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Can the Market Evaluate Legal Regimes? A Response to Professors Rasmussen, Thomas, and Skeel

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by Lynn M. LoPucki[*]

INTRODUCTION

Scholarly projects benefit from thoughtful criticism—particularly by those committed to a contrary view. For that reason, I feel fortunate that the three leading proponents of the efficiency of

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Delaware bankruptcy reorganization have taken the time to respond to our study.[1]

These three critics recognize that the stakes are enormous. As Professor Rasmussen and Professor Thomas put it, the bankruptcy reorganization of large, public companies was "Delawarized" during the decade of the 1990s.[2] If it can be shown that, during the period of Delawarization, the Delaware court provided a wasteful and inefficient reorganization process, it follows that even a very sophisticated "market" can make huge errors, and that by the time the market realizes it has made a mistake in the choice of a legal regime, that regime may already be locked in by a network effect. That, in turn, would discredit the frequently made argument that a legal regime must have been efficient or the market would not have chosen it.

I. RASMUSSEN AND THOMAS' COMMENTS

In our study of bankruptcy refiling rates, Sara Kalin and I found that the refiling rates for Delaware reorganizations were six to seven times as high as the refiling rates for reorganizations in courts other than Delaware and New York.[3] Because the costs of each refiling are so high that we doubted they could be offset by possible advantages of Delaware reorganization not investigated, we concluded that the extraordinarily high failure rate that resulted from these reorganizations suggests a lack of efficiency, and we asserted in the title of our article that our empirical findings were "evidence of a 'race to the bottom.' "

Rasmussen and Thomas do not challenge our empirical findings,[4] but, on essentially four bases, they do challenge our conclusion that the data constitute evidence of inefficiency. First, they argue that, with respect to prepackaged cases, Delaware's higher refiling rate may have occurred by chance. Second, using a mathe-

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1. *See* Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231, 250 tbl.5 (2001) (reporting on study of bankruptcy refiling rates by large, public companies).

2. *See* Robert K. Rasmussen & Randall S. Thomas, *Whither the Race? A Comment on The Effects of the Delawarization of Corporate Reorganizations*, 54 VAND. L. REV. 283 (2001).

3. *See* LoPucki & Kalin, *supra* note 1, at 250 tbl.5 (finding refiling rates of 30% total and 7.9% per year for firms emerging from Delaware reorganization in the period of Delawarization (1991-1996), and 5% total and 1.1% per year for firms emerging from reorganizations in courts other than Delaware and New York City during the same period).

4. *See* Rasmussen & Thomas, *supra* note 2, at 285 ("We have no quarrel with their factual findings.").

matical model, they argue that the additional costs of Delaware's refilings could be offset by cost savings in the initial Delaware bankruptcy cases. Third, they observe that we have investigated only a few of the variables that, in combination, might account for Delaware's high refiling rate, and they argue that some variable not studied might yet absolve Delaware of responsibility for its apparent failure. Finally, they raise some methodological concerns.

A. The Performance of Prepackaged Bankruptcies

Prior to our study, Rasmussen and Thomas advanced the theory that Delaware's prepackaged bankruptcies must be efficient because they are contractual arrangements among all of the interested parties (the "Delaware prepack superiority theory").[5] In our study, we found that: (1) Delaware bankruptcies were significantly more likely to result in refilings than were bankruptcies in other courts;[6] (2) Delaware prepacks were considerably more likely to result in refilings than were prepacks in other courts;[7] and (3) Delaware prepackaged cases were slightly more likely to lead to refilings than Delaware nonprepackaged cases.[8] We discovered no category of cases with a worse refiling rate than the 33% refiling rate for Delaware prepacks. These findings seem to cast serious doubt on Rasmussen and Thomas' Delaware prepack superiority theory.

In their comment on our study, Rasmussen and Thomas make clear that they are not yet ready to give up.[9] Confident that their theory must be correct and that the data are somehow mis-

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5. *See* Rasmussen & Thomas, *supra* note 2, at 288-90; Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1390-91 (2000).

6. LoPucki & Kalin, *supra* note 1, at 248-51.

7. *Id.* at 252-55.

8. Only if one includes the periods before and after Delawarization do firms emerging from Delaware prepackaged bankruptcies perform even as well on the criterion of refiling as those emerging from Delaware nonprepackaged cases.

Table 1
Delaware Refiling Rates by Prepackaged Status

	Refilings/ Emergences 1983-90	Refilings/Emergences 1991-96, the period of Delawarization	Refilings/ emergences 1997	Totals 1983-97
Prepackaged	0/0	5/15 = 33%	0/2	5/17 = 29%
Nonprepackaged	1/1	4/15 = 27%	2/3	7/24 = 29%
All cases	1/1	9/30 = 30%	2/10	12/41 = 29%

9. Rasmussen and Thomas assert that "LoPucki and Kalin's data offer little insight into the validity of our theory." Rasmussen & Thomas, *supra* note 2 at 291.

leading, they turn first to the possibility that Delaware's high refiling rate for prepacks occurred by chance.

The data are as follows:

Table 2
Refiling rate for prepackaged bankruptcies
Firms emerging 1991-1996

Court	Number of firms emerging	Number refiling	Percent refiling
Delaware	15	5	33%
New York	3	1	33%
Other courts	12	0	0%
Total	30	6	20%

Applying Fisher's exact test to a comparison of the Delaware rate with the rate for other courts (excluding New York), Kalin and I measured the possibility of so great a difference occurring by chance at 7.4%.[10] Rasmussen and Thomas do not question the accuracy of that measurement.[11]

Instead, they object to our exclusion of the New York cases from the comparison because New York was not "the venue of choice" during the period of comparison,[12] and demand that Delaware be measured "against all of its competitors."[13] In fact, we excluded New York from the calculation not because we thought it was "the venue of choice," but because New York was like Delaware in refiling rates, competitive demeanor, and volumes of cases attracted during the period of comparison. By our theory, New York suffered from the same faults as Delaware and should be classified and criticized along with Delaware. We focus our criticism on Delaware only because New York has since declined in importance.

Nevertheless, to escape our finding of weak statistical significance, Rasmussen and Thomas seek to classify New York, with

10. Comparing Delaware's refiling rate for prepackaged cases in the period 1991-96 (33%) with prepackaged cases in all other jurisdictions, including New York, in the same period (7%), the likelihood that so great a difference would occur by chance is 17% based on Fisher's exact test.

11. Rasmussen & Thomas, *supra* note 2, at 285 ("We have no quarrel with their factual findings.").

12. *Id.* at 292-93. While technically correct, their assertion is misleading. The change in method that Rasmussen and Thomas propose would attribute one prepackaged refiling to the other courts. That single refiling was by a company (JPS Textile Group) that filed and emerged in New York in 1991 while New York was still clearly *the* venue choice. *See* Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 979 (1999) (including a graph showing three shops to Delaware and six to New York during 1991).

