WHY BAD THINGS HAPPEN IN LARGE CHAPTER 11 CASES: SOME THOUGHTS ABOUT *COURTING FAILURE*

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A REVIEW OF:**

Lynn M. LoPucki, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (University of Michigan Press, 2005).

Thomas J. Salerno, Presentation to the Los Angeles Bankruptcy Forum: "Courting Failure" – A Cautionary Tale of How You Can Examine a Statistical Forest and Still Manage to Miss The Trees (Feb. 8, 2005) (unpublished remarks, contact author).

Todd J. Zywicki, *Is Forum-Shopping Corrupting America's Bankruptcy Courts?: Review of Lynn M. LoPucki, "Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts,"* GEO. MASON L. & ECON. WORKING PAPER NO. 05-16 (2005), *available at* http://ssrn.com/abstract_id=781487.

George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19 (2004).

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** The author wishes to express his sincere gratitude to Messrs. LoPucki, Salerno, Zywicki, and Kuney, each of whom reviewed prior versions of this article and, despite somewhat harsh or caustic comments about their views in it, generously gave their time in e-mails and telephone calls to assist the author in better understanding their views and correcting his errors. Of course, they do not necessarily concur with the opinions expressed in the article or have any responsibility for any remaining errors. The author also expresses his gratitude to Bankruptcy Judge Steven Rhodes of the Western District of Michigan, who provided a "view from the bench" about some of these matters.

INTRODUCTION

Forum shopping – for example, a Texas company like Enron choosing to file its bankruptcy case in the Manhattan bankruptcy court – is rampant in large Chapter 11 cases. In *Courting Failure*,[1] Professor Lynn LoPucki argues that forum shopping is driven by judicial "corruption," with judges agreeing to make improper decisions in order to lure the largest cases to their courts.[2] Two of LoPucki's leading critics focus on refuting the charge of judicial corruption, but neither addresses the underlying economic causes of forum shopping. More importantly, neither critic addresses the fact that forum shopping undermines bankruptcy practice and policy in large Chapter 11 cases.

THE CONTEXT

When Congress enacted the Bankruptcy Code in 1979, it consciously attempted to make bankruptcy reorganization a more common remedy.[3] Managers were encouraged to think of Chapter 11 as a potential strategy that *they* could implement because the retention of the company's pre-bankruptcy management as the "Debtor in Possession" was now the norm.[4] This was a significant change from Chapter X of the prior law, in which the court automatically appointed a trustee when the bankruptcy case was filed.[5] This resulted in the displacement of management and disruption of the business. To the same end, the statute removed the bankruptcy judge from the administration of cases and relegated him to a more adjudicative role.[6] The company's management became responsible for the administration of the bankruptcy case. Finally, Congress sought to break the hold of the "bankruptcy club" by encouraging "outsiders" to represent companies in bankruptcy; it legislated away the "rule of economy" and replaced it with the premise that bankruptcy professionals should be compensated on the same level as their non-bankruptcy counterparts.[7]

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[1] Lynn M. LoPucki, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (University of Michigan Press, 2005).
[2] Id.

[3] *See* H.R. REP. NO. 95-595, at 5 (1977).

[4] *See* COLLIER ON BANKRUPTCY § 1101.01 (15th ed. 1979).

[5] *See* COLLIER ON BANKRUPTCY § 44.04 (14th ed. 1974).

[6] George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 33-39 (2004).

[7] *Id.* at 39-45.

These reforms had their intended effect. Within a few years, many large companies entered into Chapter 11 proceedings; often successfully reorganizing, preserving jobs, and providing far better recoveries to creditors than would have occurred outside of bankruptcy or under the prior law. Money began to flow, then flood, through the bankruptcy courts as Chapter 11 became a "mainstream" business strategy. Bankruptcy professionals steered substantial businesses and floods of cash through the bankruptcy process and enhanced their stature and personal wealth.

An unanticipated, but ultimately very significant, change in bankruptcy practice was the ability to choose the court that would administer the bankruptcy case, or to "forum shop."[8] Instead of filing the bankruptcy case where the company's principal business operations were located, the "home court", a company could instead file where it was incorporated (often, Delaware) or wherever the bankruptcy case of an affiliate was pending.[9] In an extreme example of the latter forum shopping maneuver, Winn-Dixie incorporated a subsidiary in New York, had the subsidiary file a bankruptcy petition twelve days later, and then immediately filed the bankruptcy cases of the corporate group where its newborn affiliate's bankruptcy case was pending.[10]

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[8] Under the 1938 Chandler Act**,** venue for large public cases under Chapter X of the prior Bankruptcy Act was limited to the firm's principal place of business. Thomas J. Salerno, Presentation to the Los Angeles Bankruptcy Forum: "Courting Failure" – A Cautionary Tale of How You Can Examine a Statistical Forest and Still Manage to Miss The Trees (Feb. 8, 2005) at 22 (unpublished remarks, contact author). Some public companies attempted to evade this restriction by filing under Chapter XI, which permitted state of incorporation venue, but the venue rules were changed in 1973 to require all corporate cases to be filed at the debtor's principal place of business, regardless of Chapter. *Id.* Prior to the enactment of the Bankruptcy Code, there was no opportunity for forum shopping. While the Bankruptcy Code enacted the venue alternatives discussed above, the Legislative History does not suggest that Congress consciously sought to encourage forum shopping. *See* H.R. REP. NO. 95-595, at 49 (1977).

[9] *See* Salerno, *supra* note 8, at 22-23.

