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Jared A. Ellias

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Bankruptcy Law:
*Explaining Bankruptcy Forum Shopping*¹

Jared Ellias

Forum shopping is one of the most controversial features of American corporate bankruptcy law. The controversy dates back to Congress's decision in 1978 to create a unified court system for both consumers and businesses in local federal bankruptcy courts. Acknowledging that this geographically focused system is a clumsy fit for large firms with operations in many different jurisdictions, Congress implemented a venue statute that gives most large companies their choice of several jurisdictions. Over the past thirty years, the corporate bankruptcy bar has embarked on an ambitious experiment in forum shopping, effectively rewriting the statute to create two de facto specialized national-business bankruptcy courts: the District of Delaware and the Southern District of New York. Why have more than 60% of large firms in recent years chosen to file for bankruptcy in those two venues?

A large literature has sought to answer this question, chiefly through case studies and interviews with lawyers. That literature is a debate between two feuding camps. One camp believes that these two experienced courts attract firms because they have expert judges and stores of legal precedent that make bankruptcy more predictable. A rival camp disputes this explanation, arguing instead that "predictability" is a cloak for the true, self-interested motivation of the managers, lawyers, and senior creditors that influence the debtor's venue decision. In support of this position, a judge in Texas recently cast doubt on the value of judicial expertise, pointing out that the Bankruptcy Act is the same in all jurisdictions. A better explanation, he implied, was geographic convenience for the New York lawyers and bankers who dominate corporate bankruptcy practice.²

Which camp is right ought to have a market answer. In a well-functioning market, the prices of a bankrupt firm's financial claims at the beginning of the bankruptcy process incorporate a large quantity of information that amounts to an unbiased estimate of the outcome of the

1. Summarized and excerpted from Jared A. Ellias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119 (2018).

2. See *In re Crosby Nat'l Golf Club, LLC*, 534 B.R. 888 (Bankr. N.D. Tex. 2015).

bankruptcy process and the future value of the firm. If predictable law and expert judges drive forum shopping, the market should be better at predicting bankruptcy outcomes in Delaware and the Southern District of New York than in other jurisdictions. This claim can be tested by looking for evidence in theoretically unbiased market data.

This chapter summarizes an article that tested this claim with a new methodology and a hand-collected dataset of 285 large bankrupt companies linked to the trading-price records of 1,049 financial contracts (investments characterized as corporate loans, bonds, and equity). The evidence from this study suggests that the first camp is right: experience matters.

The data reveal investment returns for traders who buy claims against a Chapter 11 debtor at the beginning of the bankruptcy process and receive the bankruptcy payoffs at the end of the case. To illustrate the test statistic, consider a debtor that borrowed \$100 from a bank. When the company falls into distress, an investor can buy the bank's claim at a discount to the face value of the debt. In this example, suppose the distressed investor bought the claim for 50 cents on the dollar (\$50) and received a payoff at the end of the bankruptcy process equal to 60 cents on the dollar (\$60). This investor earned a 20% return on her investment, or

$$\frac{60-50}{50} = \frac{10}{50} = .2.$$

The squared return is $\sqrt{.2^2} = .04$

Importantly, if the investor had sustained a 20% loss, the squared return would be $\sqrt{-.2^2} = .04$

Thus, the test statistic measures the “pricing deviation”: The absolute difference between the market's recovery expectations at the beginning of the bankruptcy process and the discounted present value of the ultimate bankruptcy payoff. All else equal, a low price deviation suggests that the market's pricing assumptions were relatively accurate.

The results generally support the view that the market is able to form more accurate recovery expectations for the firms that reorganize in the two destination jurisdictions. Under both ordinary least squares and quantile regression, the data show that filing in Delaware or New York is associated with a lower pricing deviation than in other bankruptcy venues. The difference is statistically significant when

controlling for firm size and industry, the lawyers advising the debtor, the duration of the bankruptcy case, changes in market conditions over the bankruptcy period, prepackaged or prenegotiated filings, and other potential confounding variables. The evidence is highly robust for Delaware individually, which is statistically significant in all specifications.

