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Citation: 54 Buff. L. Rev. 343 2006-2007



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ARTICLES

Beyond Recidivism

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INTRODUCTION

Lynn LoPucki has done path-breaking work that has enormously advanced our understanding of large Chapter 11 cases.¹ Several years ago, Lynn LoPucki made a major and previously unnoticed discovery about large Chapter 11 cases in the early 1990s. Those filed in Delaware returned to bankruptcy at an extraordinarily high rate—almost ten

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1. While he has done much of the work on his own, LoPucki has also been able to work with other extraordinarily capable scholars. *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597 (1993); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669 (1993); Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967 (1999); Lynn M. LoPucki & Joseph W. Doherty, *Why Are Delaware and New York Bankruptcy Reorganizations Failing?*, 55 VAND. L. REV. 1933 (2002). Moreover, LoPucki has been completely open in sharing his data and helping others, even when their own views differ dramatically from his own. We count ourselves among the many beneficiaries of his generosity.

times the rate elsewhere.² This difference is exceedingly unlikely to have arisen by chance. There is something special about Delaware during this period, yet there is no obvious difference in the size or the complexity of the cases filed there.³ The phenomenon calls out for an explanation, and LoPucki deserves much more credit than he has received for this startling finding. In his most recent work, LoPucki has pushed the debate still further. He argues that the high recidivism rate in Delaware has spread to other jurisdictions and is symptomatic of a destructive race to the bottom.⁴

The race, according to LoPucki, is being run by bankruptcy judges. Most bankruptcy judges see only small Chapter 11 cases.⁵ The debtor is an electrical subcontractor, a mom-and-pop restaurant, or a travel agency. These cases do not make headlines and are not very interesting. By contrast, in a mega-case, the bankruptcy judge controls the fate of thousands of workers and hundreds of millions of dollars. Bankruptcy judges live to preside over these cases, and most never do. In the early 1990s, the bankruptcy court in Delaware developed a set of practices that made it attractive to case placers, those who decided where to file. Suddenly, the big cases started being filed in Delaware. Bankruptcy judges elsewhere took note and mimicked them in an effort to attract large cases to their own courts.

Some of the practices that attract big cases are beneficial. Judges become less imperious, more responsive, and more predictable. But competition also leads to judicial practices—from promiscuous critical vendor orders to overly

2. More precisely, LoPucki focuses on cases where a company emerged from Chapter 11 between the start of 1991 and the end of 1996. Here (and elsewhere in the paper) the comparisons are between Delaware and the rest of the country excluding the Southern District of New York. The refiling rate was higher in the Southern District than the rest of the country, but again, not as high as Delaware.

3. See Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231 (2001); LoPucki & Doherty, *supra* note 1.

4. LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* (2005).

5. See Edward R. Morrison, *Bankruptcy Decisionmaking: An Empirical Study of Continuation Bias in Small Business Bankruptcies*, 50 J.L. & ECON. (forthcoming 2007).

generous retention bonuses to second-rate managers—that are costly and contrary to the spirit and letter of the law. In their effort to attract cases, bankruptcy judges fail to enforce the law. The desire to attract business has, to use LoPucki's word, "corrupted" the bankruptcy courts.

The link LoPucki draws between recidivism and competition lies at the heart of LoPucki's empirical claim that bankruptcy judges have gone astray. He claims that his data show that modern reorganization practice is the product of a destructive race to the bottom. The desire for interesting cases leads to bad judging, and recidivism is one of the consequences. Such is LoPucki's hypothesis.

Drawing inferences from statistics is a tricky business. Anyone who closely examines LoPucki's data will find that his basic recidivism result is unassailable. There is no question that the recidivism rate in Delaware in the early 1990s was higher, much higher, than elsewhere. But connecting the recidivism rate to a destructive race to the bottom is quite a different matter.

In the first half of this Article, which will focus on LoPucki's work, we make a narrow and largely methodological point.⁶ LoPucki's data do not support the race to the bottom hypothesis. This hypothesis may be correct. Much evidence suggests that there has been competition for cases.⁷ Some modern reorganization practices are surely objectionable. And the competition may have led to these objectionable practices. But LoPucki's data do not prove that the two are connected.

6. The first half of this paper is a *précis* of a longer and more detailed examination of LoPucki's work that one of us has made elsewhere. See Robert K. Rasmussen, *Empirically Bankrupt* (Vanderbilt Univ. Law Sch. Law & Econ. Working Paper Series, Working Paper No. 06-07, 2006), available at <http://ssrn.com/abstract=895547>.