[10] Interestingly, while rejecting manufactured venue, the Manhattan bankruptcy court endorsed forum shopping generally. M. Natasha Labovitz, *You Can Still Shop After Winn Dixie: The Right to Choose Venue Survives the Transfer to Fla.*, 24 AM. BANKR. INST. J. 16, 62 (2005). In *Winn Dixie*, faced with intense creditor opposition, the Debtor capitulated and agreed to change the venue of the *Winn Dixie* cases to Florida, but the Creditors' Committee opposed and sought to keep the cases in Manhattan. At the hearing, Judge Drain held that venue in Manhattan was permissible but agreed to transfer venue to Florida "in the interests of justice" based upon the fact that Winn Dixie had manufactured the Manhattan venue. *Id.* He nonetheless went on to endorse forum shopping, noting that counsel

LOPUCKI'S CLAIMS

In his recent book *Courting Failure*, UCLA Professor Lynn LoPucki argues that this flood of cash and mega-cases has led to competition among the courts for the biggest bankruptcy cases, which in turn has corrupted the bankruptcy courts.[11] LoPucki's book can be readily criticized as a polemic; he clearly revels in attaching the adjective "corrupt" to courts and judges. LoPucki's premise – that competition for large bankruptcy cases is leading courts to curry favor by engaging in inappropriate judicial practices – has been justly met with criticism. On the other hand, LoPucki demonstrates that forum shopping has become a serious problem, distorting bankruptcy law as it is applied to the largest cases.[12] Unfortunately his critics, including the two discussed in this paper, have largely ignored that issue.

In essence, LoPucki argues that the Delaware and Manhattan bankruptcy judges have offered prospective Chapter 11 cases a "deal," albeit a tacit and unstated one: "file in my court, and I will predictably rule in your favor and contrary to established bankruptcy law on several issues of critical importance to you." LoPucki then catalogs a number of issues as to which those courts predictably make rulings that differ markedly from the mainstream, arguing that this proves that the courts are corrupt.[13] As a corollary, LoPucki argues that the "corrupt" courts are also failures at reorganizing companies, premised upon a statistical analysis of "recidivism" (Chapter 11 debtors who file a second bankruptcy case within five years after "successfully" completing their first bankruptcy case).[14]

Much of LoPucki's case is persuasive and compelling. For example, LoPucki discusses a number of changes allegedly arising out of "judicial corruption," by which judges make rulings contrary to mainstream bankruptcy law or practice and render their courts more popular in the eyes of prospective debtors.[15] Two

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was probably under a duty to engage in it, and to complain that "'allegations [that forum shopping is improper] not only by the movants, but by purportedly learned professors and members of Congress, do no good to the bankruptcy system and impugn and malign the courts.'" *Id.* at 62 (quoting Transcript of Apr. 12, 2005, *In re Winn –Dixie Stores, Inc.*, Ch. 11 Case No. 05-11063 (Bankr. S.D.N.Y. 2005)).

11 *See generally* LoPucki, *supra* note 1.

12 *Id.*

13 *Id.* at 138-39.

14 *Id.* at 97-102.

15 *Id.* at 137-181.

important examples of those changes are "critical vendor" orders and third-party releases.

A core principle of bankruptcy law is equality of distribution. Nothing in the Bankruptcy Code appears to countenance "critical vendor" orders.[16] Such orders reverse the ordinary rule that no unsecured pre-bankruptcy creditor may receive anything until the plan of reorganization is confirmed, and even then will receive only exactly what all other unsecured creditors receive. Arguing that some vendors are "critical" to the company's continued survival and will not continue to supply the company unless they are paid immediately and in full, some companies seek orders authorizing payment of such creditors in full at the outset of the bankruptcy case ("critical vendor orders").

Obviously, critical vendor orders have tremendous practical appeal. Management cannot tell until after the bankruptcy case has been filed if a critical vendor will jeopardize the reorganization. If that occurs, however, prudent management would want to know that a successful reorganization will nonetheless be possible. As a consequence, debtors often choose to file their cases in courts that have expressed a willingness to enter critical vendor orders. LoPucki identifies willingness to issue critical vendor orders as a key aspect of the "deal" the Manhattan and Delaware courts have made with the forum shoppers.[17]

A critical vendor order may also provide the company's management with extraordinary business leverage in dealing with its trade vendors. A dramatic example of the abuse of critical vendor orders occurred in the *K-Mart* case, in which the court allowed K-Mart to identify its "critical vendors" and then to pass out $300 million to pay those vendors' pre-petition claims in full.[18] Non-critical general unsecured creditors ultimately recovered a distribution of only 10% paid more than fifteen months later.[19]

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[16] An extensive history and analysis of critical vendor orders is presented in Anthony Michael Sabino, *The Death of Critical Vendor Motions and the Potential Demise of the Doctrine of Necessity: Farewell to Two Misbegotten Doctrines*, 6 TRANSACTIONS: TENN. J. BUS. L. 47 (2004).

[17] LoPucki, *supra* note 1, at 163-67.

[18] *Id.* at 134.

[19] *Id.* at 165-66.

Likewise, there are often strong practical reasons a company might want to obtain third-party releases, discharging persons other than the debtor (management, officers and directors, guarantors, insurers) from creditors' claims. On the other hand, it seems clear that Congress did not intend the bankruptcy courts to release claims against third parties. Indeed, Section 524(e) of the Bankruptcy Code appears to prohibit third-party releases.[20] Nonetheless, some courts have found the issuance of third-party releases to be appropriate and permissible. LoPucki identifies willingness to grant third-party releases as another part of the "deal" the Manhattan and Delaware courts struck with the forum shoppers.[21]

In the 1980s and 1990s, the bankruptcy courts in Manhattan and Delaware made it clear that they would authorize critical vendor orders and third-party releases. They also received the lion's share of the largest bankruptcy filings.[22] LoPucki argues that this is not a coincidence. Moreover, he claims that these two practices were aspects of the "deal" through which those courts successfully solicited bankruptcy cases (which he characterizes as "corruption").[23]

By the 1990s, insolvency professionals in various jurisdictions were meeting with members of their local bankruptcy benches in an effort to persuade the judges to become more "friendly" to large cases; i.e., more like the Delaware and Manhattan bankruptcy courts.[24] For example, these professionals routinely urged courts not to determine fees on the basis of local billing rates, but instead to permit the New York

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[20] 11 U.S.C. § 524(e) (2004) ("discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt").

[21] LoPucki, *supra* note 1, at 127.

[22] During the period 1980 – 1986, the Manhattan bankruptcy court received 32% of the large, publicly held case filings. *Id.* at 47. During the 1990s and through the early years of the new millennium, Delaware received a dramatically disproportionate number of the large, publicly held bankruptcy filings. *Id.* at 90 (presenting table).

[23] *See supra* notes 17, 21.