13. Rasmussen & Thomas, *supra* note 2, at 293 (emphasis omitted).

its 33% refiling rate, together with other districts having no refilings, rather than with Delaware, which has an identical 33% refiling rate. In other words, they would imply that Delaware is normal because it is like New York. That approach obscures rather than illuminates the pattern of refilings. The pattern is that New York and Delaware prepacks perform significantly worse than prepacks in the rest of the country and that, nationwide, prepacks (with a 20% refiling rate) perform worse than nonprepacks (with a 14% refiling rate).[14]

Even adopting Rasmussen and Thomas' view as to the appropriate comparison—that is, including New York with the rest of the country—Delaware's refiling rate for prepacks (five of fifteen refiling) is still substantially higher than that of the rest of the country (one of five refiling).[15] The difference, however, is statistically significant only at the 0.1686 level. That is, there is a 17% probability that so large a difference would occur by chance. By standard convention, such a finding is not considered statistically significant.

Considering the adverse finding of statistical significance thus neutralized, Rasmussen and Thomas declare Delaware's high refiling rate not proven with respect to prepacks.[16] The fallacy in their reasoning becomes apparent when one realizes that the evidence that nonprepackaged cases are the cause of Delaware's high refiling rate is even weaker than the evidence against prepackaged cases. That is, the refiling rate for Delaware nonprepackaged cases (four refilings among fifteen emerging companies) is slightly *lower* than the refiling rate for Delaware prepackaged cases (five refilings among fifteen emerging companies).[17] If, as Rasmussen and Thomas assert, our data show Delaware prepacks to be blameless, then Delaware nonprepacks must be even more so. Accepting Rasmussen and Thomas' reasoning would then leave us with the irony that Delaware's higher refiling rate is proven with statistical significance at the 0.01 level,[18] but both types of cases involved are blameless. The more reasonable conclusion to draw from this data

14. The latter difference was not statistically significant. LoPucki & Kalin, *supra* note 1, at 252.

15. Since the cutoff date for our study, another of the fifteen Delaware prepacks studied refiled. Ithaca Industries, which emerged from Delaware reorganization on November 22, 1996, refiled in Delaware on May 9, 2000. That case brings Delaware's refiling rate for prepacks during the period of Delawarization to 40% (six of fifteen).

16. Rasmussen & Thomas, *supra* note 2, at 303-04.

17. *See supra* note 8.

18. *See* LoPucki & Kalin, *supra* note 1, at 250.

is that Delaware has a higher refiling rate, and both prepacks and nonprepacks are to blame.

Offering a second reason why Delaware prepackaged reorganizations are efficient despite their higher refiling rate, Rasmussen and Thomas theorize that firms in distress use prepackaged bankruptcies as a means of determining whether that distress is economic or merely financial:

> In this respect, one can view the filing of a prepackaged bankruptcy as an attempt by managers to screen out the cause of the firm's financial distress. If the distress is caused only by a mismatch between the capital structure and the firm's operations, the prepackaged bankruptcy should solve the problem. If the distress is caused by the firm's operations as well, one would expect that a second reorganization proceeding is needed. Note here that this second reorganization proceeding should not be considered a failure of the first bankruptcy proceeding. The first proceeding was designed to separate out those firms that need a full-blown Chapter 11 proceeding from those that do not. . . . The fact that a full-blown Chapter 11 proceeding follows a prepackaged bankruptcy cannot thus be viewed as a failure of the system.[19]

For this "diagnostic" theory of prepackaged bankruptcies to make sense, the costs of prepackaged bankruptcies must be significantly lower than the costs of the nonprepackaged bankruptcies that they would avoid.[20] In fact, just the opposite appears to be true. When they fail, prepackaged bankruptcies do so at a level of speed and violence that exceeds that of nonprepackaged cases, inflicting indirect costs that appear to far exceed the indirect costs of nonprepackaged cases.

Tables 3 and 4 show the dollar amounts for the Delaware refilers of one element of the costs of bankruptcy: the operating losses that the firms incurred between confirmation and refiling. For the five Delaware prepackaged cases that failed, they average 23% of prebankruptcy assets, more than double the corresponding figure (11%) for failed nonprepacks. This difference in operating losses dwarfs any possible direct cost savings available from using a prepack instead of a nonprepack in the first instance. Direct costs are about 1.5% of prebankruptcy assets for prepacks and 2.8% for nonprepacks, so that the potential direct cost savings from a diagnostic prepack is probably no more than 1.3% of prebankruptcy assets. Given that the failure rate for Delaware prepacks was one in three, the filer of a diagnostic prepack would be taking a one-third chance of a 23% loss in order to save 1.3%. Moreover, at 24.5% of prebank-

19. Rasmussen & Thomas, *supra* note 2, at 291 n.29, 295.

20. If nonprepackaged cases are cheaper, debtors can reduce total costs by filing them initially.

ruptcy assets,[21] the cost of each positive diagnosis by prepack would be nearly double the cost of even a failed attempt at a cure in the same case.[22]

Table 3

Operating Losses Suffered by Delaware Refilers During the Period Between Bankruptcies
Prepackaged Cases
(All dollar amounts in thousands)

(1) Case Name	(2) Confirmation date	(3) Refiling date	(4) Years between cases	(5) Ending date of reporting period (Q is quarter)	(6) Operating losses[23]	(7) Assets before first filing	(8) (6) total divided by (7)
Memorex 1	2/7/92	2/11/94	2.0	3/31/93 Q 6/30/93 Q 9/30/93 Q 12/31/93	-80,423 9,362 10,024 5,095 Total -5,942	1,736,200	-3%
Spectra-vision	10/29/92	6/8/95	2.6	12/31/93 12/31/94 Q 3/31/95 Q 6/30/95	3,205 -229,386 -5,365 -6,871 Total -8,417	610,434	-39%
Cherokee	6/1/93	11/7/94	1.4	5/28/94 Q 8/27/94 Q 11/26/94	-17,136 -1,114 -6,066 Total -4,316	214,200	-11%
Memorex 2	3/14/94	10/15/96	2.6	3/31/95 3/31/96 Q 6/30/96 Q 9/30/96	-84,850 -207,475 1,047 -8,466 Total -9,744	1,139,985	-26%
Westmore-land Coal	12/16/94	12/23/96	2.0	12/31/95 12/31/96	-95,960 -2,388 Total -8,348	265,500	-37%
Average			2.1		-143,353	793,064	-23%

21. The firm pays direct costs of 1.5% of assets and incurs indirect costs of 23% of assets, resulting in total costs of 24.5% of assets.

22. The cost of a failed attempt at cure would be direct costs of 2.8% of assets and indirect costs of 11% of assets, resulting in total costs of 13.8% of assets.

23. Data reported in this column are the operating losses reported in the respective companies' 10-K or 10-Q filings with the Securities and Exchange Commission, for the periods ending on the dates specified in column (5). In some cases, these figures may include adjustments for losses actually suffered over several years but recognized in the specified year. I nevertheless believe it is appropriate to attribute them to the year in which they were recognized because: (1) in the two cases of greatest significance—Spectravision and Memorex 2—the recognition occurred in the second year after confirmation, making it implausible that these losses were understood to exist at the end of the first bankruptcy; and (2) the "overstatement" of losses from these recognitions probably will be offset by the "understatement" of losses suffered in the interim between bankruptcies but not recognized until after the refilings. That is, on average, the bumps in operating loss recognition can be expected to even out.