7. While commentators disagree over the extent to which judges alter their behavior to attract cases, there is wide agreement that at least some judges take at least some actions that have the effect of making their courts more attractive to those filing large cases. See, e.g., Marcus Cole, "Delaware is Not a State": Are We Witnessing Jurisdictional Competition in Bankruptcy?, 55 VAND. L. REV. 1845, 1874-76 (2002); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1369 (2000).

The problem stems from a limitation built into the methodology that LoPucki uses. Statistical techniques—comparing different rates in different places over different times—only work when the number of objects under study is large enough. The more data points, the more one can exclude competing hypotheses and the more robust the finding. But when there are few data points, one cannot exclude competing hypotheses. If we are mathematicians and all we know is the location of a single point on a curve, we can say nothing about the curve's slope. If we have only two points, we can say something about the slope of the curve, but we still cannot distinguish the curve from a straight line. In the social sciences, it is the same way.

Regression analysis allows us to understand the forces at work only if we have enough data. Statistics can be suggestive. The finding of an extraordinarily high rate of recidivism in Delaware in the early 1990s cries out for further investigation. But when the number of cases is small, case studies become the methodology of choice, not regression analysis. Regression analysis can take us to base camp but no further. Understanding what was going on in Delaware and elsewhere during the early 1990s and later requires delving into the facts of each case and trying to make sense of them. Only by doing this can one make sense of what was going on in Delaware.

We do not undertake the ambitious project of understanding what happened in Delaware in the early 1990s in this short Article.⁸ Instead, we attempt to take stock of what we know and how we should move forward. First, in Part I, we show that there were simply not enough cases in Delaware during the relevant time period to allow us to draw firm conclusions. Delaware practices may have triggered a race to the bottom, but the data do not show it. Indeed, with respect to the cases of most interest,⁹ the differences in the recidivism rates (both between Delaware and elsewhere in the early 1990s and between those filed

8. Again, one of us has pursued this question elsewhere. See Rasmussen & Thomas, *supra* note 7.

9. For reasons we explain below, the cases central to the race to the bottom debate are the ones that are neither prepackaged nor prenegotiated.

elsewhere early on and those filed later) are not even statistically significant.¹⁰

In Part II, we argue that a debate over whether there has been a race to the bottom misses a more fundamental point. The modern reorganization case is hard to reconcile with the prevailing justifications for having Chapter 11 in the first place. The standard claim is that Chapter 11 serves to protect the value that businesses have as going-concerns. In modern Chapter 11 cases, however, there is typically very little going-concern value. Given that few of the businesses are worth saving, one needs to search for some other rationale for Chapter 11. To return again to LoPucki, he proposes many reforms, but fails to offer an adequate account of the purpose the system, as reformed, would serve.

I. STATISTICS AND RECIDIVISM

Nearly 40% of the Chapter 11 cases filed in Delaware in the early 1990s later reentered bankruptcy.¹¹ By contrast, outside of Delaware and the Southern District of New York, the rate is only 5%.¹² Prepackaged bankruptcies are the most striking. Half of Delaware's large cases during this time were prepacks, and half of them filed again. Prepacks constituted a seventh of the docket elsewhere, but not a single one filed elsewhere ended up refiling.¹³ Despite this stark difference in outcomes, Delaware increased its share of prepackaged cases after 1996 to almost 80%.¹⁴ Indeed, while the number of prepackaged cases in total declined by a third in the seven years after 1996 as compared with the preceding seven years, Delaware actually received more

10. The differences in the recidivism rates between Delaware and elsewhere are statistically significant at the 5% level only with respect to prepackaged cases, not with respect to either the prenegotiated cases or the ones that were neither prepackaged nor prenegotiated. We are not suggesting that there was no recidivism problem in these cases, only that, because of the small sample size, the result is less striking than it appears and the inferences one can reasonably draw are necessarily limited.

11. See Rasmussen, *supra* note 6, at 59.

12. See *id.*

13. See *id.* at 60.

14. See *id.* at 61.

prepackaged cases in the later period. The decline in prepacks has been at the expense of the other jurisdictions.

Understanding why the prepackaged plans failed in Delaware, but not elsewhere, is an interesting question, as is the question of why Delaware today has a near monopoly on these cases. Nevertheless, we should not exaggerate the stakes. The failure of prepackaged plans in Delaware does not seem to have been at the expense of the unsophisticated. Most companies that file prepacks were failed leveraged buyouts or had otherwise taken on large amounts of high yield debt.¹⁵ Carl Icahn and other professional investors held the affected debt.¹⁶ Trade debt and the other ordinary obligations of the business were typically left unimpaired. A more aggressive restructuring that converted more of the debt into equity would have saved time and money, but those in control of the reorganization and others like them were the ones that bore the brunt of the cost.¹⁷

More to the point, the recidivism of prepackaged plans in Delaware is hard to connect with LoPucki's corruption story. Delaware judges may have handled these cases badly and may continue to handle such cases badly (a question we do not confront here). It is even possible that judges elsewhere would have replicated the same errors if given the chance. But they were not. Prepacks virtually disappeared outside of Delaware. Since 1996, only three courts other than Delaware have seen prepackaged cases, with only the Southern District of New York attracting more than two. There is no evidence that the judges elsewhere sought prepackaged cases, and LoPucki's competition story suggests they would not. Judges do not compete to become rubber stamps.¹⁸ The problems with

15. *See id.* at 72-73.