[24] *Id.* at 124-27 (recounting efforts in Houston, Chicago and Los Angeles, including a public announcement by the Houston court that, in response to a recommendation by a local bar committee, the court would expressly change its policy on hourly rates); *Id.* at 132-35 (discussing Chicago's ultimately unsuccessful efforts to solicit large case filings); *see also* Todd J. Zywicki, *Is Forum-Shopping Corrupting America's Bankruptcy Courts?: Review of Lynn M. LoPucki, "Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts"*, GEO. MASON L. & ECON. WORKING PAPER NO. 05-16, 33-35, (2005), *available at* http://ssrn.com/abstract_id=781487.

lawyers, who often brought the mega-cases in tow, to bill at New York rates.[25] This type of accommodation can scarcely be characterized as "corruption," however, unless one thinks that all lawyers everywhere are alike and hence deserving of the same hourly rate. On the other hand, it does suggest a widespread perception of the existence of forum shopping and a desire to compete for large cases; perhaps principally among the members of the local bar, but clearly with some accommodation from the bench.

One of the most dramatic examples of judicial competition cited by LoPucki occurred in Chicago. After perceiving that a number of large local companies were choosing to file their Chapter 11 cases elsewhere, the Chicago bankruptcy court promulgated local rules that were intended to demonstrate that it could be as "user-friendly" as Delaware. In an apparent response, major cases were filed in Chicago, notably *United* and *K-Mart*.[26] Chicago "breached the trust," however, by failing to deliver on two core requirements of a favored jurisdiction. First, the bankruptcy judge in the *Conseco* case refused to grant third-party releases to the officers and directors, even after objecting creditors had withdrawn their objections.[27] Then, the Seventh Circuit reversed the critical vendor order in *K-Mart*.[28] LoPucki reports that no large cases have been filed in Chicago since.[29]

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[25] LoPucki recounts that the Miami bankruptcy court publicly reduced a prominent New York firm's fee application by one-third, noting that its work was not worth the high rates it charged. New York firms thereafter attempted to avoid the Miami bankruptcy court. LoPucki, *supra* note 1, at 44. In contrast, the Oklahoma bankruptcy court publicly announced that attorneys could bill at the rates customary in their home office (e.g., New York rates) and became the second most popular court for large case filings in the early 1980s. *Id.* at 45.

[26] *Id.* at 132.

[27] *Id.* at 133-34.

[28] In re Kmart Corporation, 359 F. 3d 866 (7th Cir. 2004); *see* LoPucki, *supra*, note 1 at 133-34.

[29] *Id.* at 133 (recounting Chicago's 27-month "run" as a forum of choice).

BUT IS IT "CORRUPTION"?

LoPucki's assertion of wide-spread "corruption" in the bankruptcy bench attracts headlines and publicity, but the source of his "sex appeal" is also his Achilles' heel. "Corruption" in the judiciary is ordinarily thought of as a judge doing something he knows he should not do in order to obtain a benefit he knows he should not receive. No one in the practicing bar believes that "corrupt," the adjective, as so understood, can be applied to the bankruptcy bench.[30]

Even LoPucki acknowledges that the ordinary benefit of money or its equivalent obtained by judicial corruption is not applicable here.[31] LoPucki suggests that the motivation for corruption in this case is the prestige associated with administering large cases and the somewhat amorphous financial benefits flowing to the local bar, but even he seems to recognize the weakness in his argument and finds himself reduced to arguing that the judges "know or should know" that their actions are wrong and hence they must be "corrupt."[32]

This is LoPucki at his weakest. The greatest flaw in *Courting Failure* is LoPucki's inability to present a plausible motivation to justify his frequent use of the adjective "corrupt" to describe the bankruptcy bench. On the contrary, the general perception in the community is that the members of the bankruptcy bench are sincere, well-meaning, and conscientious, and that they have given up the opportunity to earn multiples of a bankruptcy judge's salary in order to "do the right thing."

Importantly, while the decisions discussed above represent minority viewpoints, well-intentioned, principled judges *can* make all of the decisions LoPucki identifies as "corrupt." Consider the two examples discussed above: critical vendor orders and the third-party release.

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[30] This has led to some bitter comments to the effect that the graphic on the cover of LoPucki's book constitutes slander *per se:* tilted scales of justice, a wad of money in the heavy scale and a basket of prominent bankruptcy cases (Enron, Adelphia, etc.) in the lighter scale, visually suggesting that the bankruptcy judges presiding over the identified cases had been bought.

[31] LoPucki, *supra* note 1, at 20.

[32] *See id.* at 19-21. In conversation, LoPucki also argues that trends (such as increasing numbers of judges "realizing" that critical vendor orders should be permissible) are inconsistent with chance conversions to a minority viewpoint and instead should be seen as indicia of judges courting forum shoppers. E-mail correspondence with Lynn M. LoPucki, author and professor, UCLA School of Law (Sept. 22, 2005) (on file).

The judicial antecedent of the critical vendor order is the "Doctrine of Necessity," established by the Second Circuit – arguably the most respected "business" Court of Appeals – in railroad reorganization cases.[33] The Second Circuit understood that there were, in fact, "critical vendors," and that the benefit associated with a successful reorganization might outweigh any detriment associated with "bending the rules" in order to pay the critical vendors. Thus, critical vendor orders are derived from real perceptions about actual business problems and have enjoyed some judicial support since the beginning of the twentieth century.

Much the same thing may be said of third-party releases. In the 1980s and 1990s, many professional businesses, including law and accounting firms, operated as general partnerships. When those businesses became insolvent, they could be effectively administered only through the use of third-party releases. Each of the partners would be required to contribute his or her non-exempt net worth in return for a release of claims by both the debtor/trustee *and* the general creditors, the latter effected through an order of the bankruptcy court providing a third-party release and injunction against collection efforts. A general partnership simply could not be effectively administered in any other manner, and this type of bankruptcy administration allowed creditors to recover multiples of what they might otherwise recover. Laventhol & Horwath,[34] Gaston & Snow,[35] and Keck, Mahin & Cate[36] are all examples of successful bankruptcy cases that were absolutely dependent upon the ability to provide the partners with third party releases.

The point for present purposes is that honorable, well-meaning, and intelligent judges can approve critical vendor orders and third-party releases without being "corrupt." The courts that approved critical vendor orders and third-party releases did so based on a rational, albeit a distinct minority, analysis. Even something as extreme and, in retrospect, clearly improvident as the *K-Mart* critical vendor order[37] is understandable. If a judge believed that critical vendor orders were

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33 *See generally* Sabino, *supra* note 16.

