

The Microeconomics of Chapter 11 – Part 1

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The argument that chapter 11 professional fees are too high is largely dead, at least in academic circles.¹ Several recent studies, admittedly based on rather humble sample sizes, have put the level of fees in large chapter 11 cases at about 2.5 percent of assets or less.² This compares favourably with other significant corporate transactions.³

But little attention has been given to the issue of how professional fees are allocated within chapter 11 cases. As several of the prior studies have noted, while it is easy to think that chapter 11 professional fees are all bankruptcy related, in fact all debtors would some incur some amount of professional fees even in the absence of financial distress.⁴

Further, even those professional fees that are related to the firm's financial distress are not necessarily related to professionals with bankruptcy-specific expertise. For example, with or without chapter 11, a firm that wants to sell its assets will need the services of corporate attorneys who can document the transaction.

Examining these issues is of vital importance because a significant strain of bankruptcy scholarship is premised on the notion that chapter 11 is excessively expensive, notwithstanding the existing evidence that suggests otherwise.⁵ In particular, these theorists employ the long-recognised principle that lenders will recoup anticipated losses through higher *ex ante* interest rates to support the argument that altering or

Notes

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Disclosures. First, the data used in this study was initially collected by a leading law firm for use in litigation. Ultimately, the litigation was resolved without use of the database. The firm had originally contacted me about serving as an expert witness, but that proved unnecessary as a result of the settlement. I am grateful that the firm has allowed me to use the data for this article. The firm in question does not appear in the database.

Second, as discussed in the text, *infra* Part II, the sample used for this study is comprised of approximately 4,000 time entries in chapter 11 cases filed between 2001 and 2003. At various times from 1995 through 2002 I was an associate in the corporate reorganization department of a law firm that appears frequently in my database, and one of the time entries in the sample is my own. Further, I billed time on matters for two other debtors in this sample before they filed their chapter 11 cases. All information contained in this article is based upon publicly available material. The opinions expressed in this article are my own, and must not be taken to reflect the opinions of my former employer or any former client. Cf. Charles A. Sullivan, *The Under-Theorized Asterisk Footnote*, 93 *Geo. L. J.* 1093 (2005).

- 1 See Douglas G. Baird, 'Bankruptcy's Uncontested Axioms', 108 *Yale L.J.* 573, n.3 (1998) ('Lawrence A. Weiss ... showed me that the direct costs of bankruptcy were lower than I (and many others) had thought.'). *But see* Aruro Bris *et al.*, 'Who Should Pay Bankruptcy Costs?', 34 *J. Legal Stud.* 295, 295-94 (2005) ('The fees of professionals ... drain substantial resources from the estates of large bankrupts.'). Press articles about the expense of chapter 11 continue to abound. *E.g.*, Richard Truett, 'Filing for bankruptcy can be an expensive proposition', *Crain's Detroit Business*, April 4, 2005.
- 2 Lynn M. LoPucki & Joseph W. Doherty, 'The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases', 1 *J. Empirical L. Stud.* 111, 140 (2004) (reporting that the average ratio of fees and expenses to assets in a sample of 48 chapter 11 cases was 2.2%); Stephen J. Lubben, 'The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases', 74 *Am. Bankr. L.J.* 509, 540 (2000) (finding that professional fees averaged 2.5% of assets if prepackaged cases were excluded from the sample); Lawrence A. Weiss, 'Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims', 27 *J. Fin. Econ.* 285, 286 (1990) (reporting professional fees of 3% of assets, based on a sample of 31 publicly traded firms that filed for bankruptcy in the early 1980s). Cf. Jerold B. Warner, 'Bankruptcy Costs: Some Evidence', 32 *J. Fin.* 337, 340 (1977) (discussing a sample of eleven railroad cases filed under section 77 between 1933 and 1955).
- 3 See Lubben, 'The Direct Costs of Corporate Reorganization', *supra* note 2, at 542.
- 4 See LoPucki and Doherty, *supra* note 2, at 119; Lubben, 'The Direct Costs of Corporate Reorganization', *supra* note 2, at 519.
- 5 *E.g.*, Lucian A. Bebchuk, 'Ex Ante Costs of Violating Absolute Priority in Bankruptcy', 57 *J. Fin.* 445 (2002); Barry E. Adler, 'A Theory of Corporate Insolvency', 72 *N.Y.U. L. Rev.* 343 (1997); Alan Schwartz, 'A Normative Theory of Bankruptcy', 91 *Va. L. Rev.* 1198 (2005).

even replacing chapter 11 will reduce the costs of debt financing and thus promote efficiency.⁶ But if most of the supposed costs of chapter 11 are in fact exogenous to the Bankruptcy Code, this entire body of scholarship may be hollow, inasmuch as changes to chapter 11 will be of slight consequence to the overall *ex ante* costs of debt finance. Reductions in the cost of chapter 11 may have only a modest correlation with reductions in the cost of financial distress.