Table 4

Operating Losses Suffered by Delaware Refilers During the Period Between Bankruptcies

Non-Prepackaged Cases

(All dollar amounts in thousands)

(1) Case Name	(2) Confirmation date	(3) Refiling date	(4) Years between cases	(5) Ending date of reporting period (Q is quarter)	(6) Operating losses[24]	(7) Assets before first filing	(8) (6) total divided by (7)
Harvard Industries	8/10/92	5/8/97	4.7	Q 9/30/92 9/30/93 9/30/94 9/30/95 9/30/96 Q 12/31/96 Q 3/31/97	3,624 -9,375 37,619 38.469 -9,474 -17,234 -18,759 Total 24,870	504,000	5%
TWA	8/11/93	6/30/95	1.9	Q 12/31/93 12/31/94 Q 3/31/95 Q 6/30/95	-58,251 -279,494 -76,261 54,382 Total -59,624	2,683,000	-13%
United Merchants	8/15/91	2/22/96	4.5	6/30/92 6/30/93 6/30/94 6/30/95 Q 9/30/95 Q 12/31/95	-16,896 -11,160 -11,314 -6,663 -8 -107 Total -46,118	224,500	-21%
Grand Union	5/31/95	6/24/98	3.1	41 weeks 3/30/96 3/29/97 3/28/98	-27,600 -65,300 -132,500 Total -25,400	1,394,800	-16%
Average			3.6		-151,568	1,201,575	-11%
Averages for all Delaware filers					-147,004	974,624	-18%

These data suggest that managers' use of prepacks to perform Rasmussen and Thomas' diagnostic function would be economically irrational. Considered along with our data on refiling rates, these operating loss data also suggest that the results of Delaware prepacks are worse than the results of Delaware nonprepacks—contrary to Rasmussen's and Thomas' Delaware prepack superiority theory.

B. Rasmussen and Thomas' Bankruptcy Cost Model

Rasmussen and Thomas criticize our focus on refiling rates as the exclusive measure of the Delaware bankruptcy court's performance. To make their point, they introduce a mathematical

24. Data reported in this column are the operating losses reported in the respective companies' 10-K or 10-Q filings with the Securities and Exchange Commission, for the periods ending on the dates specified in column (5).

model to demonstrate how other cost variables might offset the cost effects of Delaware's high refiling rates.[25]

Rasmussen and Thomas' model conceives of the cost of choosing Delaware reorganization as having two components. The first is the direct cost (consisting principally of professional fees) of the initial reorganization ("filing costs"). The second is the percentage chance of a refiling times the direct cost of a refiling ("refiling costs"). The cost of choosing Delaware reorganization is the sum of the two.

Rasmussen and Thomas use the model to demonstrate that, if Delaware's filing costs are 20% lower than other courts' filing costs, Delaware's lower filing costs can easily offset the effect of Delaware's higher refiling rates. In the model, this occurs principally because filing costs are incurred in every case, while refiling costs are incurred only in the relatively small number of cases that result in refilings.

As Rasmussen and Thomas acknowledge, the model is a crude one and ignores indirect costs entirely.[26] But if it is possible to prove Delaware reorganization inefficient, it will be through the use of such a model, and Rasmussen and Thomas have advanced the ball by suggesting it. The most persuasive point they make with the model is that refiling costs will have to be very high to offset any comparative advantage that Delaware may have in filing costs.

Whether Delaware has any comparative advantage in filing costs is today a matter of mere speculation.[27] In the past few years, the Delaware bankruptcy reorganizations of large, public companies do appear to move significantly faster than bankruptcy reorganizations in other courts.[28] That was not true, however, during the period of Delawarization.[29] Nor is it even clear that faster cases result in lower fees. Despite the common-sense appeal of the faster-is-cheaper hypothesis, Professor Robert Lawless was unable to find

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25. Rasmussen & Thomas, supra note 2, at 297.

26. *Id.* at 297.

27. To date, studies of the direct costs of bankruptcy reorganization have not distinguished costs in Delaware from costs elsewhere. *See, e.g.*, Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, 26 FIN. MGMT. 56, 66 (1997) (finding that "the direct costs of traditional Chapter 11 cases average 3.93% of pre-bankruptcy total assets," which is "significantly larger than the average direct costs for prepacks (2.85%), and exchange offers (2.51%)").

28. A preliminary tally from the Bankruptcy Research Database indicates that Delaware reorganizations completed in the years 1997 to 2000 took only a little more than half as long as reorganizations in other courts, and that New York is not a major contributor to the difference.

29. *See* Eisenberg & LoPucki, *supra* note 12, at 990-91 (finding that Delaware case processing times were faster than those in other districts, but that the difference was not statistically significant when the researchers controlled for other variables).

evidence to support it in his study of direct costs in small firm bankruptcies.[30] The hypothesis has not been documented in large firm bankruptcies, except to show that fees in prepackaged cases are lower than fees in non-prepackaged cases.[31]

As Professor Eisenberg and I have previously noted, there is one reason to expect that Delaware fees will be *higher* than fees in other courts.[32] Because Delaware filers are nearly always represented by remote counsel and because a Delaware local rule requires that they also retain local counsel, fifty-six of fifty-eight Delaware filers in the Bankruptcy Research Database (97%) had both remote and local counsel. By contrast, only one of fifty-two New York filers (2%) had both remote and local counsel, and only fifty of 175 filers in other courts (29%) had both remote and local counsel.[33] In most cases, choosing the Delaware court adds the cost of an additional law firm.

Rasmussen and Thomas understand that their model omits the indirect costs of refiling, including the business disruption and operating losses that result from a continuation or renewal of the firm's economic and financial distress after the first case.[34] So their continued confidence in the efficiency of Delaware prepacks even in the face of Delaware's high refiling rates suggests that they do not realize the magnitude of the indirect losses.[35]

As previously shown, the operating losses (before interest) incurred by refilers between emergence from a Delaware prepackaged bankruptcy and refiling averaged 23% of the refilers' prebankruptcy assets. By contrast, the direct costs for a prepackaged case averaged about 1.8% of the refilers' prebankruptcy assets.[36] Thus, if Delaware procedures in prepackaged bankruptcy cases generate even a single additional refiling, Delaware would have to achieve 20% cost reductions[37] in sixty-three successful prepackaged cases to

30. *See* Robert M. Lawless et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 875 ("Surprisingly, we did not obtain evidence of such a relationship at any statistically significant level.").

31. *See generally* Elizabeth Tashjian et al., *Prepacks: An Empirical Analysis of Prepackaged Bankruptcies*, 40 J. FIN. ECON. 135 (1995).

32. *See* Eisenberg & LoPucki, *supra* note 12 at 996-97.

33. *See id.* at 996 n.100.

34. *See* Rasmussen & Thomas, *supra* note 2, at 297, 296 (stating that, "[t]o be sure, our simple formula may not include all costs of refiling," and noting that "[t]he indirect costs of bankruptcy . . . may well exceed the direct costs").