34 *See* 1922 WL 88184 (S.D.N.Y. Apr. 17, 1992).

35 *See* 1996 U.S. Dist. LEXIS 17774 (S.D.N.Y. Nov. 25, 1996).

36 *See* 241 B.R. 583 (Bankr. N.D. Ill. 1999).

37 *See* LoPucki, *supra* note 1, at 165.

permissible and understood that K-Mart faced hundreds of "critical vendors," should the court cease ordinary business and dedicate months to conducting critical vendor evidentiary hearings in order to validate each of the debtor's business judgments in the absence of any live dispute? Or should it accept the debtor's business judgment?

LoPucki does an excellent job of demonstrating that there is a serious problem associated with bankruptcy forum shopping. He identifies the categories of decisions that characterize a "debtor friendly" jurisdiction[38] – decisions that sharply vary from bankruptcy norms. Additionally, he confirms that large cases tend to select debtor friendly jurisdictions. It is only in his final conclusion, when characterizing the motives of the judges who sit in debtor friendly jurisdictions, that LoPucki overstates his case[39] and, in so doing, undermines the impact of his argument.

THE CRITICS

Two strikingly different critics of *Courting Failure* have emerged. Each focuses primarily on refuting LoPucki's core charge of judicial corruption, and as a consequence neither engages in a thoughtful analysis of the problems revealed by forum shopping. The critics and their arguments are as different as night and day.

Salerno

Thomas J. Salerno, the leader of the bankruptcy group at Squire, Sanders & Dempsey, has become the self-appointed defender of the Delaware and Manhattan judges who face LoPucki's charges of corruption. Salerno is offended by LoPucki's character attacks on bankruptcy judges, a group of professionals that "cannot

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[38] *Id.* at 139.

[39] *See, e.g., id.* at 180-81. To be fair, LoPucki presents a great deal of circumstantial evidence that strongly suggests the existence of judicial competition for large cases. As noted above, courts met with their local bars to discuss why cases were being filed elsewhere and what could be done to change that trend. Courts then explicitly modified their local rules to render their procedures more "user friendly;" in the case of Houston, publicly announcing a change in the court's policy on hourly rates. *Id.* at 123-27. These changes were successful in diverting large cases into, for example, the Chicago court. *See supra* text accompanying note 29. Thus, one can make a persuasive case that at least some courts were acting with the objective of obtaining the favor of the forum shoppers, requiring these courts to defend their actions on the grounds that they did not *improperly* solicit the cases.

publicly defend itself."[40] He responded venomously in his presentation and in a spirited debate with LoPucki at the Los Angeles Bankruptcy Forum.[41]

Salerno's general approach rests on an *ad hominem* "those who can't do, teach" argument. Unlike Mr. Salerno himself, "Professor LoPucki has never had any practical experience in the area of complex financial restructurings, and certainly has never represented any party of any major import in any Chapter 11 of any 'large' company…."[42] In his response, Mr. Salerno lectures on how Chapter 11 cases unfold "in the real world," suggesting that Professor LoPucki misconstrues the data because he does not understand the process.[43]

The shrill and mocking tone[44] of Salerno's response undermines its most important aspect: his attack on LoPucki's statistical analysis.[45] LoPucki relies heavily on statistics to provide external, objective support for some of his claims. The statistics are derived from his own database (the "Bankruptcy Research Database," or "BRD"), which he asserts includes information about every "large" (more than $100 million in assets) publicly held company to file bankruptcy since the Bankruptcy Code became effective.[46] LoPucki uses statistical analyses of BRD data to "prove" some of his contentions, but Salerno correctly notes that the "proof" is much more persuasive to someone who, like LoPucki, operates at a great remove from actual bankruptcy practice.[47]

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[40] Salerno, *supra* note 8, at 4.

[41] *See id.* at 28.

[42] *Id.* at 7-8.

[43] *See generally* Salerno, *supra* note 8.

[44] "Apparently, Professor LoPucki doesn't bother himself with such concerns…." "Again, that was of no interest to Professor LoPucki…." *Id.* at 15-17.

[45] *Id.* at 16-22.

[46] *Id.* at 18.

[47] *Id.* at 4, 16-22.

For example, LoPucki notes that the Bankruptcy Code requires the court to find that a plan of reorganization is "feasible" before it can be confirmed.[48] LoPucki concludes that if the company files a second bankruptcy case within five years of a court's confirming its plan of reorganization, the initial bankruptcy was a "failure."[49] LoPucki then presents an analysis of BRD data demonstrating that a significantly higher number of re-filers filed their initial cases in Delaware or Manhattan, allowing him to conclude that those courts were "failures" as well and, had they "done their job," they would have recognized that the plan of reorganization in the initial case was not feasible, and no one would have been put through the expense of two bankruptcy cases.[50]

Salerno provides his most valuable contribution by challenging LoPucki's statistical methods. Some of the challenge is rather pedestrian (Salerno identifies what he contends are inaccuracies in the BRD data, such as an inability to track issues like name changes)[51] and some of it is amusing.[52] On the refiling issue, for example, Salerno notes that the second case may have no direct connection with the first and that the factors that led to the second filing might not have been foreseeable when the first plan was confirmed, two common occurrences that undercut what LoPucki contends is "proven" by his study of recidivism.[53]

Salerno's most important challenge, however, is on a substantive level. The statistical information LoPucki accumulated in the BRD does not – and could not –

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[48] LoPucki, *supra* note 1, at 106.

[49] *Id.* at 100-01.

[50] *Id.* This issue, on which LoPucki has written numerous articles, is a quintessential demonstration of the failings of academia. The premises in his argument proceed in a logical sequence, but the result is far removed from any practical reality. Except in the most extreme situations, an independent evaluation of feasibility will require a very sophisticated financial and economic analysis, one that far exceeds what any bankruptcy judge can be expected to accomplish on his own. If opposing litigants present competing analyses and critiques, a judge can weigh the issues, but if the parties simply agree that the plan is feasible, it is hard to imagine how a bankruptcy judge could on his own develop the information necessary to challenge that agreement.