This paper thus offers the first look at the intra-debtor distribution of professional fees. I analyse a new sample of almost 4,000 attorney time entries, from more than 30 law firms, in 27 very large chapter 11 cases filed between 2001 and 2003 to look at several basic questions regarding the allocation of attorney's fees within chapter 11 cases. For example, I look at the relationship between an attorney's hourly rate and their contribution to the monthly costs of chapter 11. I look for evidence of staffing decisions that favour the professionals – do the cases seem to be staffed with a high number of senior attorneys with high hourly rates? I also examine the departments involved in the chapter 11 cases, and their proportional contribution to the overall fees in the cases.

Examining the costs of corporate reorganisation from an internal perspective reveals several important new insights, including that

- Most of the attorneys in large corporate bankruptcy cases are not bankruptcy specialists; bankruptcy attorneys comprise only a quarter of the overall legal talent deployed in the average case.
- About forty percent of the attorneys' fees in a case relate to bankruptcy attorneys, which suggests that as much as sixty percent of the legal costs may be exogenous to chapter 11.
- While it is common to focus on the high hourly rates charged by partners at leading law firms, that focus may be misguided. Attorneys in the top quartile of hourly rates spend almost 30 hours per month on debtors' cases, but attorneys in the middle two quartiles spend an average of 40 hours on these cases, resulting in far greater costs to the estate.

The remainder of this paper proceeds in three parts. First, I review the fee studies that have been done to date. These studies have generally undermined many

of the earlier contentions about chapter 11, but they have yet to look at the internal allocation of professional fees within a chapter 11 case. Part II then presents the empirical results of this paper. And Part III looks at the implications of my findings for the ongoing debates about chapter 11.

I argue that this study provides another hurdle to those who would replace chapter 11 with some other approach, as the costs of chapter 11 include costs that these other systems would likely also experience.⁷ Moreover, I use Part III of the paper to develop the broader argument that *ex ante* costs of chapter 11 are virtually irrelevant to current discussions of chapter 11. Specifically, while the costs of chapter 11 might be relevant if the *status quo* is extremely inefficient or a proposed new bankruptcy system results in substantial cost reductions, neither situation presently holds. Thus I reject the recurrent fixation with the *ex ante* costs of chapter 11 in the academic literature.

But my findings also suggest that bankruptcy courts could do a better job of prodding law firms to improve their approach to large chapter 11 cases. I doubt that these firms are intentionally adopting suboptimal staffing strategies – indeed, even the patterns I see in this study may be defensible – but there are several policy questions embedded in the staffing patterns I find, and Congress has yet to express a clear preference on many of these points.

For example, if the heavy use of mid-level associates by the firms in the sample is a reflection of the hiring policies at these firms, is that a cost that should be born by the estate and thus its creditors? Good arguments exist to support both answers to this question, but it is not clear that these arguments are being considered in any meaningful way by the relevant parties to the debate. Thus, I conclude by arguing that courts, and the United States Trustee, are not focused on the costs of chapter 11 in a way that will have meaningful results. The pattern of staffing in chapter 11 cases is far more complex than 'conventional wisdom' has previously suggested.

I. The macroeconomics of chapter 11

To date there are four main studies of professional fees in large chapter 11 cases, each of which looks at the costs of chapter 11 in the aggregate.⁸ First, Lawrence

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- 6 See, e.g., Alexander Hamilton, 'Report on Public Credit', in *Writings* 531, 540-41 (Joanne B. Freeman ed. 2001) (arguing that failure to pay existing public debt according to its terms would ultimately cost the United States when it sought to borrow in the future).
- 7 See generally Elizabeth Warren & Jay Lawrence Westbrook, 'Contracting Out Of Bankruptcy: An Empirical Intervention', 118 *Harv. L. Rev.* 1197 (2005).
- 8 In addition, Robert M. Lawless and Stephen P. Ferris have conducted a series of important studies on the bankruptcy costs for smaller businesses that I omit because of differences in scale. See Stephen P. Ferris & Robert M. Lawless, 'The Expenses of Financial Distress: The Direct Costs of Chapter 11', 61 *U. Pitt. L. Rev.* 629 (2000); Robert M. Lawless & Stephen P. Ferris, 'Professional Fees and Other Direct Costs in Chapter 7

