I Introduction

The costs of corporate reorganization are strangely compelling in a financial crisis, or even a run of the mill recession. The hundreds of millions of dollars paid by “bankrupt” or “insolvent” firms like Lehman Brothers, or Enron before it, merely to address their situation often seems quite odd to the casual reader of the *Wall Street Journal*, who still thinks of bankruptcy as the equivalent of corporate death.1

A similar phenomenon can be seen in the academic literature, dating back to at least Modigliani and Miller in 1958, and the notion that a firm’s capital structure amounts to little more than slices in a pie.2 In this world, debtor-firms are typically discussed relative to a backdrop of complete contracts and zero transactions cost.3 Accordingly, firms that encounter financial distress – that is, having liquid assets insufficient to meet current fixed claims – simply renegotiate their obligations and proceed accordingly.4 Slight deviations from the background assumptions can be assumed and then addressed by neatly automated responses.5 That Kmart, a large discount store chain, would pay more than $134 million to professionals to do so is inconsistent with this idealized understanding of the world, and thus each dollar spent is deemed evidence of inefficiency.

Of course, both views of “bankruptcy” are based on basic misunderstandings or gross oversimplification. Both assume that financial distress is costless, whereas even liquidation does not happen by itself.6 Indeed, only abandonment of a distressed firm might be costless – if we limit our conception of cost to actual “out of pocket” expenditures by the debtor-firm.7

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1 Throughout I follow American practice and use “bankruptcy” to refer to the insolvency or failure of a business entity – typically a corporation – cognizant of the fact that in some jurisdictions bankruptcy only refers to the financial distress of individuals.
More broadly, understanding the cost of a corporate reorganization system is important because debtor-firms face the reality of a world with incomplete contracts, incomplete information, uncertain asset values, and complex capital structures that highlight the many ways in which assumptions about capital structure irrelevance or managerial rationality, or both, fail. Given these truths, and the added reality of asset market disruptions, it is generally thought that reorganization structures are important tools to avoid excessive and economically disruptive liquidation of firms’ assets. And if given a choice of possible approaches to reorganization, the cost of any particular system, weighed against its benefits, provides an obvious metric for evaluation.

In this context, a study of the costs of chapter 11 of the United States Bankruptcy Code is important along at least two dimensions. First, such a study is important within the United States, as it provides important information for policymakers and creditors about the efficiency of the present system and how it might compare with possible alternatives. Second, and perhaps more importantly, given the economic relevance of the United States, which remains the largest single economy, and its relatively long history of corporate reorganization, the cost of chapter 11 can provide important information in other jurisdictions seeking to remodel their own business bankruptcy systems.

This study provides an examination of chapter 11 costs using two datasets. First, I examine a dataset comprised of more than 900 randomly selected chapter 11 cases filed in 2004. In addition, I also utilize a dataset of 97 large chapter 11 cases, also filed in 2004. Both datasets are amongst the largest, if not the largest, datasets ever used in a study of chapter 11 costs. Considered together, these two

datasets provide important insights not only on the very large cases that are the subject of most theoretical inquiry, but also for the more typically smaller chapter 11 cases that might be more comparable with bankruptcy or insolvency cases in other jurisdictions.

Chapter 11 is part of a larger system of American business bankruptcy. The current Bankruptcy Code was enacted in 1978, replacing the prior Bankruptcy Act, which had been in place since 1898, although with substantial amendments enacted during the 1930s. Chapters 1, 3, and 5 provide general provisions that apply in all types of bankruptcy cases, personal and business. Chapter 7 provides the kind of liquidation bankruptcy proceeding that can be found in any developed economy: A trustee takes charge of the debtor’s assets, sells them, and pays out the proceeds to creditors according to a set statutory scheme. Chapter 11 can be used for either reorganization or liquidation, but the default rule is that the debtor stays “in possession” of its own bankruptcy estate, with a trustee appointed only in cases of gross mismanagement.

Under both chapters 7 and 11, debtors enjoy the protection of an automatic stay, which prohibits most collection efforts as soon as the bankruptcy petition is filed. And while chapter 11 is often derided as overly long and overly expensive, such simple descriptions of chapter 11 ignore the dynamic nature of the process, which is no longer as it was when first enacted in 1978.

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The aim of this study is on one level descriptive. I describe the nature of chapter 11 costs, and how those costs are distributed in chapter 11 cases. Moreover, I develop models of chapter 11 direct costs that can be used to predict chapter 11 costs ex ante and evaluate chapter 11 costs ex post.

And the goal of the study is also to provide specific information about the components of chapter 11 cost. In particular, in Chapters 5 and 6 I look at the cost associated with bankruptcy attorneys and financial advisors. Taken together, these two groups of professionals account for almost 60% of total chapter 11 costs.

Another goal of this study is to provide baseline information for considering both the efficiency of chapter 11 and the cost of future chapter 11 cases. The models presented in this paper allow for a prediction of what a typical chapter 11 case should cost. Future cases that fall outside the prediction intervals warrant extra scrutiny and even criticism. And the cost information presented herein provides

16 David A. Skeel, Jr., Creditors’ Ball: The “New” New Corporate Governance in Chapter 11, 152 U. Pa. L. Rev. 917, 918 (2003) (“The endless negotiations and mind-numbingly bureaucratic process that seemed to characterize bankruptcy in the 1980s have been replaced by transactions that look more like the market for corporate control.”).
a basis for comparing chapter 11 to other American corporate transactions, as well as other corporate reorganization systems, both theoretical and actual systems in use in other jurisdictions.