Written Testimony of David A. Skeel, Jr.

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Committee on the Judiciary
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Thank you for the opportunity to testify about H.R. 2533, the proposed "Chapter 11 Bankruptcy Venue Reform Act of 2011." My name is David Skeel, and I am the S. Samuel Arsht Professor at the University of Pennsylvania Law School. It is a great honor to appear before you today.

Under the current venue rules, a debtor is permitted to file for bankruptcy in the district in which it has: 1) its domicile (which, for a corporation is its state of incorporation), 2) its residence, 3) its principal place of business in the United States, 4) its principal assets, or 5) an affiliate that has already filed for bankruptcy.[1] The proposed Chapter 11 Bankruptcy Venue Reform Act of 2011 would eliminate two of the existing venue options, domicile and the place where an affiliate has already filed for bankruptcy.

The objective of the reform is to make it harder for companies to file for bankruptcy in Delaware or New York. Nearly all of the large companies that file for bankruptcy in Delaware are incorporated in Delaware; removing domicile as a venue option would make it impossible for most to file for bankruptcy in Delaware. Removing the affiliate option would make it harder for companies to file for bankruptcy in New York, because many of the big cases that are brought to New York begin with an affiliate filing in New York.

In my view, removing the domicile and affiliate options would be an enormous mistake. It would overturn a long history of bankruptcy practice; it would undermine the effectiveness of our corporate bankruptcy system; it would increase the administrative costs of the system; and it would not help the very parties the proposal is ostensibly designed to help.

[1] The first four options are in 11 U.S.C. § 1408(a); the affiliate option is § 1408(b).

In the remarks that follow, I'll develop these points in a little more detail by focusing on three issues in particular: first, the historical context; second, the remarkable effectiveness and distinctive expertise of Delaware and New York; and finally, reform proponents' concerns about the convenience of cases in Delaware and New York.

The Historical Context

With the exception of a short period in the 1970s, a company has always been permitted to file for bankruptcy in its state of incorporation.[2] Prior to the 1930s, large corporations usually did not file for bankruptcy if they fell into financial distress. Instead, they used a judicial process known as equity receivership to reorganize. For this process, too, the company's state of incorporation was considered an appropriate venue location.

The assumption that companies should be permitted to file for bankruptcy in their state of incorporation is closely linked to the longstanding belief that corporations should generally be regulated by the states, not by Congress. Corporations are creatures of the states. They are created by the states, and the states are the ones who regulate their internal affairs. Corporations are also subject to federal laws, of course, including the antitrust and securities laws, the environmental laws, and bankruptcy itself. But the starting point is always state law.

The longstanding rule that corporations can file for bankruptcy in their state of incorporation needs to be seen in this context. It is a direct reflection of the historical commitment to state oversight of corporations. Removing a corporation's right to file for bankruptcy in a district in its state of incorporation would flip the traditional understanding of corporate regulation on its head.

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[2] I focus in this section on domicile as a proper filing location. The affiliate provision has a different justification: facilitating efficient administration of cases involving multiple entities.

This tradition should only be overturned if the case for repudiation is undeniable and overwhelming. In my view, it isn't. To the contrary, eliminating domicile as a venue option would seriously undermine the current bankruptcy process.

The Virtues of the Current System

There have been two major complaints about the current venue framework. The first is that it has led to forum shopping that has created a "race to the bottom" in Chapter 11 practice. The second is that cases in Delaware and New York are inconvenient for some constituencies, especially employees and other relatively small creditors. I will consider the first complaint in this section and the second in the following section.

The leading academic advocate for reform, Lynn LoPucki, has argued that Delaware and New York have attracted cases by, among other things, paying high fees to the debtor's bankruptcy lawyers, permitting the debtor's managers to keep their jobs, giving the company much more flexibility with its "first day orders," and simply rubberstamping the company's proposed bankruptcy plans and sales of its assets.[3] Professor LoPucki argues that other courts, starting with courts in Texas and Chicago, have copied Delaware's and New York's practices. According to Professor LoPucki, this has had terrible consequences for the bankruptcy process. He has pointed out, for instance, the many companies that reorganized in Delaware in the 1990s later filed for bankruptcy again. Professor LoPucki accuses the bankruptcy judges in Delaware and New York, and the judges that seem to have adopted similar practices, as well as the system as a whole, of being corrupt.

I should perhaps start by saying that I believe that the allegations that bankruptcy judges around the country are corrupt are unfounded and unfair. The bankruptcy judges I know are extraordinarily impressive; I have never met one who was corrupt. I will therefore focus on the substantive criticisms that have been leveled by Professor LoPucki and others.

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[3] Professor LoPucki makes these arguments most fully in his book, *Courting Failure*. Lynn M. LoPucki, *Courting Failure: How Competition for Big Cases is Corrupting Bankruptcy Courts* (2005).

It does seem to me quite clear that bankruptcy courts around the country have adopted practices that were pioneered in Delaware and New York. In the 1990s, Delaware judges acted much more quickly than other courts on "first day orders"—which include the debtor's request to hire a bankruptcy lawyer, its request to continue paying its employees, and requests to pay some "critical vendors." Now, courts around the country deal with these requests much more expeditiously than in the past. Courts also are more willing to pay New York rates to lawyers from New York. While there have been occasional missteps, I believe the emergence of Delaware and New York as the venues of choice in some of the large cases has been extremely beneficial for the bankruptcy process overall.