16. *Id.* at 75.

17. Gilson suggests that creditors may find it in their interest to keep substantial leverage in a reorganized company so as to keep pressure on managers to improve results. *See* Stuart C. Gilson, *Transaction Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, 52 J. FIN. 161, 182-83 (1997).

18. LoPucki describes the temptation that "corrupts" the bankruptcy judge in the following way:

prepackaged plans in Delaware, whatever they may have been, did not spread elsewhere, and it is not the focus of LoPucki's story.

Prepackaged plans have a dynamic that is different from other cases. Hence, combining prepacks with other types of cases in Delaware is suspect. The apples and apples comparison is between the same types of cases across different jurisdictions and different times. There are, in addition to prepackaged cases, two other types. The first is the prenegotiated plan. During the early 1990s, prenegotiated plans were both a substitute for prepackaged cases and were comparatively rare. There were also only five prenegotiated plans outside of Delaware and none failed.¹⁹ There is a difference in the recidivism rate of course (20% versus 0%), but the difference is not statistically significant.²⁰ To establish a race to the bottom, we should focus on the comparison involving the cases that were neither prepackaged nor prenegotiated. It is in these types of cases, the Enrons, Polaroids, and Kmart's, where LoPucki says that the judges' heads have been turned.

LoPucki's empirical claim rests on two comparisons. First is the comparison between the recidivism rate in Delaware and the rate in other jurisdictions in the early

[The bankruptcy judge becomes] the most powerful person in the room. Millions and sometimes even billions of dollars turn on his or her decision. The status that power confers extends beyond the courtroom.

Celebrity comes along with the power. The judges' decisions are reported in the media. Judges in the biggest cases have standing invitations from professional organizations to travel to resort cities . . . to give speeches and be honored. If they return to law practice . . . clients with big cases will seek them out.

See LOPUCKI, *supra* note 4, at 20. Very few of these benefits accrue to a judge who oversees a prepackaged bankruptcy for a month. One might argue that a bankruptcy judge that refused to "play ball" in a prepackaged case would earn a reputation as a "toxic judge," but bankruptcy judges outside of New York and Delaware during the period in which LoPucki claims they had become "corrupted" never had a chance to show whether they would or not.

19. See Rasmussen, *supra* note 6, at 59.

20. If we combine prepackaged and prenegotiated cases, Delaware's refiling rate for this grouping of cases is 42% and that of other courts is 0%.

1990s.²¹ Second is the comparison between this recidivism rate in the other jurisdictions during this period and the rate in these same jurisdictions subsequently. The comparisons are consistent with LoPucki's story. During the early 1990s, Delaware had a recidivism rate of 33% compared with a rate of 8% elsewhere. Moreover, the recidivism rate elsewhere jumped from 8% to nearly 20% after 1996. This is the evidence that LoPucki has to support his empirical claim of destructive competition. Delaware's judges had lax practices that led to higher rates of recidivism. When these practices are mimicked, a higher recidivism rate follows.

But these two comparisons standing on their own do not prove destructive competition. To be sure, there was a higher recidivism rate in Delaware than elsewhere in the early 1990s and the recidivism rate outside of Delaware increased after 1996 relative to what it was before.²² Destructive competition is one hypothesis, but many other forces were at work that might have produced these results. To interpret the data, we must control for the factors that have nothing to do with the race to the bottom story. For example, businesses in particular industries might have been more inclined to file in Delaware and these might have been industries in which the Chapter 11 failure rate is unusually high. Chapter 11 has never had much success with legacy airlines. No airline from the era before deregulation has ever filed for Chapter 11 and emerged successfully. All but Continental Airlines failed, and Continental needed two trips to the bankruptcy court to right itself.²³ If Delaware had a disproportionate number of airline cases, this might explain the higher rate.

There are other things for which we want to control as well. LoPucki's story is about making the forum attractive for case placers. Hence, we need to control for filings where the filer is someone other than the typical case placer. In the early 1990s, LoPucki asserts, the case placers were managers and their professionals. Hence, we should exclude cases where they did not control the filing. We cannot do

21. Following LoPucki, we are looking at cases filed after 1989 that emerged before 1997.

22. See Rasmussen, *supra* note 6, at 52.

23. See *id.* at 69.

this perfectly, but we can at least control for involuntary cases. We cannot tell why the creditors might have been filed in such a court, but we can be confident that it was not because the court was looking for their business.