35. *See, e.g., id.* at 298.

36. *See* Tashjian et al., *supra* note 31, at 144.

37. Rasmussen and Thomas suggest the 20% figure. Rasmussen & Thomas, *supra* note 2, at 297.

offset the resulting increase in operating losses.[38] If the differences in refiling rates that Sara Kalin and I observed are in fact the product of differences in the Delaware court's procedures in prepackaged bankruptcy cases, those procedures caused between four and five additional cases during the period of Delawarization.[39] Delaware would need 20% direct cost savings in over 250 successes to offset them.

Large as they are, the interim operating losses reported in Tables 3 and 4 are not a complete measure of the indirect costs of failed bankruptcy reorganization. An appropriate model for testing the efficiency of Delaware prepacks should also take into account the operating losses incurred during the failed reorganization and the firm's loss of the time value of its assets. Those two components together could equal or even exceed the interim operating losses, so that the total indirect costs may approach half the entire asset value of the company.[40] As Rasmussen and Thomas undoubtedly realize, any bankruptcy cost model constructed on the basis of currently available data would be highly speculative. But the indirect costs of reorganization are so much greater than the direct costs that the former will dominate the model. Within the relevant ranges, the effectiveness of reorganization is more important than its price.

C. The Omitted Variable that Would Save Delaware

Rasmussen and Thomas accuse Kalin and me of claiming "to have resolved the issue of how well Delaware performs in the bank-

38. The savings in each case would be 20% of filing costs. Filing costs are 1.8% of prefiling book assets. Thus, measured in percentages of prefiling book assets, the gain from filing cost savings in sixty-three successful Delaware prepacks would be 20% x 1.8% x 63 = 23.3%. That would not quite offset the 23.4% loss of assets in the average failed prepack.

39. This estimate is based on the fact that five of fifteen Delaware prepacks resulted in refiling while zero of twelve prepacks in other courts (excluding New York) led to refiling. At the other court rate, one would expect zero filings in Delaware, but the number of other court cases is slightly lower than the number of Delaware cases.

40. Delaware prepackaged bankruptcies are "in court" only briefly. That is possible, however, only because the negotiations and voting that occur during nonprepackaged cases occur in the period before the filing of prepackaged cases. Tashjian et al. found that the period from the initial restructuring announcement to the resolution of financial distress was nearly as long for prepackaged cases (21.6 months) as for traditional Chapter 11 cases (28.5 months). Tashjian et al., *supra* note 31, at 142. It seems reasonable to expect that these firms incur operating losses during reorganization that are equal to or greater than those that they incur post-confirmation. In addition to those losses, the firm earns no return on its assets during the period in which the operating losses are incurred.

ruptcy context."[41] We have made no such claim. We designed our study to determine the rates at which emerging companies later refiled. We designed it with no intention of testing the efficiency of the Delaware bankruptcy court. Thus, as Rasmussen and Thomas point out at great length, we did not collect data on other measures of the "success" of bankruptcy reorganizations, such as the profitability or long term survival of emerging companies or the prevalence of workouts that might substitute for refilings. Hence, at the conclusion of our study, we were not in a position to make findings as to the relative "success" of Delaware cases as compared with other court cases. It remains possible that Delaware's poor record on refiling is offset by a relatively good record on some other facet of bankruptcy reorganization, and we have not claimed otherwise.[42] As Rasmussen and Thomas put it, there might be some "omitted variable" that, when considered, will show that Delaware's record is not worse than the records of other courts.[43]

The existence of such a variable is not impossible, but given the frequency and magnitude of Delaware's failures, it is not likely. During the period of Delawarization, 30% of Delaware cases led to refiling, compared to only 5% in other courts (New York excluded).[44] The nine Delaware companies that refiled, on average, had operating losses equal to 18% of the prefiling value of their assets.[45] While I agree with Rasmussen and Thomas that additional research will be necessary to be sure that some omitted variable that would exculpate the Delaware bankruptcy court is not driving the results, I find it difficult to imagine what that variable might be.

Rasmussen and Thomas suggest three possibilities for future investigation. First, they surmise "that there was not sufficient debt reduction [in the Delaware reorganizations] to alleviate financial distress."[46] Second, they suggest "that the firm did not change its operations enough to alleviate its economic distress."[47] Third, they hypothesize that Delaware firms may have "experienced an

41. *See* Rasmussen & Thomas, *supra* note 2, at 287.

42. *See, e.g.*, LoPucki & Kalin, *supra* note 1, at 255 ("While the data we present do not disprove the arguments for the efficiency of Delaware reorganization, they do cast doubt on those arguments, and, less directly, on the efficiency of Delaware incorporation.").

43. Rasmussen & Thomas, *supra* note 2, at 299-300 (discussing the possibility of an "omitted variable").

44. *See* LoPucki & Kalin, *supra* note 1, at 250 tbl.5.

45. *See supra* Table 4.

46. Rasmussen & Thomas, *supra* note 2, at 300.

47. *Id.* at 301.

external shock to business" to a degree that firms reorganizing in other courts did not.[48]

The first two variables they suggest are incapable of exonerating Delaware. If investigation showed that firms emerge from Delaware reorganization with higher levels of financial or economic distress, that would be a fault attributable to the Delaware court. The Bankruptcy Code places responsibility on the court to determine, before confirming a plan, that the need for further reorganization is not likely.[49] If researchers such as ourselves could determine that these emerging firms had high levels of financial or economic distress that elevated their risks of refiling, there is no reason why the Delaware court could not have done so as well.

If, on the other hand, investigation showed that firms emerged from Delaware reorganization with levels of financial or economic distress lower than, or about the same as, firms emerging from other courts, that would not exonerate the Delaware court either. It would suggest either some other defect in the Delaware reorganization process or some preexisting difference in the firms that chose to reorganize in Delaware.

The third variable Rasmussen and Thomas think might exculpate Delaware is post emergence "external shocks"—adverse events that disproportionately impact firms after they emerge from Delaware reorganizations. They admit that this is the weakest of their three suggestions.[50] The firms that reorganize in Delaware come from all over the United States. If there is any reason why those firms should experience external shocks after reorganization at a significantly higher rate than firms that reorganize elsewhere, it is not apparent.

Rasmussen and Thomas suggest that the reason might lie in the nature of the firms that chose to file in Delaware.[51] One can imagine a number of possible differences between firms that reorganize in their home courts and those that file in Delaware. The latter might be more aggressive risk takers or be under the sway of managers, financial advisers, or attorneys who are. The latter might have something to hide, and believe correctly that it can be more easily hidden in Delaware. But those explanations generally fail to exculpate the Delaware court because they involve matters

48. *Id.*

49. *See infra* text accompanying notes 66-68.

50. *See* Rasmussen & Thomas, *supra* note 2, at 302 ("While this explanation is plausible, we view it as the least likely of the three.").

51. *Id.* ("[T]here may be something about the nature of the firms ending up in Delaware that left them more vulnerable to unexpected changes.").

that are within the duty of the court to discover and remedy. If the shocks that cause refilings result from conditions that were present while the court processed the bankruptcy case, those shocks should be considered failings of the court, and not "external."