It is possible, though unlikely, that an omitted variable explains the results. For example, the market may simply be better informed *ex ante* about the types of firms that reorganize in the destination courts. But there does not appear to be an obvious reason why this would be true. All firms in the sample are large firms without obvious confounding differences in the distribution of firm industry across the venue cohorts. Further, the rate of coverage by Wall Street research analysts—a common proxy variable for market informedness in the literature—shows no evidence of a pattern that would explain the results. Alternatively, the firms that reorganize in Delaware and New York could simply be inherently more predictable firms. But, again, common proxy variables for firm-specific uncertainty used in other research, specifically prebankruptcy stock variance and cash flow volatility, offer no evidence of a systematic difference across the venue cohorts.

In theory, the influence of predictable law and legal precedent should be strongest at the beginning of the bankruptcy process. As the firm moves through the bankruptcy process, the judge will issue orders, which should diminish uncertainty about the outcome, and the theoretical benefit of *ex ante* predictability should diminish. Consistent with this theoretical expectation, the observed pricing advantage of New York and Delaware persists in the early part of the bankruptcy case but dissipates as the case advances deeper into the plan of reorganization process and as the firm prepares to emerge from bankruptcy protection. These results suggest that the market's observed advantage in pricing accuracy only persists during the period in which knowledge of law and the judge would appear to matter the most.

The theoretical losers of increased predictability are the holders of junior claims. As Chapter 11 firms generally cannot pay their debts in full, junior claims such as unsecured debt and equity are often equivalent to out-of-the-money call options on the assets of the bankruptcy estate, which are more valuable when underlying asset values are uncertain. Further, junior claimants have incentives to reduce their expected losses and extract hold-up payments by using litigation to impose costs and uncertainty on senior creditors. In theory, then, junior claims are worth less when uncertainty is lower and the

bargaining leverage that junior claimants expect to acquire through litigation might be reduced if the law has fewer ambiguities to exploit and the judge has the experience to filter weak claims. As theory would suggest, the data show that out-of-the-money claims of Delaware-venued bankrupt firms appear to be worth relatively less at the beginning of the Chapter 11 process as compared to claims of firms reorganizing in less experienced venues, controlling for heterogeneity in capital structure, market conditions, and the ultimate payoff.³ Importantly, this does not appear to be the result of a transfer of value from senior creditors. However, I do not find evidence of the same relationship for the New York-venued sample.

The data do not support the claim that senior claimholders drive forum shopping for their advantage. The market price of senior claims at the end of the bankruptcy process does not suggest that bankruptcy judges in the destination venues disproportionately approve plans of reorganization that transfer value to senior creditors from junior claimants. A pro-secured creditor bias (or a pro-management bias) could, however, be expressed through other channels. While the data support the views of the proponents of bankruptcy forum shopping, it is possible that the predictions of both the proponents and detractors of forum shopping have merit. The data also do not resolve whether the firms that reorganized elsewhere would have been better off filing for bankruptcy in a destination venue. The main conclusion is that the market appears to be better at predicting the outcome of the bankruptcy process in more experienced bankruptcy courts and that this correlation is robust to controls and supported by other evidence.

3. In the language of option-pricing theory, the value of the out-of-the-money claim theoretically increases in the volatility of the bankruptcy case. The results here suggest that the greater certainty of more experienced courts effectively reduces the volatility of the bankruptcy case, and the pricing consequences appear to be consistent with what option-pricing theory would predict.