In addition, we want to make sure that we identified the relevant populations correctly. By LoPucki's account, Delaware became a magnet for large cases with the filing of Continental. Hence, if we can, we would like to control for cases filed before Continental. We also want to make sure that the second filing was a result of the first filing and not some event that came along later. LoPucki does this by drawing a sharp line at five years. Anyone who files again within five years is assumed to be filing because the first Chapter 11 failed. Anyone who files after five years is assumed to be filing for some other reason. LoPucki's test is a reasonable way to account for the possibility that the second Chapter 11 arose for independent reasons. Nevertheless, we want to make sure that any result is not an artifact of drawing the line at five years rather than at four or six.

Making such adjustments is a standard part of regression analysis. The problem we confront, however, is that we simply do not have enough cases to make these adjustments and still have any hope of being able to rely on statistical inference alone. Indeed, the sample size is so small that the differences are not very compelling even on their own terms. They hover at the very edge of statistical significance.²⁴ LoPucki faces an insuperable challenge given the technique he is using. The small number of cases puts a limit on what can be done with statistics alone. The results are extremely sensitive to small changes in sample selection.

24. The difference between the cases that were neither prepackaged nor prenegotiated is not statistically significant at the 5% level after using a continuity correction, something ordinarily done when the sample size, as here, is small. If one excludes only prepackaged bankruptcies (combining prenegotiated and traditional reorganizations), the difference does become statistically significant at the 5% level. Again, none of this is surprising given the small sample size. It does suggest that *something* is going on outside the prepackaged cases. Moreover, the results as a whole show a statistically significant difference between Delaware and other jurisdictions, even controlling for prepacks. Something important is going on, but we do not have enough data to tell what it is.

To see the problem, if we reduce the window for recidivism from five years to four, the recidivism rate in Delaware drops by two thirds. At this level, Delaware cannot be differentiated statistically from other courts. Indeed, the performance of Delaware under this specification is identical to that of the Central District of California. If we put pre-Continental cases, involuntary petitions, and airline cases to one side, recidivism in Delaware disappears. We do not mean that the difference becomes statistically insignificant. We mean that recidivism *disappears completely*. No large Chapter 11s file again. Excluding prepackaged and prenegotiated cases, only one large voluntary Chapter 11 that filed after Continental in Delaware failed during the relevant time period, and it was TWA, an airline case.

Put prepackaged and prenegotiated plans to one side, and LoPucki's Delaware recidivism result turns on three cases.²⁵ Three cases (out of nine in all) are simply not enough to allow the inference of competition or corruption. Three points are scarcely enough to tell us much about the shape of a curve. There is a similar problem with the comparison between cases filed outside of Delaware before 1996 and afterwards. There are four recidivists out of the eighteen companies that emerged. This difference is not statistically significant either.²⁶

The recidivism rate between Delaware and elsewhere is statistically significant if we combine prenegotiated plans with those that were neither prepackaged nor prenegotiated. But we need to explain why the two types of cases belong together. Even then, the result involves only four cases and still hovers at the edge of significance. The result is statistically significant only if we draw the line for refilers at five years. If we drew the line at any other place—one year, two years, three years, four years, or six years—the difference in recidivism rates ceases to be statistically significant.²⁷

25. See Rasmussen, *supra* note 6, at 63.

26. This difference remains even if we include prenegotiated plans.

27. Moreover, combining the prenegotiated cases with those that are not either prepacks or prenegotiated is not enough to establish statistical significance in comparing the recidivism rate outside of Delaware and New York before 1996 and after. One can establish statistical significance if one

We do not, however, want to argue about statistical significance. Social scientists are too easily hung up on the accident of statistical significance, and in any event LoPucki has found enough connections in enough places to suggest that, whether statistically significant or not, something was going on in Delaware that was different. The problem rather lies in our inability to draw many inferences from the data.

LoPucki analogizes his findings to the connection between smoking and lung cancer. He does not identify cases in which competition led to a loss of jobs or the destruction of a business, but he infers it from the statistical pattern, just as we can infer that smoking leads to lung cancer even if we do not know whether a particular person got lung cancer as a result of smoking. LoPucki, however, does not recognize the crucial difference between his study and those on smoking and lung cancer. We know that smoking causes lung cancer only because we are able to control for the many other variables that are at work. Miners may smoke more than doctors, and miners may be more likely to contract lung cancer, but we cannot infer from this alone that smoking causes lung cancer. We have to control for occupation (and much else). Only after we do this and the correlation between smoking and lung cancer still remains, can we draw the causal connection.