The type of variable most likely to save Delaware will be one that demonstrates a failure rate from other courts' reorganizations that rivals Delaware's. That variable might be some measure of failure other than refiling—such as high operating losses that are resolved by means other than refiling. Those other means might be out-of-court workouts, mergers, or business closings. As Rasmussen and Thomas note in their comment, I have already begun gathering data for such a study.[52]

D. Other Methodological Concerns

Rasmussen and Thomas acknowledge that they "have no quarrel with [our] factual findings"[53] that Delaware refiling rates are much higher than those of other jurisdictions. They do not assert that we misapplied any statistical test or generated any incorrect results.

They make essentially three methodological points. First, they criticize us for speculating that Delaware reorganization *may be* inefficient without having first completed an exhaustive study to determine the causes of Delaware's high refiling rates. Ironically, this criticism follows immediately on their own conclusion that Delaware prepackaged reorganization is efficient—based on two studies showing Delaware cases moved about 20% faster than cases in other courts during the period of Delawarization.[54]

Second, they criticize us for not having gathered data on a number of variables that they believe might explain Delaware's higher refiling rate.[55] Here, they seem to have forgotten that we did not design our study to explain Delaware's higher refiling rate. Prior to our analysis of the data we collected, neither we nor anyone else (to our knowledge) knew that Delaware had a higher refiling rate.[56]

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52. *Id.* at 307.

53. *Id.* at 285.

54. *Id.* at 289 ("We have concluded from the available evidence that, at worst, the Delaware bankruptcy court is doing as good a job as any jurisdiction in handling prepackaged bankruptcies.").

55. *See supra* notes 45-51.

56. Prior studies of recidivism in Chapter 11 had entirely overlooked the possibility of geographical differences in rates. *See, e.g.*, Edith Shwalb Hotchkiss, *The Post-Bankruptcy Perform-*

Rasmussen and Thomas' third methodological criticism is that we used "bivariate" tests of statistical significance rather than multivariate ones (regressions).[57] We consider bivariate testing more appropriate than multivariate testing in these circumstances for two reasons. First, our exploration was a preliminary one. We had data on only two variables that we considered possible explanations: industry and firm size. As to industry, we found that firms in the two industries that produced the highest proportions of refiling—retailing and manufacturing—were not significantly more likely to file in Delaware.[58] After testing several measures of firm size, we found only one—book value of assets—that correlated with refiling rates. It showed smaller companies were more likely to refile—exactly the opposite of the finding that would be necessary to explain why the larger companies reorganizing in Delaware had higher refiling rates.[59] Because neither of these factors demonstrated any potential for explaining the huge difference in refiling rates observed on bivariate analysis, we concluded that multivariate analysis was unnecessary. As recognized by Campbell and Stanley in their classic work on experimental design, "[t]he absence of [bivariate] correlation can rule out many simple, general, causal hypotheses . . . ."[60] Second, we found it easier to work with bivariate analysis because both our methods and our results would be transparent to a larger portion of our law review readership.

Bivariate analysis could miss an important relationship in the data, but Rasmussen and Thomas do not suggest that it did here. Their silence is significant because they have had full use of our data[61] and obviously know how to run the kinds of tests they advocate. If they really believed that a multivariate test would reveal something our bivariate test did not, they could have run the multivariate test themselves. Since receiving a copy of their re-

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ance of Firms Emerging From Chapter 11, 50 J. FIN. 3, 4, 7 (1995) (finding that 32% of a sample of 197 public companies that emerged from bankruptcy reorganizations filed between October, 1979 and September, 1988 "are involved in a second bankruptcy or distressed restructuring," but not mentioning the difference in refiling rates between New York and other courts).

57. Rasmussen and Thomas object to the statistical test of significance that we employ (Fisher's exact test) as "univariate." *See* Rasmussen & Thomas, *supra* note 2, at 305 ("Turning to LoPucki and Kalin's efforts to control for the effects of other variables on bankruptcy refiling rates, it is important first to note that these are all bivariate 'tests' of the significance of these variables.").

58. *See* LoPucki & Kalin, *supra* note 1, at 257.

59. *Id.* at 257-59.

60. DONALD T. CAMPBELL & JULIAN C. STANLEY, EXPERIMENTAL AND QUASI-EXPERIMENTAL DESIGNS FOR RESEARCH 64 (1963).

61. *See* Rasmussen & Thomas, *supra* note 2, at 305 n.58 and accompanying text (acknowledging access to our data).

sponse, we have done multivariate testing without discovering anything new.[62] Thus, I take Rasmussen and Thomas' point to be one regarding statistical methodology, not Delaware bankruptcy reorganization.[63]

Rasmussen and Thomas also complain that we used one-digit SIC codes, which they consider "overbroad" as proxies for business type.[64] They cite no authority in support of their complaint. In fact, one-digit SIC codes are commonly used in empirical research.[65] In analyzing our data, the choice was between one-digit SIC codes and ignoring the debtors' business types entirely. Using two-digit SIC codes divided the firms among so many categories that the numbers in each category were too small for statistical evaluation. The 188 companies studied were distributed among forty-four categories. The maximum number of refiling companies in any single two-digit SIC category was three and that occurred only with respect to two categories. I know of no way to obtain statistically significant results from data with such small Ns, and Rasmussen and Thomas suggest none.

E. Is Delaware in Compliance with the Feasibility Requirement?

Rasmussen and Thomas dispute our contention that Delaware's refiling rate exceeds that permitted by the Bankruptcy Code. They quote the Code provision that confirmation should not be "likely to be followed by . . . the need for further financial reorganization [ ] of the debtor," state that "[r]oughly 70% of the firms that file in Delaware do not need a second reorganization," and then go directly from that statement to their conclusion that "this statutory requirement is being met."[66] The validity of their argument depends upon three unstated assumptions, all of them questionable. The first is that the Bankruptcy Code uses the word "likely" to refer to a

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62. I will spare both myself and my readers the presentation of these entirely uninteresting results.

63. That said, I must confess that, in a world where people are judged by the power of the statistical tests they run, I am a little embarrassed at having employed a bivariate statistical test where I might have used a multivariate test instead. Thus does empiricism edge inexorably toward the incomprehensible.

64. Rasmussen & Thomas, *supra* note 2, at 306.

65. *See, e.g.*, Brian L. Betker et al., *"Warm with Sunny Skies:" Disclosure Statement Forecasts*, 73 AM. BANKR. L.J. 809, 817-18 (1999) (using one-digit SIC codes); Naercio Menezes-Filho, et al., *R&D and Unionism: Comparative Evidence from British Companies and Establishments*, 52 IND. & LAB. REL. REV. 45, 53 (1998) (same).

