, this ability to change the selection has to be cabined so as to prevent opportunistic changes.

In the end, moving the choice of venue from after the onset of financial distress to before the firm has to enter the credit markets may both lead to firms selecting value-maximizing jurisdictions and, through court competition for Chapter 11 cases, to more value-maximizing interpretations and implementations of the Bankruptcy Code.

CONCLUSION

Venue matters. Different courts reach different results when presented with similar cases. Potential litigants are aware of this fact and act accordingly to select the most receptive courtroom for their claims. This phenomenon has fueled concern over forum shopping for generations. Scholars have argued endlessly over whether this strategic behavior is a good or bad thing without reaching consensus about anything, even over how frequently the practice occurs.

The bankruptcy area may be one area where, although forum shopping is prevalent, we can agree on the appropriate response. The source of this consensus is not that there are fewer differences in the way different bankruptcy courts handle corporate reorganizations than elsewhere. In fact, the contrary may be true. Indeed, it is the Delaware bankruptcy courts' handling of these cases that has led to calls to eliminate the state of incorporation as an appropriate venue.[216]

Rather we believe that consensus can be generated about forum shopping in corporate reorganizations because there are strong theoretical arguments in favor of it. Our argument is that if we force companies to make their choice of bankruptcy venue prior to the time that they seek capital in financial markets, managers will have strong incentives to preselect a forum that will maximize the value that they will receive from financial investors for their interest in the firm. Thus, the available venues for bankruptcy, rather than being contracted, should be expanded in order to maximize managers' choices.

The time at which such venue should be selected, however, needs to be changed. Managers now exercise their choice of venue at a time when their interests diverge from those of the owners of the firm. If we force managers to make their venue choice early, then managers, counseled by their attorneys, will select the bankruptcy venue that best serves their interests at that point in time. This will lead them to select the most efficient bankruptcy forum in order to maximize their returns in the capital markets.

Such a rule will have beneficial effects on judges, too. The Bankruptcy Code as it is now written imbues bankruptcy judges with substantial discretion, and there is no reason to believe that such discretion will be removed anytime soon. Instead, with our system, bankruptcy judges, who want to handle corporate reorganization cases, will have an incentive to exercise their discretion by making their forums more efficient.

Finally, we believe that our proposal to allow more liberal bankruptcy venue selections, so long as they are made at the firm's creditors' request prior to financial distress, has the virtue of being analytically sound and yet capable of implementation without radical legal reform. Economically-grounded proposals have the virtue of conceptual purity and intellectual rigor.[217] Yet, critics of legal reform proposals based on economic insights frequently claim that these policy recommendations propose a complete rejection of existing law and require wholesale departures from current prac-

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[216] We have argued that this suggestion is misguided. It overlooks the importance of prepackaged bankruptcies. These bankruptcies provide efficiency gains for all involved, and Delaware is a natural candidate for specializing in this area. To the extent that there are particular practices that should be curtailed, they should be curtailed in all forums and not reduced through the indirect route of the venue provisions.

[217] *See generally* Baird, *supra* note 30, at 573 (comparing the premises of law and economics bankruptcy scholars, whom Baird calls "proceduralists," with those of traditional bankruptcy scholars).

tices.[218] This is often true and creates formidable resistance to these proposals' implementation by members of the practicing bar. Our proposal provides an opportunity for incremental reform that will improve the efficiency of the bankruptcy laws.

[218] *But see* Adler, *Accelerated Resolution*, *supra* note 31; Adler, *Re-Examination*, *supra* note 31; Hansen & Thomas, *supra* note 5.