Another example illustrates what happens absent such controls. Let us assume that you decide to study the life expectancy of those who watched football on television. Your initial result would be quite striking. You would discover a strong inverse correlation between the two. Regardless of whether they watch professional or college football, whether it is on the weekend or on Monday night, those who watch football tend to die sooner than the population as a whole. Nor is the phenomenon connected with television. Those who watch football on television tend

drops those cases in which the corporation that emerged from Chapter 11 was private, but one needs some reason to do it here and not elsewhere. But we do not think a debate over statistical significance with this or that measure is the issue. LoPucki's results are suggestive, but they are also remarkably fragile. They fall far short of what is needed to make the use of the word "corrupt" appropriate.

to live shorter lives than those who watch other programming.

But you should not stop here. Before you can say whether football watching shortens life expectancy, you need to ask what else might be at work. Among other things, you must account for the fact that many more men than women watch football on television. Once you do this, the effect disappears. Men watch more football on television than women, and they have shorter life expectancies. The connection between smoking and lung cancer is robust precisely because the connection between smoking and lung cancer remains even after variables such as gender, ethnicity, socio-economic status, and occupation are taken into account.

LoPucki cannot analogize his results to smoking and lung cancer because he has not controlled for all the things that might have led to higher rates of recidivism in Delaware (and later elsewhere) other than judges aiming to make case placers happy. The same factor (or combination of factors) that led the company to file in Delaware might have also led them to fail again. LoPucki is unable to eliminate such possibilities, not because he is unwilling, but because he lacks the data. The handful of traditional reorganizations in LoPucki's sample is simply insufficient to allow us to identify competition among the courts as the cause of higher rates of recidivism.

None of this is to suggest that the judging in Delaware in the early 1990s was admirable. Indeed, there is much to suggest that it was not.²⁸ Nor is it to deny that what happened in Delaware powerfully influenced practices elsewhere. There is much to suggest that it did. Moreover, one can argue (as LoPucki does so forcefully) that some practices in large cases today are costly and objectionable. But LoPucki's critique of current Chapter 11 practices must stand or fall on its own. His empirical study of large corporate Chapter 11s in the early 1990s, as valuable and as important as it is, cannot be connected to modern

28. Some of the problems were set out in a report commissioned by the Federal Judicial Center. See GORDON BERMANT ET AL., *FED. JUDICIAL CTR., CHAPTER 11 VENUE CHOICE BY LARGE PUBLIC COMPANIES: REPORT TO THE JUDICIAL CONFERENCE COMMITTEE ON THE ADMINISTRATION OF THE BANKRUPTCY SYSTEM* (1997).

bankruptcy practice using the methodology he employs. Three data points are not enough.

II. MAKING THE CASE FOR CHAPTER 11

To offer a critique of modern bankruptcy practice, one ought to have a coherent vision of what reorganization law should be doing and measure existing practice in light of that vision. To understand large, modern reorganizations, one must know something about the businesses themselves, not just the bankruptcy process. Before one begins a debate over the appropriate treatment of asset sales, critical vendor orders, key employee retention programs, or other features of the modern Chapter 11 landscape, one must have some theory of why we should have a reorganization law at all. Scholars have neglected this task. More specifically, they have not reconciled the vision of reorganization law they offer with the types of cases in Chapter 11.

Those who would defend some form of Chapter 11 are, whether they know it or not, at a crucial crossroads. They might defend Chapter 11 as an appropriate place to sell large businesses or to bless non-bankruptcy workouts, but they are not inclined to do this. They find fault with the control now exercised by those who decide to place the business in bankruptcy and do not think Chapter 11 exists to serve the needs of senior lenders.²⁹ But if they do not want Chapter 11 to play this role, what role should it play? This is a different and far more difficult challenge. The comfortable homilies they have long relied upon simply no longer work.

Any justification of Chapter 11 has to start with an explanation of the purposes it serves. The easiest path is

29. See, e.g., George W. Kunej, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 24-25 (2004) ("secured creditors, capitalizing upon agency problems to gain the help of insiders and insolvency professionals [have] effectively take[n] over—or hijack[ed]—the Chapter 11 process and essentially created a federal unified foreclosure process."); Stephen J. Lubben, *The New and Improved Chapter 11* (Seton Hall Pub. Law Working Paper No. 2, 2004), available at <http://ssrn.com/abstract=567321>; Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession: Creditor Control of Chapter 11 Reorganization Cases*, 21 BANKR. STRATEGIST 1, 2 (2003); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

one that rationalizes the existing practice: Chapter 11 is a useful place to sell assets and implement non-bankruptcy workouts. In contrast to the 1980s, the majority of large Chapter 11 cases today use the bankruptcy forum for exactly this purpose. During the 1980s, nine out of ten large businesses entering Chapter 11 began without a prepackaged or prenegotiated plan and emerged as operating companies. By 2002, it was less than one in four. Going-concern sales in bankruptcy are now commonplace. In 2002, 56% of all large Chapter 11s resulted in going-concern sales of one sort or another. Of those that remained, 62% put in place a deal reached before the bankruptcy began. Together, sales and workouts account for 84% of the cases.³⁰ LoPucki and others, however, want Chapter 11 to do something else. But they need to tell us what that is.