66. *See* Rasmussen & Thomas, *supra* note 2, at 293-94.

probability of more than 50%. That is not the dictionary definition of the word.[67] Nor do I think many bankruptcy experts would ascribe that meaning. To bankruptcy judges and practitioners, a 50% refiling rate—or for that matter, Delaware's 30% refiling rate—probably seem astronomical. Considering the costs of refiling shown in Tables 3 and 4, that should not be surprising. Rasmussen and Thomas' second unstated assumption is that, if a court's refiling rate is below 50%, the court has complied with the statute even if it made no inquiry into the likelihood of refiling. Most courts consider it their obligation to inquire into the confirmability of a plan even in the absence of objection.[68] Rasmussen and Thomas' third unstated assumption is that each firm emerging from Delaware reorganization had the same (30%) likelihood of refiling. It seems more reasonable to think that the emerging firms had varying levels of likelihood of refiling, some much lower than 50%, and others—particularly the prepacks that refiled in the first two years after confirmation—much higher. If so, the Delaware court violated 11 U.S.C. § 1129(a)(11) in confirming plans in the latter cases.

II. SKEEL'S COMMENTS

A. A Gap Between Investors' Beliefs and Efficiency?

Kalin and I argued that proof of Delaware's inefficiency in bankruptcy reorganization would, by analogy, undermine the proffered proofs of Delaware's efficiency in incorporation. The latter proofs are in the following form:

1) Major premise: If market actors choose a regime, the regime is efficient.
2) Minor premise: Market actors choose Delaware incorporation when they incorporate in Delaware and when they pay a premium for Delaware corporations.

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67. My dictionary defines "likely" as "probable" or having a "high probability of occurring," suggesting that the level of probability necessary to qualify a possibility as "likely" varies with the context. WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY (1991) (providing definition of "likely"). Nothing in my dictionary suggests a requirement that the probability must exceed 50% for a future event to be "likely." *See id.*

68. *See, e.g., In re* Holthoff, 58 B.R. 216, 218 (Bankr. E.D. Ark. 1985) ("In addition to the consideration of objections [to confirmation of the Chapter 11 plan] raised by creditors, the Court has a mandatory independent duty to determine whether the plan has met all of the requirements necessary for confirmation."); *see also* 11 U.S.C. § 1128 (1994) (requiring that the court hold a hearing on confirmation of a plan).

The analogous proof for Delaware bankruptcy reorganization is similar:

1) Major premise: If market actors choose a regime, the regime is efficient.
2) Minor premise: Market actors choose Delaware reorganization when they agree to bring prepackaged cases to Delaware.

If it can be shown that Delaware bankruptcy reorganization was inefficient during the period of Delawarization, but that market actors chose it anyway, that disproves the major premise in the reorganization proof and, by analogy, casts doubt on the major premise in the incorporation proof.

Professor Skeel understands the analogy. But he distinguishes the two proofs by pointing out that the minor premise of the incorporation proof rests on both the decisions of managers and investors to incorporate in Delaware and the decisions of investors to pay a Delaware premium. Accordingly, the minor premise of the incorporation proof reflects both the market for incorporations and the market for shares in Delaware corporations, while the minor premise of the reorganization proof rests solely on the decisions of managers and investors to reorganize in Delaware. The minor premise for the reorganization proof reflects only the market for Delaware reorganization. Skeel reluctantly concedes that the market for Delaware reorganization may be imperfect because, with respect to "traditional reorganizations, at least," it may reflect only the choices of debtors and their managers while ignoring the interests of creditors.[69] The argument for the efficiency of Delaware incorporation is stronger, Skeel says, because it includes not just the suspect choice of investors and managers to incorporate in Delaware, but also includes confirmation of the "correctness" of that choice by the additional choice of investors to pay a premium for firms thus incorporated.[70]

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69. David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 VAND. L. REV. 309, 315 (2001) ("When a troubled firm files for bankruptcy in Delaware, on the other hand—and, as a Delaware enthusiast, I say this at the risk of making an admission against interest—the firm's managers (and their lawyers) may simply be looking out for their own interests.") [hereinafter Skeel, *What's So Bad About Delaware?*]. Skeel's reluctance to make this concession undoubtedly results from his endorsement in an earlier article of the efficiency of the market for reorganizations. *See* David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243, 1276 (2000) (arguing from contractualist premises that "speed and administrative efficiency, as well as sophistication" are characteristics of Delaware bankruptcy cases).

70. Skeel, *What's So Bad About Delaware?*, *supra* note 69, at 316 ("[R]efiling rates seem a far less dependable source of evidence of efficiency than market valuations.").

But Skeel's concession is not enough to distinguish the market for reorganizations from the market for incorporations. First, his concession may not apply to prepackaged bankruptcy cases.[71] In prepackaged cases, the parties—including the creditors—contract and vote for a Delaware reorganization before the case is filed. Second, the market for Delaware incorporation suffers from the same lack of creditor control that Skeel cites with respect to traditional Delaware reorganization. Creditors "agree" to managers' and shareholders' decisions to incorporate or reincorporate in Delaware only in the same rarified law-and-economics sense in which it can be said that creditors "agree" to Delaware venue in traditional reorganization cases. They do not prohibit it in their loan agreements at the time they extend credit.[72]

Thus, what remains of Skeel's distinction between incorporation and reorganization are merely Daines's finding that investors pay a premium for Delaware incorporation and the lack of a corresponding finding with respect to Delaware reorganization. Daines's finding—even if true—is far from conclusive on the issue of the efficiency of Delaware incorporation. Modern finance theory recognizes the common sense truth that stock prices are not perfect calculations of value but merely the products of the differing assessments of investors.[73] When those assessments are wrong, particular classes of stocks can trade consistently at depressed or inflated prices.[74] High prices for the stocks of Delaware corporations could be merely the reflection of investors' beliefs that Delaware corporations are worth more. Or they could result from investors' irrational preference for some other characteristics of stocks that are correlated with Delaware incorporation.[75]

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71. Indeed, Professors Rasmussen and Thomas' contribution to this issue argues that, with respect to prepackaged cases, the concession Skeel makes is wrong. *See* Rasmussen & Thomas, *supra* note 2, at 288-89.

72. Whether bankruptcy venue may directly be a matter of contract between a borrower and its lender is an open question. But contractual devices by which creditors could control venue are available. *See* LYNN M. LOPUCKI & CHRISTOPHER R. MIRICK, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS, 2001 CUMULATIVE SUPPLEMENT 26-30 (2001) (describing devices by which lenders can prevent their debtors from filing bankruptcy at all).

73. *See* Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 482-83 (1997) (describing the heterogeneous expectations model of securities pricing).

74. *Id.* at 487 (noting the existence of "classes of stocks that consistently produce either higher, or lower, risk-adjusted returns than the market as a whole"); *see also id.* at 488 (identifying two of those classes as stocks that trade at low price-to-earnings ratios and stocks with high betas).

75. For example, if investors had an unjustifiably high preference for riskier stocks and Delaware stocks were riskier, investors would have an unjustifiably high preference for Delaware stocks. *See id.* at 488 (noting that riskier stocks tend to trade at unjustifiably high prices).