Weiss studied a sample of 37 publicly-traded firms that filed for bankruptcy between 1979 and 1986.⁹ The study offered the first examination of direct costs under the 1978 Bankruptcy Code.¹⁰

Weiss first looked at the costs associated with bankruptcy filings. He defined the direct costs of bankruptcy as the ‘legal and other professional and administrative fees associated with the bankruptcy filing’.¹¹ Three measures were employed to calculate these costs: (1) market value of equity, (2) book value of debt plus the market value of equity, and (3) book value of total assets.¹² These values were assessed at the end of the fiscal year before the bankruptcy filing.¹³ The study concluded that, on average, the direct costs of bankruptcy were 20.6% of the market value of equity, 3.1% of the book value of debt plus the market value of equity, and 2.8% of the book value of total assets.¹⁴

Ultimately, Weiss found that direct costs of bankruptcy were substantially lower than previous studies had reported.¹⁵ Further, other factors such as the leverage afforded unsecured creditors under the 1979 Bankruptcy Code to delay final resolution of the bankruptcy and to negotiate with secured creditors as well as firm size and location of the bankruptcy filing had a more significant impact on the costs of bankruptcy and the maintenance – or lack thereof – of the priority of claims. Therefore, Weiss concluded that direct bankruptcy costs ‘will have little or no impact on the pricing of claims before bankruptcy’.¹⁶

In 1997, Brian Betker examined more up-to-date data with respect to direct costs of bankruptcy.¹⁷ He asserted that ‘several related innovations’ had changed the way firms restructured their debt and could alter firms’ direct costs of bankruptcy.¹⁸ First, he noted the growth of pre-packaged chapter 11 cases.¹⁹ Second,

during the 1980s and 1990s, a number of highly leveraged transactions (HLTs) became financially distressed and had to restructure their debt.²⁰ Presumably claimholders involved in HLTs would seek to preserve as much going-concern value as possible by restructuring quickly and efficiently.²¹ Third, during this time, a distressed-debt market had developed in which funds would buy large blocks of debt in distressed firms to obtain voting power and equity in reorganised firms.²² Though some viewed these investors as predatory ‘vultures’ who sought to delay reorganisations just to extract concessions from debtors, Betker argued that ‘by consolidating large blocks of debt, vulture investors facilitate[d] restructurings by reducing the number of claimholders...’.²³ Finally, informal bondholder committees usually formed as a result of large debt defaults, for which the financially distressed firms typically agreed to pay advisors’ fees.²⁴ Thus, with these new effects on debt restructurings in mind, Betker sought to determine the direct costs of bankruptcy.

Betker studied a sample of 157 firms that experienced financial distress between 1986 and 1993, including 75 traditional chapter 11s, 48 prepacks and 29 exchange offers.²⁵ He found that the direct costs of traditional chapter 11 cases averaged 3.93% of total prebankruptcy assets (median 3.37%) which was substantially larger than average direct costs for prepacks (mean 2.85%, median 2.38%), though direct costs for exchange offers (mean 2.51%, median 1.98%).²⁶ Betker further found evidence of economies of scale in restructuring debt; that is, direct costs increased with total assets but declined with the square of total assets and that the restructuring type did not affect the ‘concave relation between direct costs and firm size’.²⁷

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Business Liquidations’, 75 *Wash. U. L.Q.* 1207 (1997); Robert M. Lawless et al., ‘A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies’, 1994 *U. Ill. L. Rev.* 847.

9 Lawrence A. Weiss, ‘Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims’, 27 *J. Fin. Econ.* 285 (1990).

10 *Id.* at 286.

11 *Id.*

12 *Id.* at 289.

13 *Id.*

14 *Id.* Market value of equity for the sample ranged from 2.0% to 63.6%; book value of debt plus the market value of equity for the sample ranged from 1.0% to 6.6%; book value of total assets for the sample ranged from 0.9% to 7.0%. *Id.*

15 *Id.* at 299.

16 *Id.* at 299.

17 Brian L. Betker, ‘The Administrative Costs of Debt Restructurings: Some Recent Evidence’, 26 *Fin. Mgmt.* 56 (1997) (hereinafter ‘Betker (1997)’)

18 *Id.*

19 *Id.*

20 *Id.*

21 *Id.* at 56-57.