Bankruptcy Law:
*What is Bankruptcy Claims Trading?*¹

Jared Ellias

The rise of claims trading is one of the most important changes in bankruptcy practice over the past thirty years. Many critics fear that claims trading has made Chapter 11 much harder to administer. Chapter 11 is built on a model that assumes managers will have lengthy and contentious negotiations with creditors that culminate in a consensual settlement and a fully supported plan of reorganization. In the late 1990s, however, practice began to drift further and further away from this classic paradigm as, the story goes, a robust secondary market developed in the debt and equity of Chapter 11 debtors. Some creditors decided not to negotiate with managers and instead sold their claims to a new type of investor that both helped to create the secondary market and grew along with it: distressed hedge funds that specialize in activist investing in Chapter 11. Over the years, there have been many calls to change bankruptcy law or practice to accommodate what many see as a disruptive change.²

This chapter summarizes the first empirical study of the one of the largest markets for bankruptcy claims: trading in the corporate bonds issued by Chapter 11 debtors. The study relies on the entire record of bond trading for all Chapter 11 debtors that filed for bankruptcy between 2002 and 2012, matched to important dates and case information from the court dockets. The data source used for the study—the FINRA TRACE dataset, which is a record of all over-the-counter secondary-market transactions in fixed-income securities, as reported by FINRA member broker-dealers—has a key limitation. Consider a hypothetical trade of a small amount of a bond issued by Debtor prior to Debtor's bankruptcy. Assume that one hedge fund sells the right to receive \$100 from Debtor to another investor for \$10 (or 10 cents on the dollar) on March 1, 2005. The dataset reveals that a trade of \$100 of Debtor's bond issue happened on March 1, 2005, at the sale price of \$10. It does not, however, reveal the identity of the buyer or the seller. While this limits the empirical conclusions, the data still

1. Summarized and adapted from Jared A. Ellias, *Bankruptcy Claims Trading*, 15 J. EMPIRICAL LEGAL STUD. 772 (2018). This summary was originally published, with minor alterations, as *What is Bankruptcy Claims Trading? Evidence from Bond Trading*, 37 A.B.I. J. (Dec. 2018).

2. See, e.g., Aaron L. Hammer & Michael A. Brandess, *Claims Trading: The Wild West of Chapter 11s*, 29 A.B.I. J. (July/August 2010).

show that the market for Chapter 11 bonds is, though very active, perhaps less important for the administration of bankruptcy law than many critics have feared.

The Chapter 11 bond sample consists of all bonds issued by Chapter 11 debtors that traded while the issuing firm was operating in Chapter 11: 389,154 individual trades on 54,536 trading days in 494 bonds issued by 204 firms with an aggregate face value of \$512 billion and an aggregate market value of approximately \$280 billion. These bonds often trade at a substantial discount to par, which explains the difference between the face value and the market value of the trades. As the numbers suggest, the Chapter 11 bond market is a very large market.

One important question is how active the market for Chapter 11 debt actually is. While the literature commonly speaks of a “robust” secondary market, it is also common for courts and commentators to assume that Chapter 11 debt trades in an “illiquid” market. Obviously, each description is right some of the time, but the advantage of empirical approach is that it reveals which is right more often on average. On average, 94% of Chapter 11 debtors that file for bankruptcy with outstanding bond debt experience trading in their bonds while the firm is in Chapter 11. In fact, Chapter 11 bonds are, on average, among the most heavily traded bonds in the corporate-bond market as a whole. The median Chapter 11 bond experiences turnover during the bankruptcy case—where turnover is defined as the total volume of trading scaled by the face value of the bond—that places it in the top 15% of all outstanding corporate bonds. In other words, the median Chapter 11 bond trades more actively than 85% of the corporate-bond market.

While most Chapter 11 bonds are actively traded, the sample reveals a wide distribution of trading. For the median bond, aggregate trading is equivalent to more than 113% of the outstanding face value of the bond between the petition date and the approval of a plan of reorganization. This is not to say that 113% of petition-date holders of the bond sold their claim to a new investor. Because the dataset does not reveal the identity of the traders, it cannot distinguish between, for example, three trades of approximately 40% of the issue, with the other 60% held by a patient investor, or 113% of the bond issue traded once. The tails of the distribution are very different than the median, with the 25th percentile bond only seeing 27% aggregate turnover and the 75th percentile bond seeing more than 345% aggregate turnover during that same period. Thus, while the majority of Chapter 11 cases involve heavy trading, the level of trading in the most actively traded bonds is qualitatively different from the median case.