That said, I still believe that it may be possible to use capital market prices to assess the efficiency claims made on behalf of the Delaware Bankruptcy Court. The study would not compare the stock prices of Delaware-reorganizing firms with book values, as Skeel proposes.[76] Instead, it would examine the returns to investors in Delaware-reorganizing firms during the period of Delawarization. If Kalin and I are correct in thinking that the market overvalued Delaware reorganizations, the returns to investors in those reorganizations will be lower than the returns available in comparable investments—such as reorganizations in other courts during the same period.

The data collection for such a study would be difficult. Because debt holders are entitled to most of the value of a reorganizing company, their investments are the ones that should be tracked. But much of that debt would not be publicly held, and trading may have been suspended on even the portion that was. Much of the data would be in the hands of those who made private markets for trading in claims. Despite its difficulty, the study might be worth undertaking.

B. What Do the Failure Rates Tell Us?

Skeel, like Rasmussen and Thomas, seeks to identify a cause for Delaware's high refiling rates that would exculpate the Delaware bankruptcy court. Skeel proposes two possibilities, neither of which duplicate those proposed by Rasmussen and Thomas. First, he suggests that the firms reorganizing in Delaware may have "more complicated capital structures—such as more classes of debt

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Rasmussen & Thomas claim that, "[i]f LoPucki and Kalin were correct, one would expect that firms with similar financial characteristics would be valued differently based on where they were incorporated," Rasmussen & Thomas, *supra* note 2, at 286 n.12, and they then chide us for failing to make such a showing. They do not seem to realize that the Daines study on which they rely for their attack *is* such a showing.

Rasmussen and Thomas also dispute our suggestion that the market for Delaware incorporation could suffer from lack of information because "[t]he effect of incorporating in Delaware has been the subject of intense scrutiny for the past three decades." *Id.* Their argument confuses scrutinizing information with having it in the first place. Delaware is one of the few states that sells its corporate records in bulk, making it difficult to do research on Delaware incorporation. For example, I was forced to rely on the Support Administrator of the Delaware Division of Corporations to obtain a random sample of Delaware corporations for a study of UCC filings. *See* Lynn M. LoPucki, *Why the Debtor's State of Incorporation Should Be the Proper Place for Article 9 Filing: A Systems Analysis*, 79 MINN. L. REV. 577, 640 n.207 (1995).

76. As Skeel points out, the "noise" in such a measurement would make it almost impossible to generate credible results. *See* Skeel, *What's So Bad About Delaware?*, *supra* note 69, at 316-17.

and stock—than firms that take their cases elsewhere."[77] These more complicated structures may cause the companies to emerge from reorganization with more debt, which causes them to refile more frequently.[78]

Although I have no data on the number of classes of debt and stock in the cases studied, I do have data on two other indicators of the complexity of capital structure: asset size and number of entities in the corporate group.[79] As Kalin and I reported, the difference in asset size between corporations reorganizing in Delaware and those reorganizing elsewhere is small.[80] So is the difference in numbers of entities in the corporate groups. Among the twenty-four Delaware cases in the LoPucki-Kalin data set for which corporate group data was available, there were 635 constituent corporations, an average of 26.5 per group. The corresponding figures for the sixty-two cases in courts other than Delaware and New York City were 1525 constituent corporations, an average of 24.6 per group.[81]

Admittedly, this data does not go the heart of Skeel's theory. Delaware reorganizing firms might have more complex capital structures despite their similarities in asset and group size. But given these similarities—and the entire lack of evidence that Delaware corporations do have more complex structures—it does not seem likely that the capital structures of Delaware corporations will be so much more complex as to provide an explanation for the huge differences in refiling rates observed.

Skeel's second candidate for the Omitted Variable that Would Save Delaware is the proportion of managers seeking to keep their jobs through reorganization. "In their effort to keep their jobs, managers may make too many concessions to creditors in Delaware cases, and this, together with the distinctive characteristics of Delaware cases, could be part of the explanation for the high Delaware refiling rate."[82] Kalin and I did not collect data on this vari-

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77. *Id.* at 319.

78. *Id.* at 319-20.

79. The number of entities is a measure of the complexity of capital structure because the division of a business among members of a group is an alternative means of giving priority in particular assets to particular creditors. *See* David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1614 (1991) (noting that placing assets in a borrowing subsidiary is a means of granting priority in them); Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 20-21 (1996) (providing an example of the "parent-subsidiary" strategy for prioritizing debt).

80. *See* LoPucki & Kalin, *supra* note 1, at 257-59.

81. An independent samples t-test (n=86, t=0.29, p=0.77) revealed that these differences are not statistically significant. These data cover a broader time period than the period of Delawarization.

82. Skeel, *What's So Bad About Delaware?*, *supra* note 69, at 321.

able, and hence could not report on it. But even if the data were collected and they showed what Skeel suspects, they could not save Delaware from responsibility for its high refiling rates. Whether tainted managers maintain their jobs through reorganization is a function of the reorganization procedure itself. If the flaw is that managers survive in office in Delaware reorganizations, it is a flaw in Delaware's reorganization process rather than an exogenous condition with which Delaware must cope.

C. Do We Need a Reorganization Czar?

Skeel suggests the appointment of independent experts to evaluate proposed plans of reorganization. As Skeel recognizes, "[t]his is not a novel idea."[83] In addition to the Securities and Exchange Commission,[84] the United States Trustee,[85] and "the committee process,"[86] Congress has anointed bankruptcy judges as the independent experts charged with evaluating plan feasibility.[87] Bankruptcy judges are not only Congress's current choice, but also a logical one. Because bankruptcy judges specialize in a narrow range of cases, they have the opportunity to develop the necessary expertise. Perhaps the most frequently repeated justification advanced in favor of forum shopping by large, public companies over the years is that shoppers have sought the greater expertise of the New York and Delaware judges.

Skeel does not say who should be appointed as independent experts or attempt to explain why they would be more expert than Delaware's bankruptcy judges. With almost 60% of the nation's large, public company bankruptcies being processed at a single lo-

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83. *Id.* at 323.

84. *See id.*

85. One of the U.S. Trustee's jobs is to "monitor[ ] plans and disclosure statements filed in cases under chapter 11 of [the Bankruptcy Code] and fil[e] with the court in connection with [confirmation hearing] comments with respect to such plans." 28 U.S. C. § 586(a)(3)(B) (1994).

86. *See* General Counsel's Statement Concerning Commission's Participation in Bankruptcy Reorganization Cases Corporate Reorganization Release No. 331, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,484 (Feb. 2, 1984) (noting the SEC's expectation that, upon its withdrawal from plan approval process, public investors would be represented by "the committee process"). The reference was to creditors' and equity holders' committees appointed pursuant to 11 U.S.C. § 1102 (1994). Those committees may "participate in the formulation of a plan" and "advise those represented by such committee of such committee's determinations as to any plan formulated." *Id.* § 1103(c)(3).