[51] *See* Salerno, *supra* note 8, at 21. In conversation, LoPucki asserts that Salerno's contentions are factually incorrect. E-mail correspondence with Lynn M. LoPucki, author and professor, UCLA School of Law (Sept. 22, 2005) (on file).

[52] Salerno began his presentation at the Los Angeles Bankruptcy Forum debate with a highly entertaining Power Point demonstration that statistically "proved" that the Cardinals "threw" the World Series in 2004.

[53] Salerno, *supra* note 8, at 19-20.

address the real questions: how much money did creditors actually receive, how soon did they receive it, and was there a better solution?[54] If creditors receive 15% in the first bankruptcy case and 3% in the second, the relevant question is whether a different approach in the first case could have yielded more than 18% or yielded that 18% more quickly. If the alternative, for example, was a liquidation in the first case that would have yielded 9%, the sequential bankruptcy cases that LoPucki decries as a failure actually would have been in the best interests of creditors.[55]

For present purposes, the important point is that no statistical analysis can provide useful information because data on the important issues cannot be compiled in a database. A court may be statistically more or less likely to appoint a trustee, for example, but the critical question is whether creditors will fare better or worse in a given case if a trustee is appointed, and a statistical analysis cannot shed any light on that question. Although muffled by his strident advocacy, Salerno's core critique is sound: the BRD compiles data about tertiary issues like re-filing, but one cannot draw significant conclusions from that tertiary data because, for example, whether a company files bankruptcy a second time does not tell us whether a better alternative to the first plan of reorganization existed, or whether the adjudication in the first case was flawed. LoPucki's analysis must rise or fall on its own strength and not on support from an "objective," statistical "proof" derived from the BRD database.

From my perspective, the most interesting aspect of Salerno's piece is the way that it innocently displays the world-view that is at the heart of the forum shopping problem.[56] Forum shopping is driven by the ability of lawyers to enjoy huge "successes" and reap substantial fees by placing large cases before judges who will predictably do – and not do – things that vary from normal bankruptcy law and practice. For example, critical vendor orders and third-party releases are contrary to established bankruptcy norms, but the judges who adopt those minority views clearly

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54 *Id.* at 18.

55 A related question is: "Whose ox is being gored?" If, for example, the initial case had concluded as a traditional liquidation, the secured creditors might receive much or all of the proceeds. If they agree to "step back" and allow funds to flow to unsecured creditors under a plan of reorganization that provides the secured creditors with a speculative but substantial "upside," does the failure of the initial case have any policy implication? Or does it just represent a case in which the secured creditors' intentional gamble did not pay off, while the unsecured creditors enjoyed the "price" of the gamble?

56 *See* Salerno, *supra* note 8, at 12.

appeal to the forum shoppers, as Chicago's brief stint in the spotlight demonstrated. Salerno sees nothing wrong with enabling attorneys to forum shop to such courts.[57]

Similarly, parties to the bankruptcy process, which Salerno correctly identifies as driven by negotiation,[58] prefer a judge who will accept anything the parties agree upon over a judge who thinks that he has an independent duty to adjudicate, for example, plan confirmation issues, even where the parties are in agreement ("independent adjudication"). While independent adjudication is clearly the mainstream characterization of a judge's duty, the Delaware and Manhattan bankruptcy judges have developed a reputation for approving whatever the parties agree upon. Salerno demonstrates that he has become so comfortable with the Delaware and Manhattan approach that he no longer grasps that independent adjudication is the mainstream: "LoPucki would also presumably have a bankruptcy judge deny confirmation of a fully consensual plan based upon his or her assessment that the plan might not be feasible. This is absurd."[59]

This statement exemplifies Salerno's critical misunderstanding and one of the core problems of the Delaware and Manhattan courts that share his mindset. Zywicki describes this *laissez-faire* approach to adjudication, in contrast to the independent adjudication advocated here, by explaining that "the overriding mindset of such courts may be to treat bankruptcy proceedings as primarily multi-party private actions and to permit the parties to work out matters primarily privately and through private negotiation."[60] This "mindset" misunderstands the core policies of the Chapter 11 process.

One of the critical and unique features of Chapter 11 is the ability to bind *both* an opposing minority *and* those who do not participate in the process at all. The essential protection for these two communities, often in combination representing one of the largest constituencies in any bankruptcy case, is the presence of a judge who will independently adjudicate important issues, including whether a plan of

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[57] *Id.* (echoing Judge Drain, *supra* note 10).

[58] *Id.* at 8.

[59] *Id.* at 11. Admittedly, Salerno is correct on the *precise* issue: a bankruptcy judge cannot realistically contest feasibility in a vacuum, not because the judge *should not*, but because practically speaking he cannot. *See supra* note 50. On the other hand, it is presented as an example of the *laissez-faire* alternative to independent adjudication (the principle that the court should not interfere with an agreement between the parties). That attitude is one of the core problems in the bankruptcy process that has been exacerbated by forum shopping.

[60] Zywicki, *supra* note 24, at 33.

reorganization should be confirmed without the affirmative consent of these two groups. Expecting the bankruptcy judge to exercise an independent adjudicative duty where the Bankruptcy Code expressly instructs him to do so and where his decision will affect multitudes of creditors and other parties who do not retain counsel or actively participate in the case – is far from absurd. This expectation has been a mainstream aspect of the bankruptcy process for as long as there have been bankruptcy laws.[61]

Independent adjudication is critical because a bankruptcy court's orders almost always affect the rights of persons not present before the court. For example, when a court approves a Section 363 sale and strips *all liens* from the underlying property; determines whether the transaction will have tax consequences and what they may be; determines whether successor liability – or benefits – may exist with respect to regulatory and licensing matters, governmental requirements, taxes, and claims of employees, vendors and unsatisfied creditors; or rules on the assignment of executory contracts, it typically affects the legal rights of parties who will not appear in the proceeding and may not even receive actual notice of the manner in which the sale order will affect their legal rights.[62]

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[61] In correspondence, Salerno argues the contrary. He asserts that judges ordinarily approve whatever the parties agree upon, and that they have no practical alternative to doing so. E-mail correspondence from Thomas J. Salerno, Chair, Reorganization Practice Group, Squire, Sanders & Dempsey, LLP (Sept. 16, 2006) (on file). Both of his claims have some merit. Judges do encourage settlement and are reluctant to reject a settlement on which the parties agree. Some issues, including feasibility, are difficult for a judge to address unless a party advocates them. *See supra* note 50. But that does not mean, as Salerno suggests, that independent adjudication stops whenever the parties reach an agreement. In a cash collateral hearing in the first days of a case, the parties (the debtor and the secured creditor) may agree on a variety of matters that will essentially determine the course of the rest of the case. Only a court that accepts a duty to make an independent adjudication can protect the rights and interests of the creditors who are not present then. Perhaps a better example is a "quick" Section 363 sale. LoPucki notes that such sales may be manipulated by corrupt management, and Kuney notes that they provide less opportunity for pervasive scrutiny by various consituencies. LoPucki, *supra* note 1, at 167; Kuney *supra* not 6, at 105-06. Only independent adjudication by a judge will protect the interests of creditors.