I have outlined the benefits of the current framework, and responded to criticisms, in great detail in my scholarly work. Rather than repeat those arguments here, I will simply refer to several of these articles in footnotes, and note that the criticisms are flawed in numerous respects. They are based on very small numbers of cases, for instance, and the conclusions often disappear if the time frame of analysis is adjusted even slightly.[4] In the discussion that follows I'll focus on the "big picture" problem with the attack on Delaware and New York, which is that these courts have been extremely effective.

Since its emergence as a prominent bankruptcy venue starting in roughly 1990, Delaware's bankruptcy judges have established a reputation for speed and efficiency in handling the Chapter 11 cases filed in Delaware. In a study of Delaware cases in the 1990s, a co-author and I found that Delaware cases were indeed appreciably faster than cases in other districts.[5] We also found that companies appeared to be attracted to Delaware by the expertise of the Delaware

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[4] Professor Douglas Baird and Dean Robert Rasmussen give a vivid illustration of the precariousness of the empirical data. Using Professor LoPucki's data, they show that the statistical significance of his finding that companies that reorganized in Delaware in the 1990s were more likely to file for bankruptcy a second time disappeared if he used a time period other than five years. If he considered companies that refilled within one, two, three, four, or six years of the first reorganization. Delaware would not have looked statistically different than other venues. Douglas G. Baird & Robert K. Rasmussen, Beyond Recidivism, 54 *Buffalo Law Review* 343, 352 (2006).

[5] The study is described and the results reported in Kenneth Ayotte & David A. Skeel, Jr., An Efficiency-Based Explanation for Current Reorganization Practice, 73 *University of Chicago Law Review* 425, 461 (2006).

bankruptcy judges.[6] The single best predictor of whether a company would file for bankruptcy in Delaware rather than in the state of its headquarters was the relative expertise of the two bankruptcy courts. If the local judges were experienced in handling Chapter 11 cases, the company was much more likely to file the case in the state of its headquarters.

In the past decade, many of the very largest cases—the so-called mega mega cases—have filed for bankruptcy in the Southern District of New York. Here, too, they appear to have been attracted by the expertise of the New York bankruptcy judges. The New York judges are expert in dealing with the administrative and other complexities of the very largest cases. The court has developed the infrastructure to handle these cases.

If Congress were to remove domicile and affiliate filing as venue options, it would destroy the expertise that has been developed in these courts. Although it is difficult to know for sure, I suspect that the amendments would increase the administrative cost of the bankruptcy system. The administrative efficiency that the Delaware and New York bankruptcy courts have developed would be lost. Other courts would not handle enough cases to replicate this efficiency, which would increase the overall administrative costs of the bankruptcy system. It also seems very likely that the overall effectiveness of the bankruptcy system would decline.

I do not mean to suggest that the current bankruptcy system is perfect. I do think that courts have not scrutinized proposed sales of assets under section 363 as carefully as they should, particularly when the buyer is a current lender or insider.[7] But changing the venue rule is not the solution, and it would seriously undermine the effectiveness of the current framework.

Convenience

The other major objection to the current system is that Delaware and New York filings are inconvenient to employees, other local creditors and the local community. It is much harder

[6] *Id.*

[7] This issue is discussed in *id.* at 464-67 and David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences* 170-173 (2011).

to attend a hearing in Delaware or New York, the reasoning goes, than it would be to attend hearings in the company's principal place of business.[8]

It is important to keep in mind that the vast majority of Chapter 11 cases, and the majority even of large cases, are filed in the district where the company has its headquarters and principal place of business. For all of these cases, convenience is thus not an issue. Moreover, the cases that tend to be filed locally are the cases in which local creditors are most likely to wish to participate.

Of the large companies that do file for bankruptcy in Delaware or New York, many are companies for which no single location will be convenient for most of its local creditors. When a retailer like Kmart (although Kmart itself filed for bankruptcy in Chicago) files for bankruptcy, for instance, there will be local creditors nearly everywhere in the country. There is no single, ideal filing location. Moreover, for these companies, Delaware and New York are more convenient than many locations. Both are serviced by major airports and by train lines.

There obviously may be exceptions to these patterns, and convenience for as many parties as possible is an important concern. But gutting the venue statute is not the best solution to this concern. Two better approaches already exist. First, if a case truly does not belong in Delaware or New York, the district court has the power to transfer the case "in the interest of justice or for the convenience of the parties."[9] A number of cases have been transferred under this provision, and courts could be encouraged to use it still more frequently.

The other solution is to make it as convenient as possible for creditors and other interested parties to participate in cases even when they cannot realistically appear in person. The use of telephonic and video appearances already is increasing and should be encouraged. Small creditors also are represented by the creditors committee— and in some cases by special committees—and are entitled to access information gathered by the creditors committee.

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[8] For further discussion of the issues in this section, see, e.g., David A. Skeel, Jr., What's So Bad About About Delaware?, 54 *Vanderbilt Law Review* 309, 310 (2001).

[9] 28 U.S.C. § 1412.

Conclusion

Although Chapter 11 is not perfect, it works remarkably well. Indeed, I believe it is the most effective corporate bankruptcy framework in the world. The solution to its flaws is to address the flaws directly, not to change the venue rules. In my view, changing the venue rules would undermine Chapter 11, and would be a serious mistake.