87. *See* 11 U.S.C. § 1129(a)(11) (1994) ("The court shall confirm a plan only if all of the following requirements are met: . . . (11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor . . . .").

cation, in the two-judge Delaware court, gains from further specialization seem unlikely. The most likely candidates to replace judges in this role would be investment bankers. But they are the very people who were paid millions of dollars in fees for their services as "financial advisors" to the bankruptcy estates in the Delaware disasters that Kalin and I documented.[88]

To the extent that the Delaware bankruptcy judges lack independence and expertise today, the situation could be greatly improved by the method Kalin and I suggest: improving the information available to the judges regarding reorganization outcomes and the relationship between outcomes and conditions at the time of confirmation.[89] Only through such improvements in information flows can we hope to create a science of bankruptcy reorganization.[90]

D. The Virtues of Delaware

Skeel argues that, even if Delaware's bankruptcy judges "have been too quick to confirm Chapter 11 cases," firms should be permitted to continue filing there because Delaware is "incapable of sustained error."[91] Reputational factors will cause the Delaware judges to self-correct:

> If the Delaware bankruptcy courts were to establish a reputation as inefficiently pro-manager, its unsavory bankruptcy reputation would have negative implications for Delaware's status in corporate law, given the close relationship between corporate law and corporate reorganization. Delaware is a small state, and it is hard to overstate the social and economic importance of its corporate culture. If Delaware's bankruptcy judges focused on managers' interests at the expense of the insolvent firm, they would face enormous social pressure in Delaware to mend their ways. Most judges care deeply about their reputation, and the way to enhance one's reputation in Delaware is to demonstrate the kind of sophistication

88. Some may object that investment bankers are partisans in the current system and that the solution is to put them in the role of neutrals. But when investment bankers are retained as financial advisers in the current system, it is usually as advisers to the estate, which puts them in precisely such a neutral role—with fiduciary duties to the estate rather than to any party.

89. *See* LoPucki & Kalin, *supra* note 1, at 271-72.

90. Another possible solution might be to designate a single court as a mandatory venue for large, public company reorganizations. To the extent that high refiling rates are the product of competition among the bankruptcy courts, the establishment of such a court would address them. Of course, such a solution would be precisely contrary to Rasmussen and Thomas' proposal to increase competition among courts. *See* Rasmussen & Thomas, *supra* note 2, at 291 ("To the extent that there is a problem with forum selection, it is not that there are too many forums to choose from; rather, there are too few.").

91. Skeel, *What's So Bad About Delaware?*, *supra* note 69, at 329.

> and responsiveness that we see in the Delaware state courts' handling of general corporate law issues.[92]

Skeel's claim is both extraordinary and, I think, probably correct. The claim is extraordinary because it asserts that the local legal culture—not the federal government—will determine future case outcomes in Delaware's federal bankruptcy court. What leads me to believe that he is probably correct is the tremendous success that local legal cultures have had in other aspects of bankruptcy case processing.[93]

What causes me to qualify my agreement is that the manner in which the Delaware bankruptcy court won the race to become the bankruptcy capital of the United States has embarrassed the federal courts and deeply offended members of the federal judiciary. As Skeel points out, the Third Circuit, which controls the appointment of judges in the Delaware bankruptcy court and reviews that court's decisions, has recently indicated its displeasure by appointing a Philadelphia lawyer as one of the two bankruptcy judges in Delaware. The federal government has, in the past, managed to appoint judges who proved resistant to local legal cultures and thereby controlled outcomes in its own courts. The best example may be the federal judges who defied local legal cultures in the southern U.S. to promote racial integration in the 1960s.[94] Thus, for us to have confidence that the Delaware bankruptcy court will be "incapable of sustained error," Delaware would need some means of preventing the federal government from exercising control over the federal bankruptcy court in Delaware.

If the federal government does manage to control future outcomes in the Delaware bankruptcy court, there is little reason to believe that those outcomes will be significantly better than outcomes in other bankruptcy courts. The Delaware Bankruptcy Court will have only its own momentum to keep it at the pinnacle of the U.S. Bankruptcy Court system. That momentum may, however, be enough. The bankruptcies of large, public companies are high-risk

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92. *Id.* at 328.

93. *See, e.g.*, Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498 (1996) (documenting large differences in bankruptcy filings and outcomes among districts); Teresa A. Sullivan et al., *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y 801 (1994) (same).

94. *See, e.g.*, Sandra Day O'Connor, *The Judiciary Act of 1789 and the American Judicial Tradition*, 59 U. CIN. L. REV. 1, 11 (1990) ("A small group of [federal] judges was largely responsible for ensuring that the Constitution and the Supreme Court's teaching endured in the face of often great, often widespread, and occasionally violent resistance.").

ventures with hundreds of millions of dollars at stake in each one. Following the herd is a means by which the professional decision-makers in those cases can limit their personal risks. At present, the herd shows no inclination to go anywhere but Delaware.

CONCLUSIONS: THE AGENDA FOR FUTURE RESEARCH

This exchange brings into focus the methods by which future empirical research can resolve the remaining differences over what happened during the period of Delawarization. Three lines of inquiry seem most promising.

The first is to compare the economic performance of the firms emerging from Delaware reorganization during the period with the economic performance of the firms emerging from other courts' reorganizations. That might be accomplished through a comparison of operating and ordinary losses of emerging companies in the first few years after bankruptcy. If firms emerging from Delaware reorganization performed as poorly on those criteria as they did on the criteria of refiling, one could, in my opinion, fairly conclude that the results of Delaware reorganizations were significantly worse than the results of other courts' reorganizations.

Even so, it would remain possible that Delaware's poor results were attributable to an adverse selection effect that brought the most difficult reorganizations to Delaware rather than to any defect in the Delaware process. Defenders of Delaware could argue that blaming Delaware for having higher failure rates than other courts is like blaming the intensive care unit of the hospital for having higher death rates than other departments of the hospital.

To address that argument directly, researchers would have to negate the possibility of large differences in the reorganizability of the firms that filed in Delaware. That would require them to identify the determinants of failure other than court city, to discover whether those determinants were more commonly present in the cases filed in Delaware, and if so, to estimate whether the difference could be sufficient to explain the difference in failure rates. Such a demonstration could never be conclusive, because the researcher could never know whether some untested variable might provide the explanation. But after some number of variables had been tested, that possibility would be small. If, as Kalin's and my data suggest, the differences in outcomes between Delaware and other courts is large and the apparent differences in incoming cases small, the data might compel the conclusion that Delaware was an inefficient forum during the period of Delawarization. But pro-Delaware theorists who remained committed to their theories could

always keep doubt alive simply by proposing additional variables that could, hypothetically, save Delaware.

It may be possible, however, to prove that the Market erred in choosing Delaware without first proving Delaware's performance inferior to that of other courts. The researcher would seek to prove that the Market overvalued Delaware reorganization during the period of Delawarization. Specifically, the researcher would compare returns from investment in Delaware bankruptcy reorganizations during the period with returns from investment in other courts' reorganizations during the same period. If the returns from Delaware reorganization were significantly worse, that would prove that the Market did not anticipate the poor performance of firms emerging from Delaware reorganization. Defenders of Delaware would then have to argue the doubtful proposition that the insiders who brought cases to Delaware knew Delaware reorganization to be superior even though investors in the same cases—acting later—thought the outcomes of the Delaware cases would be better than they in fact were.