22 *Id.*

23 Betker (1997), *supra* note 17, at 57.

24 *Id.*

25 *Id.* at 58. Betker defined a prepack as ‘one in which the firm filed both a bankruptcy petition and plan at the same time and where the firm’s creditors had either officially accepted the plan in a binding vote or all impaired creditor classes agreed in principle to vote for the plan’ and an exchange offer as ‘an out-of-court restructuring in which new securities (cash, equity, or debt) are exchanged for old debt’. *Id.*

26 *Id.* at 57.

27 *Id.* at 59.

In calculating fees as a percentage of total post-restructuring assets plus cash and property distributed to creditors, Betker found that median direct costs to firm value for traditional chapter 11s was 4.63% which was significantly larger than that for prepacks (2.64%) or exchange offers (2.26%).²⁸ Thus, Betker concluded that firms involved in chapter 11 reorganisations lost more firm value than firms involved in prepacks or exchange offers.²⁹

In an attempt to understand the varying levels of direct costs, Betker related direct costs as a percentage of pre-restructuring total assets to a series of explanatory variables.³⁰ He found that on average, traditional chapter 11 cases were larger than prepacks or exchange offers, though the median firm size did not differ significantly.³¹ Prepacks were more likely to involve HLTs than chapter 11s or exchange offers.³² Exchange offers tended to restructure the smallest fraction of debt while chapter 11s restructured the most classes of debt.³³ Further, traditional chapter 11 was typically used to restructure private and trade debt, while prepacks and exchange offers were mostly used to restructure public debt.³⁴ Finally vulture investors ended up with blockholdings in 44 cases.³⁵

Betker found that the study's results for traditional chapter 11s were consistent with his expectations.³⁶ The ratio of direct costs to assets was lower in cases involving HLTs, but the cost savings declined as the fraction of public debt in the capital structure increased.³⁷ Firms incurred less direct costs when a vulture investor acquired a 5% stake in the reorganised firm, but those cost savings decreased as the firm size increased.³⁸ For prepacks, Betker concluded that direct costs were negatively related to firm size and

positively related to the proportion of restructured debt held by trade creditors.³⁹ Vulture involvement did not seem to significantly affect the costs of prepacks.⁴⁰ For exchange offers, the results indicated that direct costs were positively related to the percentage of debt and the number of classes restructured and negatively related to firm size.⁴¹

Therefore, Betker ultimately concluded that pre-packaged bankruptcy costs were similar to exchange offers, and both were lower than traditional chapter 11 filings.⁴² Direct costs in chapter 11 cases were lower if the firm involved was an HLT, but the cost savings decreased as the ratio of public debt to total debt increased.⁴³ Direct costs of chapter 11 were also lower when vulture investors were involved in the restructuring.⁴⁴ Thus, Betker's study indicated that debt restructurings were less expensive when creditors had less trouble coordinating their efforts.⁴⁵

Next Lubben set out to challenge the existing perception that, notwithstanding Weiss and Betker, the direct costs of chapter 11 were 'excessive'.⁴⁶ Lubben conducted a study of 22 corporate bankruptcies and reported evidence that the direct costs of chapter 11 were in fact nominal, both empirically and analytically, that is to say, 'not only on a simple percentage basis but also in relation to other significant corporate transactions'.⁴⁷ Lubben asserted that many prior studies, including Betker's, overstated the direct costs associated with chapter 11 filings. Some studies 'reflect a general lack of understanding of the workings of chapter 11 ...'.⁴⁸ For example, many studies included fees incurred by all professional firms employed during the bankruptcy period, thereby failing to take account of the non-bankruptcy services performed by many of

Notes

28 Betker (1997), *supra* note 17, at 61.

29 *Id.* at 61.

30 *Id.*

31 *Id.* at 63.

32 *Id.*

33 *Id.*

34 Betker (1997), *supra* note 17, at 63. For example, none of the 29 exchange offers and only 10 of the 48 prepacks restructured any trade debt while only 9 of the 29 exchange offers restructured any private debt. *Id.*

35 *Id.* at 64.

36 *Id.*

37 *Id.* at 66.

38 *Id.*

39 *Id.*

40 Betker (1997), *supra* note 17, at 66.

41 *Id.*

42 *Id.* at 56.

43 *Id.*

44 *Id.*

45 *Id.* at 67.