[62] LoPucki discusses at length pathological Section 363 sales, such as the Polaroid sale approved by the Manhattan court, in which the insiders effected the sale to themselves and thereafter "flipped" the business outside of bankruptcy, enjoying a substantial profit. LoPucki, *supra* note 1, at 173-80. LoPucki correctly notes that limited disclosure and an inability to evaluate the alternatives are often characteristics of the Section 363 sale. *Id.* His solution – forcing almost all sales into the plan of reorganization context – is extreme and impractical; the solution contemplated by the Bankruptcy Code is simply independent adjudication. Again, mainstream jurisdictions implement independent

It is only through the exercise of independent adjudication by the bankruptcy court that orders affecting the legal rights of persons not before the court obtain their legitimacy. Contrary to Salerno's view, the agreement of the "major players" about how the case should proceed does not protect the rights of the "minor players," for example, the taxing authorities, the regulatory authorities, and the holders of intellectual property rights. Requiring those "minor players" to become aware of the provisions in a proposed form of sale order and fly across the country to protest them "or be deemed to consent" is an unreasonable burden. It is through independent adjudication by the bankruptcy court, not the agreement of the major players, that the Chapter 11 process obtains its legitimacy. But independent adjudication means a lack of "predictability," and that makes it less desirable to the forum shoppers. And so Salerno, who has become accustomed to the forum shoppers' view of the world, sees independent adjudication despite the agreement among "the parties" as "absurd."[63]

In the end, the thrust of Salerno's argument is that forum shopping is and should be permissible and that it is not reflective of judicial misconduct. While LoPucki may have been "over the top" in accusing judges of corruption, Salerno is similarly extreme, both stylistically in his abuse of LoPucki and substantively in his advocacy of "Judicially Supervised Negotiation,"[64] where judicial supervision "appropriately" ends whenever a deal is struck.

Zywicki

Professor Zywicki's critique comes from an entirely different place. Like LoPucki, Zywicki is a professor, so his response is academic, not impassioned.[65] Zywicki explores the issue in an interesting and overlooked historical context: benign vs. malign forum shopping.

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adjudication in the Section 363 sale context. The San Jose bankruptcy court, for example, has promulgated guidelines regarding Section 363 sale procedures that are designed to counteract the very problems identified by LoPucki. *See generally* U.S. BANKR. CT., N.D. CAL., GUIDELINES FOR EARLY DISPOSITION OF ASSETS IN CHAPTER 11 CASES, PRE-PACKAGED PLANS, THE SALE OF SUBSTANTIALLY ALL ASSETS UNDER § 363, *available at* www.canb.uscourts.gov.

[63] Salerno, *supra* note 8, at 11.

[64] *Id.* at 8.

[65] In addition, it is susceptible to Salerno's criticisms about academics and their distance from practical reality. For example, Zywicki remarks that "a decision *not* to forum-shop away from the home district may also be a form of forum shopping itself." Zywicki, *supra* note 24, at 25.

Zywicki begins with medieval courts, whose jurisdiction was largely concurrent and whose judges were paid from court fees.[66] There was robust competition among those judges to provide the speediest and fairest verdicts because that competition translated directly into their personal income.[67] The competition did not result in a bias in favor of plaintiffs or defendants, because the litigants perceived that they might as likely be either; they were motivated to select courts that were fair and speedy rather than biased.[68] Zywicki calls the medieval forum shopping "good" and notes that better judicial practices spread quickly between courts due to forum shopping competition.[69] Conversely, he presents plaintiffs' class action litigation as an example of "bad" forum shopping because judges are re-elected – or not – based on their propensity to "transfer wealth from out-of-state corporations to in-state [and only incidentally out-of-state] plaintiffs."[70]

Tested in comparison with these examples of judges currying the favor of forum shoppers in order to earn more money or retain elected office, the advantages that accrue to the judicial beneficiaries of bankruptcy forum shopping are nominal: "celebrity status" and the inherent "appeal" of administering large cases.[71] Bankruptcy judges simply do not enjoy a significant "upside" from being selected as a favored jurisdiction; neither their income nor their tenure improves based on their popularity.[72]

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[66] *Id.* at 9.

[67] *Id.* at 11.

[68] *Id.* at 12-13.

[69] *Id.* at 9-14.

[70] *Id.* at 15-16.

[71] LoPucki, *supra* note 1, at 20-21.

[72] As noted above, however, there is nonetheless evidence of judicial involvement in competition for cases. *See supra,* note 39. While "corruption" is a wholly disproportionate adjective, the rhetorical question "Do you think Judge Gonzalez prefers presiding over Enron or a Chapter 13 calendar?" has some persuasive effect.

A striking example used by Zywicki is Enron and the subsequent fraudulent management cases.[73] LoPucki notes that fraudulent management should fear the appointment of a trustee more than anything.[74] Shortly before Enron filed for bankruptcy, the Delaware district court appointed a trustee in the *Marvel* case based on a comparatively low showing of misconduct, leading Enron instead to file in Manhattan.[75] Despite the clear instruction of the Bankruptcy Code ("a trustee shall be appointed…"), the Manhattan bankruptcy court did not appoint a trustee, and Enron's fraudulent managers were protected from their worst fears.[76] In rapid succession, WorldCom, Adelphia, and Global Crossing filed in the Manhattan bankruptcy court, presumably hoping for (and ultimately obtaining) the same result.[77]

LoPucki is correct in identifying this trend among fraudulent managers as a matter of forum shopping. But as Zywicki points out, "there is no evidence that [Judge Gonzalez's decision not to appoint a trustee in Enron] was motivated by a corrupt desire to attract subsequent, similarly troubled cases."[78] Indeed, it is difficult to imagine any judge setting out on a quest to become the forum of choice for fraudulent managers. While the decision(s) in those cases may have been incorrect, it is difficult to argue that they were incorrect because of motivation to attract similar cases unless one thinks of these courts as having cast a net so wide as to attract all big cases, and fraudulent management cases were simply part of what the net caught.