Virtually all justifications of Chapter 11 begin with assertions to the effect that Chapter 11 is about preserving businesses. It prevents valuable assets from being sold for scrap, saves jobs, and maintains valuable relationships between the business and the rest of the world. Chapter 11 can fix the business and return it to financial health.³¹ Specialized assets are kept in their highest valued use, jobs are saved, and relationships are preserved. Stated or not, the assumption is always that businesses in Chapter 11 have value that is at risk of being lost. It is exactly this assumption that needs to be explored. Mere hand-waving and assertions that Chapter 11 can save businesses, preserve relationships, and protect jobs are insufficient. The stakes here are much larger than the Delaware recidivism debate.

In our view, the standard justifications for Chapter 11 stumble at the very beginning.³² Our economy is now one in

30. We set out these statistics at much greater length in Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673, 675-77 (2003).

31. LoPucki, for example, asserts that, "bankruptcy allows the company to keep what is good about its business and shed the rest. Most companies can be rescued simply by getting rid of the bad businesses and product lines and keeping the rest. LOPUCKI, *supra* note 4, at 116.

32. As we set out at length elsewhere, we think there are two other obstacles in addition to an absence of going-concern value, which is our focus here. The traditional account of corporate reorganizations also assumes that the

which the financially distressed business in Chapter 11 rarely has much value as a going-concern. We can illustrate with a few examples. In December 2002, the bankruptcy court in Delaware confirmed Global Crossing's plan of reorganization.³³ One of the largest corporations ever to go through Chapter 11, Global Crossing is emblematic of Chapter 11's past and its future. Global Crossing was formed in 1997 to close one of the last gaps in the Internet. The telecommunications cables connecting the continents were too small to accommodate the expected growth in the Internet use outside of North America. In 1997, those outside North America accounted for only 20% of the Internet use; by 2000, they would account for almost half.³⁴

To take advantage of this change, Global Crossing laid a trans-Atlantic cable within ten months and embarked on ambitious plans to create a global, fiber optic network. It reached one billion in revenues within its first twenty months. Global Crossing continued to invest billions in creating the first network of fiber optic cable across the world's oceans. Global Crossing's fall, however, was as swift as its rise. Competitors appeared. Internet traffic grew, but not at the rate expected. Moreover, technological innovation allowed much more information to be carried over the same cable. As a result, there was massive overcapacity in the industry. Global Crossing's revenues barely paid its ongoing expenses, and its stock price collapsed.³⁵

investors in a financially distressed business cannot sort out the financial distress through ordinary bargaining (and instead require Chapter 11's collective forum) *and* that the business cannot be readily sold in the market as a going concern. As with going-concern value, remove any one of these conditions, and the standard account of corporate reorganization law fails. It is hard to find any one of these three conditions (going-concern value, inability to bargain, or inability to sell as a going-concern) in a financially distressed business today, and it is exceedingly unlikely that all three of them will exist at the same time. See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002); Baird & Rasmussen, *supra* note 30.

33. See Ron Orol, *FCC Approves Global Crossing Sale*, DAILY DEAL, Oct. 10, 2003.

34. For an account of Global Crossing's rise, see GEORGE GILDER, *TELECOSM: THE WORLD AFTER BANDWIDTH ABUNDANCE* 183-90 (2000).

35. Reinhardt Krause, *More Worries Surface About Global Crossing After Canceled Merger*, INVESTOR'S BUS. DAILY, Nov. 13, 2001, at A8.

Compare this situation to that of the nineteenth century railroad, the paradigm for the traditional corporate reorganization. There, even if the revenues are not enough to pay the creditors in full, everyone is better off if the iron rails and wooden ties are kept together rather than sold for scrap. Investors did better by keeping the business intact. Fiber optic cable might seem to the 1990s what iron rails and wooden ties were to the 1880s. A promising technology will bring people together as never before. Closer examination, however, reveals fundamental differences between nineteenth century railroads on the one hand and Global Crossing and the many casualties of the dot com era on the other.