Trading also appears, on average, to be the heaviest at the beginning of the bankruptcy case. On average, 3% of an outstanding bond issue trades on every trading day between a firm's petition date and the approval of DIP financing. Trading drops sharply, to about 1% of the outstanding bond issue, for every day of the case subsequent to the approval of DIP financing, and the average level of trading falls again once the disclosure statement is approved. This pattern of trading suggests that, on average, the market for Chapter 11 debt is most active relatively early in the bankruptcy process.

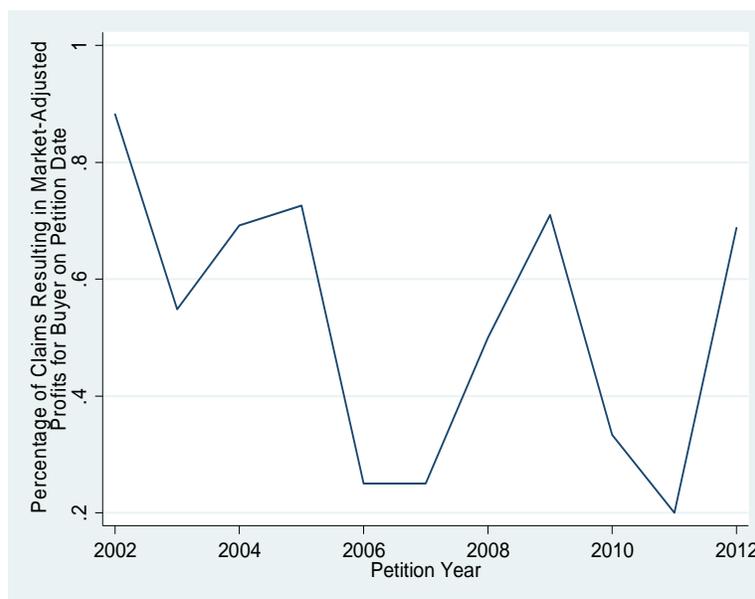
An interesting pattern in the data is that trading across levels of a firm's capital structure is relatively uncorrelated. To illustrate, consider a firm with senior bonds and subordinated bonds. In general, the level of trading in the senior bonds does not predict the level of trading in the subordinated bonds, and vice versa. On the other hand, when multiple bond issues are outstanding at the same level of claim priority—two issues of senior unsecured bonds, for example—trading in those bonds is highly correlated. This pattern suggests that traders tend to focus on one level of a firm's capital structure at any given time. Interestingly, trading in the bonds that receive a distribution of equity at the end of the bankruptcy case does not appear to be statistically significantly heavier than in bonds that receive a distribution of cash or debt.

The results presented above show that there is an active market for the claims of Chapter 11 debtors, but they do not answer an important question: how much value (if any) are claimholders giving up by selling their claims? The classic story of bankruptcy claims trading involves the sale of claims issued by bankrupt firms from traditional institutional investors to nontraditional investors, such as hedge funds, with expertise in bankruptcy. If the result of this trade involves a systematic transfer of value to specialized risk-bearers, perhaps the liquidity provided to prebankruptcy creditors presents something of a trade-off.

Investigating how selling claimholders fare required studying a subsample of claims priced around the petition date and near plan confirmation to measure the market value of the distribution the claimholder receives under the plan of reorganization. The market-adjusted returns for the claim buyer can be calculated by assuming the seller reinvests the proceeds of the sale in an S&P 500 index fund on the same day she sold her claim and sold the index fund on the day the plan was confirmed.