Professor Zywicki analyzes the other examples identified by LoPucki and comes to similarly less dramatic conclusions. Many companies file bankruptcy to effect a quick sale of their assets. LoPucki argues that this practice is often driven by improper objectives, but Zywicki notes that this conclusion is far from obvious.[79] LoPucki points out that the bankruptcy courts in Delaware and Manhattan were early supporters of the practice of Section 363 sales of the entire business,[80] but Zywicki notes that it has spread to most courts, and there is no obvious "lead"

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[73] Zywicki, *supra* note 24, at 26-28.

[74] *Id.* at 27.

[75] *Id.* at 26.

[76] *Id.*

[77] LoPucki, *supra* note 1, at 145.

[78] Zywicki, *supra* note 24, at 28.

[79] *Id.* at 28-32.

[80] LoPucki, *supra* note 1, at 168-69.

enjoyed by Delaware or Manhattan on this issue anymore.[81] If there is judicial competition going on, it is not clear that anyone is winning.

Zywicki's principal contribution on this score is his call for a "reality check." He notes that "it is unclear why judges would *want* to compete for these [Section 363 sale] cases."[82] He makes the same point with respect to pre-packaged bankruptcy cases, another of the issues identified by LoPucki as a basis of purported competition among the courts.[83] Who wants a case that will only last a couple of months and will generate no interesting issues? Even the local bar will enjoy no more than limited revenues from such cases.

Notably, Zywicki identifies awards of attorneys' fees as a significant motivating factor in forum shopping.[84] Jurisdictions can be "hard" or "soft" on fees based on a number of criteria: willingness to accept the professional's standard hourly rate vs. limiting it to the prevailing local rates; accepting fee applications as submitted vs. imposing stricter scrutiny or employing fee examiners; adopting a "tough" stance on conflicts of interest; etc.

> [T]he *marginal* difference between the fees awarded by a "tough" court versus a "soft" court[, e.g., a]n additional $50 - $75 million in attorneys' fees[,] may be a relatively small amount of money in a multibillion dollar chapter 11 case (perhaps less than one cent on the dollar to creditors). To the professionals involved, however, this is a substantial marginal difference.[85]

Thus Zywicki, like Salerno, agrees with LoPucki that there may be powerful motives for forum shopping. Where Zywicki and Salerno fall short is their focus.

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[81] Zywicki, *supra* note 24, at 29.

[82] *Id.* at 32 (emphasis in original). *But see supra* note 39.

[83] *Id.* at 39.

[84] *Id.* at 32-33.

[85] *Id.* at 34; *see also supra* note 25.

Having concluded that "judicial corruption" is not at the root of forum shopping, they act as though the problem has been solved. It has not been solved.

If forum shopping is rampant – and LoPucki, Zywicki, and Salerno all agree that it is[86] – and if the result of forum shopping is that the largest bankruptcy cases are administered and resolved in a manner different from (if not at odds with) mainstream bankruptcy law and practice, why is this occurring? Does this raise a policy concern, and should it be corrected? LoPucki presents a facile but unhelpful model of judicial corruption, and Salerno and Zywicki seem content to refute that facile model, but no one attempts to explain why this pathological condition has arisen and what, if anything, can be done to correct it.

WHO IS HIJACKING CHAPTER 11?

The answer to these core questions can be gleaned from hints and indirect comments in *Courting Failure*, in the critics' arguments (perhaps inadvertently, in Salerno's case), and more directly from Professor George Kuney's article, *Hijacking Chapter 11*, which analytically represents the prequel to *Courting Failure*.

Kuney "follows the money." He notes (as does LoPucki) that the Bankruptcy Code brought with it fundamental changes to the process of obtaining fees in a bankruptcy case: the "rule of economy" was gone, the judge was removed from case administration, and Congress had specifically urged the courts to compensate bankruptcy professionals on the same level as their non-bankruptcy counterparts.[87] It became easy (and, of course, popular) to grant fee applications, and nearly impossible to engage in the most meaningful scrutiny of them (should these services have been performed at all or in this manner?).[88] Indeed, as LoPucki notes, it is difficult to intelligently evaluate fee applications on any level, leading some courts to throw up their hands and "outsource" the evaluation of fee applications by hiring fee examiners who perform statistical analyses of timesheets – about as far removed as one can get from a meaningful review of legal services.[89] At the same

[86] LoPucki, *supra* note 1, at 16 (in the early 1980s, a third of the large bankruptcy cases were filed outside of their home courts); Zywicki, *supra* note 24, at 22 ("There is little doubt that forum-shopping occurs in bankruptcy."); Salerno, *supra* note 8, at 12 ("Venue consideration is a tactical consideration…").

[87] Kuney, *supra* note 6, at 33-39.

[88] *See also id.* at 44-45.

[89] LoPucki, *supra* note 1, at 42.

time, other changes in the Bankruptcy Code (i.e., the demise of Chapter X) gave rise to mega-cases that could pay mega-fees.

Thus, bankruptcy professionals could make a lot of money, provided that they could satisfy the two core constituencies: the insiders (i.e., management) and the secured creditors.[90] The professionals set off to satisfy those constituencies by offering them benefits the bankruptcy laws never intended, at least as those laws were interpreted by mainstream judges.

Fraudulent managers wished to avoid the appointment of trustees, although that was clearly what the Bankruptcy Code intended, and with Enron stumbled upon a court that appeared willing to protect them from that danger. Insiders and management were often motivated by third-party releases (e.g., releases of the managers from claims concerning their own misconduct). Thus, even though Congress attempted to prohibit third-party releases,[91] the attorneys sought out courts that had historically overcome that prohibition and granted them.