Of the differences that matter, the most telling is the absence of going-concern value. In Global Crossing, the value of keeping the assets together is not self-evident. Global Crossing has to compete in a market in which networks can be formed easily through contract. As long as these contracting costs are low (and they are), Global Crossing's ability to offer direct connections between Tokyo and London is not worth much. A pulse of light can be transferred between multiple carriers much more easily than rail freight. A detour of thousands of miles is irrelevant. A route that is twice as long matters if one is moving coal or wheat, but not if one is moving electrons. The value of what is being preserved by keeping a business like Global Crossing intact is much smaller than in the case of railroads.

Iridium provides a different example of an absence of going-concern value.³⁶ One of the largest business failures in history, Iridium built a five billion dollar network of satellites in low-earth orbit. The business plan was based on the idea that this network could capture 1% of the world market for cellular phones. At least this many users of cellular phones would pay a premium for a phone that would work anywhere on the globe. The business idea required a large investment in dedicated assets with a long development time. By the time the network came into

36. For information about Iridium, its history, and its bankruptcy proceedings, see David Barboza, *Iridium, Bankrupt, Is Planning a Fiery Ending for Its 88 Satellites*, N.Y. TIMES, Apr. 11, 2000, at C1; Jonathan Sidener, *Grand Telecommunications Scheme Set in Motion*, ARIZ. REPUBLIC, Mar. 26, 2000, at D1; Peter Spiegel, *Dishing Out Data*, FORBES, Jan. 24, 2000, at 110.

operation, however, cellular phone technology had outstripped it in both convenience and costs. Few people were far enough away from ordinary phone service that they wanted to spend several dollars a minute for a brick-sized Iridium phone that could be used only outdoors. Once Iridium's business plan failed, its dedicated assets had little value. The judge came close to ordering that the satellites be destroyed because the cost of maintaining them in orbit was too high relative to the revenues they were generating. There was no value for Chapter 11 to preserve.³⁷

Many giant corporations in Chapter 11 lack large infrastructure investments altogether. To focus again on cases that emerged in 2002, some, such as Chiquita Brands and NTL, were holding companies. Their operating subsidiaries were not in Chapter 11. Chapter 11 provides a relatively cheap way to put a new capital structure in place, but the value being preserved is only that of the holding company. The only thing that would happen in the absence of a reorganization would be for the equity of the operating companies to be spread among diverse creditors. There might be something lost here, but it cannot be much.

In many other large Chapter 11s, particularly those in which there was neither a prenegotiated plan nor an asset sale, the corporation is a collection of discrete businesses, such as movie theaters (Carmike Cinema), nursing homes (Sun HeathCare, Carematrix, and Mariner Post-Acute Network), or hotels (Lodgian). What is at risk is the synergy gained from putting these different discrete businesses under one umbrella. This synergy itself, however, is often of recent vintage. The business itself was formed through the same highly leveraged acquisitions that precipitated the financial distress and the need to reorganize.

Unlike a railroad, the synergy that many Chapter 11 businesses possess is intangible and often quite small. Many assets work equally as well in one business as in

37. As with many other large firms in Chapter 11, Iridium's assets were ultimately sold to a newly formed entity, in this case for \$25 million. See Jonathan Sidener, *Deal Resurrects Iridium System*, ARIZ. REPUBLIC, Nov. 16, 2000, at D1. Its principal customer was the military. Ocean drilling platforms and other remote industrial users constituted the remainder of the customer base. See Yuki Noguchi, *Iridium Finds Itself in a Contractual Bind*, WASH. POST, May 23, 2002, at E5.

another. Indeed, assets that are tailored to a specific firm may not represent a source of value but the source of failure. Neither the size of a business such as Global Crossing, nor the value of its assets, nor the number of people employed under the corporate umbrella suggests that it possesses the going-concern value on which the standard account of Chapter 11 rests.

As communication costs, transportation costs, and contracting costs drop, it has become easier to produce goods without creating a traditional business—or for there to be great value in preserving an existing one. The ability to outsource has left even large-scale manufacturers less dependent on having their own plant and equipment. More than a third of Boeing's latest airplanes are being made in Japan.³⁸ Human capital today is increasingly industry-specific, rather than business-specific. Even in the most high-tech sector of the economy, the place where the skills of the workers tend to loom largest, we see high levels of worker mobility.³⁹ Worker mobility again has increased over the last several decades, and workers are now more mobile because the skills they acquire at one business are readily transferable to another in the same industry.⁴⁰

There are, to be sure, some potential sources of going-concern value. Large businesses have thousands of employees. Each employee has multiple relationships with each other and with the business's many suppliers and customers. This vast web of relationships constitutes the firm. Large investments were required to bring it into being and investments on a similar scale would be needed to replicate it. The idea of value flowing from relationships fits with the conception of the firm that Ronald Coase established long ago. A "firm," as Coase understands it, consists of the "system of relationships which comes into existence when the direction of resources is dependent on

38. See Peter Pae, *Japanese Helping 787 Take Wing*, L.A. TIMES, May 9, 2005, at C1.

39. See generally STEPHEN A. HERZENBERG, JOHN A. ALIC & HOWARD WIAL, *NEW RULES FOR A NEW ECONOMY: EMPLOYMENT AND OPPORTUNITY IN POSTINDUSTRIAL AMERICA* 30 (1998).