The graph below shows the percentage of trades resulting in profit, by the year the firm filed for bankruptcy. For purposes of this graph, each bond in the dataset is equally weighted and the y-axis shows the percentage of all Chapter 11 bonds issued by firms that filed for

bankruptcy in each sample year that resulted in a market-adjusted profit for the buyer. For example, 80% of the Chapter 11 bonds that traded around the petition date for the firms that filed for bankruptcy in 2002 offered market-adjusted profits to the buyer if she bought the claim on the petition date and sold it at the end of the bankruptcy process for the then-market price.



As a threshold matter, the buyers of claims at the beginning of the bankruptcy process do better than a selling claimholder only about 61% of the time. The data also appear to show that hypothetical petition-date buyers do better than sellers when the economy is emerging from recessions, while sellers do better than buyers when the economy is doing well. This is consistent with distressed-debt hedge funds bidding down returns in good times, while the sheer supply of distressed debt in bad times leads to large profits for skilled investors.

None of the evidence so far answers perhaps the most important question of all: What does all this activity mean for bankruptcy governance? After all, bankruptcy law is not terribly concerned with arms-length trades in bankruptcy claims and whether buyers or sellers do better more often. What actually matters is how those trades affect the way Chapter 11 is administered. Managers do not generally negotiate with all of the holders of a bond issue; instead, they negotiate

with the activist investors who seek to influence the bankruptcy case. While some large investors may buy all of a bond issue on their own, for the most part groups of funds participate in the bankruptcy case together as “ad hoc groups.” Bankruptcy Rule 2019 requires these ad hoc groups to file disclosure statements identifying, among other things, the names of the group members and how much they held. Rule 2019 also requires ad hoc groups to file amended disclosure statements when their composition and holdings change.

The Rule 2019 statements reveal how ad hoc groups change over the course of Chapter 11.³ The sample consists of 100 initial statements, of which the median statement was filed 42 days into the bankruptcy case—on average, around the time that DIP financing was approved.⁴ Of these initial 100 groups, 42 of them never filed an updated Rule 2019 statement. Of the groups that did file updates, the changes to group composition and holdings tended to be relatively slight; very few groups changed in a material way over the course of Chapter 11. For the updating groups, the group members from the original Rule 2019 statement held, on average, 86% of the debt held by the final group in the last statement filed with the court, showing that the initial group members nearly always remained in control of the ad hoc group by the end of the case. Ad hoc groups tended not to acquire new members, and the existing members rarely bought additional debt during the bankruptcy case.⁵

This finding presents a puzzle: How is the heavy level of trading in bond debt consistent with the fact that ad hoc groups tend to enter early and seldom change very much by the end of the case? One hypothesis is that the claims trading during the bankruptcy case is much more about passive speculation than it is about influencing the outcome of the bankruptcy case. In other words, claims trading is less a route for activist entrance and exit and more an opportunity for non-activist

3. This method certainly misses the cases where one hedge fund owns nearly all of the bond issue and acts on its own, outside of the scaffolding of an ad hoc group. However, those cases are relatively rare, and the case where that one investor then sells to another single investor are probably rarer still, so it is unlikely that this biases the overall findings in a way that renders them unreliable.

4. There was a slight lag between the ad hoc group’s initial appearance in the case (on average, 24 days after the petition date) and the filing of a Rule 2019 statement (on average, 42 days after the petition date), so most groups were probably active and negotiating earlier than the initial Rule 2019 disclosure.

5. The Rule 2019 statements filed by ad hoc groups holding loans (101 groups) showed the same pattern of group stability.

investors to make passive investments. Of course, some of those non-activist funds might have the ability to become activists if necessary to defend their claims. Moreover, the mere existence of a claims-trading market clearly casts a shadow on the bankruptcy bargaining table. Additionally, the composition of creditor groups on the petition date probably reflects claims trading that occurred prior to the firm's Chapter 11 filing, meaning that claims trading is still important for bankruptcy governance. However, the results in this study cast doubt on the argument that new regulation is needed to deal with the churn created by claims trading during the Chapter 11 case itself—there appears to be less churn than was previously understood.