At the most mercenary level, *all* managers appreciated retention bonuses. Although, as LoPucki (and Congress, in the recent legislation) could see, the folks who led a company into financial collapse were probably not the focus of active recruitment efforts, courts who were willing to award failed managers substantial bonuses to encourage them to remain were very appealing to those managers.[92]

In order to satisfy the powerful secured creditors and obtain the carve-outs that were essential if they were to be paid in many cases, the professionals developed debtor-in-possession ("DIP") financing techniques that ensured that the secured creditors could "drive the bus" and control the reorganization to maximize their benefit.[93] Kuney catalogs a variety of devices that permitted secured creditors to seize control of bankruptcy cases, often with the cash collateral orders that were

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[90] *See* Kuney, *supra* note 6, at 24-26.
[91] *See supra* note 20.

[92] LoPucki, *supra* note 1, at 151-56. Under recent reform legislation, managers may not receive a retention bonus unless they present a *bona fide* offer of employment from another company. 11 U.S.C. § 503(c)(1)(A) (2005). *See also* Kuney, *supra* note 6, at 81-90 (cataloging forms of retention programs).

[93] Kuney, *supra* note 6, at 26-27.

entered on the first day of the case.[94] Again, mainstream courts rejected these devices. Indeed some, like the Northern District of California, promulgated guidelines identifying the provisions and devices that would not ordinarily be approved.[95] Again, however, this spurred forum shopping to outlier courts, courts that would, as Salerno advocates, approve anything consensual. (Often, the debtor has little negotiating leverage with the secured creditor on cash collateral, and in many cases can be expected to "take a dive" to accommodate the secured creditor's demands.)

Zywicki recognizes that there may be a normative issue here. While Delaware's advocates acknowledge that "the primary beneficiaries of speedy reorganizations [in Delaware and Manhattan bankruptcy courts] tend to be the secured creditors," at least Zywicki notes that "there are some problems with using secured creditors as a proxy for the welfare effects of jurisdictional competition."[96] With respect, quickly accommodating the interests of secured creditors is far from the purpose of the bankruptcy process. Bankruptcy cases often involve a pitched battle between the secured creditor(s) and everyone else (unsecured creditors and equity). "If the secured creditors are happy, the bankruptcy has succeeded" is a proposition with which few practicing bankruptcy attorneys would agree.

Satisfying these constituencies did not require "corrupt" judges. Rather, it required understanding the predilections and "mindsets" of the judges who might be assigned to the case, a traditionally valuable type of knowledge on which bankruptcy attorneys have always traded. ("What is this judge likely to do with this issue?" is the question always asked of local counsel.) There have always been a minority of judges who believed that critical vendor orders were permissible, at least in an appropriate case. A capable bankruptcy attorney would steer a case in which that issue was important to a court that had previously expressed a willingness to grant such orders.[97] Likewise, the professionals could appeal to the desires of secured creditors by steering a case to a court that would take a *laissez-faire* approach to the debtor's agreements with its secured creditors, as opposed to a more mainstream court that might scrutinize and independently reject some of the terms of those agreements. And of course, bankruptcy attorneys are more sensitive to a court's prior

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[94] *Id.*

[95] *See* U.S. BANKR. CT., N.D. CAL., GUIDELINES FOR CASH COLLATERAL AND FINANCING STIPULATION, *available at* www.canb.uscourts.gov.

[96] Zywicki, *supra* note 24, at 25.

[97] *See* Salerno, *supra* note 8, at 12.

pronouncements on attorneys' fees than to anything else. Thus, it was the professionals' direct and mercenary desire to obtain mega-fees from mega-cases that led them to search urgently for courts and judges who would rule favorably for their critical constituencies, thereby obtaining the rulings that LoPucki characterizes as "corrupt." In fact, those rulings were not "corrupt;" they were merely expressions of minority viewpoints. The professionals were simply selecting courts that had previously expressed the following set of views that were out of the mainstream: where the parties are in agreement, the judge *should* be a rubber stamp; if the debtor believes that its reorganization will be imperiled by a failure to deal with critical vendors, the court *should* facilitate their prompt payment; where third parties are critical to the case's success, the court *should* offer them general releases and stays; and where the debtor says that it has negotiated the best deal that it can with its secured creditor, the court *should* approve it, even if it includes cross-collateralization, control over the reorganization process, or other provisions that are routinely not permitted in other jurisdictions.

Of all of these minority views, the most essential to the forum shoppers is the one most self-evident to Salerno: a court's willingness to abdicate independent adjudication in favor of approving whatever the parties agree upon. It is possible to "work around" everything else, but if the court exercises independence, it loses "predictability" and will not be acceptable to the forum shoppers.

CONCLUSION

In a capitalist form of natural selection, the professionals who could find judges who would deliver on the professionals' promises to the core constituencies prospered and multiplied; those who could not diminished. The story of Chicago is not a story of the failure of the bankruptcy court; it is a story of the failure of the Chicago attorneys who "oversold" their ability to provide key benefits – critical vendor orders and third-party releases – and learned, along with their clients and prospective clients, that they could not, in fact, deliver.

In tandem, *Courting Failure* and *Hijacking Chapter 11* seem the perfect vindication of capitalism. The capitalist theory is that the market will supply anything for which people are willing to pay. The people who can channel the tremendous amount of money flowing through Chapter 11 – the insiders and the secured creditors – have identified benefits that they want the bankruptcy market to provide. As it turns out, the law has not been as effective in prohibiting those benefits as the market is in obtaining them. As a consequence, most large Chapter 11 cases will be forum-shopped to courts that do not apply mainstream bankruptcy law.

How can the problem be solved? For more than forty years, the Bankruptcy Act largely prohibited forum shopping, requiring that companies file their cases where they had their principal business operations. As a political matter, it seems unlikely that Congress will legislate the elimination of forum shopping. Delaware will not willingly give up its "place of incorporation" venue status and the revenues associated with those cases. It is possible, but not likely, that the "affiliate bankruptcy" venue will be eliminated, potentially affecting New York's case load. Regulation could possibly address the problem, but it is difficult to see how the problem could be solved when a viable legislative solution cannot overcome political hurdles and a theoretical solution cannot achieve practical results.