40. While Key Employee Retention Programs (KERPs) undoubtedly contain the potential for abuse, in their least objectionable form they are a recognition of this basic reality.

an entrepreneur.”⁴¹ Instead of the price mechanism directing the flow of resources, an entrepreneur takes command of them. The relationships, not the assets, are the firm.

But saying this does not tell us that businesses based on such relationships have substantial going-concern value. To make the case that a business has substantial value as a going-concern by virtue of its relationships, one must establish both that the business’s relationships are costly to replicate and that the business is itself sound. Neither is likely to be true for the large businesses that find themselves in Chapter 11.

Relationships may be relatively inexpensive to put in place. Nothing about Coase’s theory of the firm requires that the relationships that constitute the firm be costly to create or replicate. Indeed, Coase’s theory only tells us about *relative* costs. Transactions take place in a corporation only when the outside alternative is more expensive. As transaction costs outside the firm go down, the upper bound on the value of relationships inside the firm goes down as well, exerting downward pressure on the firm’s value as a going-concern. Far from supporting a traditional view of reorganization, Coase tells us the opposite.

Pillowtex offers a telling example.⁴² Pillowtex was the manufacturer of Cannon and Royal Velvet towels and Fieldcrest sheets and pillows. It cost millions to build the factories, hire thousands of employees, and create all the relationships that made Pillowtex’s business work, but the corporation has no value as a going-concern in a world in which the towels, pillows, and sheets can be made under the same labels for less off-shore.

Pillowtex is a Chapter 11 recidivist, but one that can give no comfort to those who support a traditional view of Chapter 11. To be sure, its first Chapter 11 was a two-year long effort to mediate the relationships among employees,

41. See Ronald H. Coase, *The Nature of the Firm: Origin*, in *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT* 22 (Oliver E. Williamson & Sidney G. Winter eds., 1993).

42. For a more detailed discussion, see Baird & Rasmussen, *supra* note 30, at 683-84.©

suppliers, and others. It brought together diverse interests, and a plan emerged that gave the business its best chance going forward. But forces were at work that the best intentioned cannot stop. In the end, there was nothing bankruptcy could do to save Pillowtex. The value it once had as a going-concern was gone. For better or for worse, the role that Chapter 11 can play in today's economy has little or nothing to do with reorganizing railroads or saving factories in small towns.

All of this suggests that we should look at bankruptcy cases through a different empirical lens. Pillowtex was a recidivist, but, more importantly for someone who wants to justify Chapter 11, it was a business without value as a going-concern. Quite apart from whether the second Chapter 11 was necessary, we have to ask about the first.

The problem here runs deep. Consider, for example, two of the Delaware recidivists LoPucki identifies—Cherokee and Ithaca Industries. Both were in the clothing business, both filed prepackaged plans in Delaware in the 1990s, and both returned to Chapter 11. But it is a mistake to end the story there. Cherokee is still around, but in a radically different form, one that is inconsistent with it having much going-concern value. It closed down its wholesale manufacturing and distribution operations, dismissed its work force, and focused exclusively on licensing its trademarks. Its licensees do their own sourcing. Its sole source of revenue is the "Cherokee" brand name. The corporation still exists but it is a fundamentally different business.

Ithaca Industries was, from the perspective of traditional bankruptcy scholarship, virtually identical to Cherokee. It, however, lacked a brand name for which consumers were willing to pay. The corporation failed completely. Perhaps these two prepackaged bankruptcies should have been done differently, but in neither case could Chapter 11 preserve going-concern value. There was not any.

CONCLUSION

The difficulty of finding going-concern value is a challenge that bankruptcy scholars have neglected, even those whose work has an empirical focus. It points in an uncomfortable direction. It is possible to embrace existing

Chapter 11 practice on the ground that it has reinvented itself. Overseeing asset sales and allowing those who own the business to quickly reorganize may be good things for bankruptcy judges to do. Effective oversight from the appellate courts can check abuses such as critical vendor orders get out of hand.⁴³ But if one wants to reject current practice, one has to face hard questions about just what purpose Chapter 11 is serving and those questions must take into account the realities of today's economy, one in which there are vanishingly few railroads.

43. See, e.g., *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