46 Stephen J. Lubben, 'The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases', 74 *Am. Bankr. L.J.* 509, 510 (2000) (citing Sol Stein, *A Feast for Lawyers: Inside Chapter 11 – An Expose* (1989); Lynn M. LoPucki, 'The Trouble with Chapter 11', 1993 *Wis. L. Rev.* 729 n.6; Alexander L. Paskay & Frances Pilaro Wolstenholme, 'Chapter 11: A Growing Cash Cow Some Thoughts on How to Rein in the System', 1 *Am. Bankr. Inst. L. Rev.* 331 (1993)).

47 *Id.* at 511.

48 *Id.* at 511-12.

those firms.⁴⁹ Other studies included the costs of failed workouts or previous efforts at restructuring while asserting that workouts were more efficient than chapter 11 reorganisation.

Accordingly, Lubben asserted that prior reports of the direct costs of chapter 11 have been exaggerated and thus provide little basis for comparison.⁵⁰ Lubben challenged those who would propose replacing chapter 11 with an alternative method of reorganisation to ‘either demonstrate that their system will result in lower direct costs than the already modest costs of chapter 11, or that their system will appreciably reduce the indirect costs of chapter 11 to result in a net reduction of combined costs’.⁵¹

To show that the professional fees and expenses incurred during chapter 11 were relatively minimal, Lubben analysed a sample of 22 large, public and private firms that filed for bankruptcy in 1994.⁵² The study examined professional fees along three dimensions: ‘(a) fees as a percentage of the firm’s overall debt load, (b) fees as a percentage of the debtor’s reported assets, and (c) fees in relation to total firm size’.⁵³ With respect to the entire sample, the direct costs of chapter 11 were found to average 0.87% of total firm size.⁵⁴ When prepackaged bankruptcies were removed from the sample, the direct costs increased to 1.20% of total firm size.⁵⁵ When measured as a percentage of assets, direct costs were found to average 1.8% of total firm size for the entire sample and 2.5% of total firm size when prepacks were excluded.⁵⁶ Additionally, Lubben found no indication of a scale effect for the direct costs of chapter 11.⁵⁷ Lubben ultimately concluded that ‘the direct costs of the current chapter 11 regime are quite modest, and [thus] the efficiency gains from many of

the proposed reforms may be quite feeble, if such gains are not lacking altogether’.⁵⁸

With these results in hand, Lubben asserted that ‘chapter 11 arguably represents a sizeable bargain’.⁵⁹ In light of the evidence indicating that direct costs of chapter 11 are ‘quite modest’,⁶⁰ critics claiming that the current chapter 11 scheme is inefficient would be hard-pressed to propose alternative reorganisation schemes that would impose less direct costs on financially distressed firms.⁶¹

Finally, and most recently, Lynn LoPucki and Joseph Doherty reported on ‘one of the most extensive studies to date of the professional fees and expenses awarded by U.S. bankruptcy courts in the reorganisation of large, public companies’.⁶² LoPucki and Doherty studied the professional fees and expenses awarded by U.S. bankruptcy courts in 48 chapter 11 cases involving large, public companies whose plans were confirmed between 1998 and 2002.⁶³ The authors distinguished these fees and expenses from the traditional notion of ‘direct costs’ of bankruptcy, claiming, like Lubben, that direct costs were usually both under and overstated in empirical studies.⁶⁴ For example, this sample’s ‘measure included only professional fees and expenses advanced by professionals’.⁶⁵ Further, ‘professionals who work on behalf of secured creditors may be entitled to recover their fees and expenses as part of their clients’ claims’, which though not paid directly from the debtor’s estate tended to reduce the overall value of the estate nevertheless.⁶⁶ The authors also pointed out that the phrases ‘professional fees’ and ‘in connection with the case’ as stated in the Bankruptcy Code were ambiguous and thus subject to varying interpretations amongst the different bankruptcy courts.⁶⁷ Additionally, since

Notes

49 *Id.* at 518-19.

50 *Id.* at 519.

51 Lubben, *Direct Costs*, *supra* note 46, at 512.

52 *Id.* at 511.

53 *Id.* at 512.

54 *Id.*

55 *Id.* at 512-13.

56 *Id.* at 513.

57 Lubben, *Direct Costs*, *supra* note 46, at 513.

58 *Id.*

59 *Id.* at 542.

60 *Id.* at 534.

61 Lubben, *Direct Costs*, *supra* note 46, at 544-45.

62 Lynn M. LoPucki & Joseph W. Doherty, ‘The Determination of Professional Fees in Large Bankruptcy Reorganization Cases’, 1 *J. Emp. L. Stud.* 111, 111 (2004).

63 *Id.*

64 *Id.* at 117.

65 LoPucki & Doherty, *supra* note 62, at 117.

66 *Id.*

67 *Id.* ‘Bankruptcy Code § 330(a)(1) authorizes the court to ‘award to a ... professional person [whose employment was previous authorized by the court] reasonable compensation for actual, necessary services rendered ... and ... reimbursement for actual, necessary expenses.’ Bankruptcy Rule 2016 requires that ... [a]n application for compensation shall include a statement as to what payments have therefore been made or promised to the applicant for services rendered ... in connection with the case’ *Id.* at 116.

courts typically required professionals to file 'final' fee applications shortly after the reorganisation plan has been confirmed, many applications also contained some post-confirmation fees as well.⁶⁸ Finally, the authors noted that professional fees and expense awards typically include only those costs that would be paid by the debtor's estate, thus excluding any fees or expenses that were to be paid by parties other than the debtor in possession.⁶⁹

The authors constructed a regression model of the principal determinants of fees and expenses applied for and awarded to the professionals involved in the sample's reorganisations in order to test the impact of different variables on such awards.⁷⁰ They tested a number of different variables, including the size of the firm, the length of the case, the court of the bankruptcy proceeding, the number of professional firms involved in the case, the solvency of the firm, the type of reorganisation plan being confirmed, the firm's industry, the amounts of fee cuts imposed by the court, whether the firm was liquidated during the bankruptcy proceeding, whether the debtor's lawyers were from New York, whether the firm ultimately liquidated or reorganised, and whether the debtor's lawyers were local to the court.⁷¹ However, LoPucki and Doherty ultimately settled on just four variables for use in their regression: firm size (measured by the assets reported on the bankruptcy petition), case duration, the number of professional firms seeking fees, and the location of the bankruptcy proceeding.⁷²

Using this model, LoPucki and Doherty concluded that firm size and length of time between filing and confirmation were the strongest determinants of professional fees awarded.⁷³ Further, the number of professional firms seeking reimbursement also impacted the overall amount of professional fees awarded, albeit causing a smaller effect than the first two variables.⁷⁴ Using only those three factors in their regression analysis, LoPucki and Doherty were able to explain 77% of the variance of fees.⁷⁵ Additionally, by controlling for

those three variables, the authors found that fees were significantly higher for bankruptcy cases proceeding in Delaware (approximately 32% higher).⁷⁶

LoPucki and Doherty also sought to determine whether the costs associated with chapter 11 cases were declining. To do this, they compared their results with those reported earlier by Weiss who conducted a study of 37 firms that had completed bankruptcy reorganisations between 1980 and 1988.⁷⁷ They adjusted Weiss's dollar amounts for inflation, assigned a dummy variable to distinguish their data, combined the two sets of data and ran a regression.⁷⁸ Controlling for debtor size, they found that the fees and expenses awarded in their cases were approximately 57% lower than those awarded in Weiss's cases, thereby indicating that chapter 11 reorganisations could be accomplished more cheaply today than in the early 1980s.⁷⁹ However, after adding duration of the case to their regression, LoPucki and Doherty found that the difference was no longer significant.⁸⁰ Instead, the results indicated that the decline in the cost of reorganisation resulted from accompanying change in the length of time cases remained pending.⁸¹ In other words, the authors concluded that chapter 11 reorganisations were cheaper in their study because they were shorter.⁸²

In each case, the foregoing studies examined only the aggregate level of fees associated with chapter 11. In the next section, I provide the first internal look at the costs of chapter 11.

II. The microeconomics of chapter 11

In this portion of the paper I present the results of my empirical look at intra-case professional fees. In the first section I introduce the study. Sections B and C then look at the distribution of attorney fees among specialties and across lawyers of differing seniority.

Notes

68 *Id.* at 118.

69 *Id.*

70 LoPucki & Doherty, *supra* note 62, at 119.

71 *Id.* at 119-20.

72 *Id.* at 120.

73 *Id.*

74 *Id.* at 120.

75 *Id.*

76 LoPucki & Doherty, *supra* note 62, at 120-21.

77 LoPucki & Doherty, *supra* note 62, at 138 (citing Weiss, *supra* note 9).

78 *Id.*

79 *Id.*

80 *Id.*

81 *Id.* at 139.

82 *Id.*

A. The sample

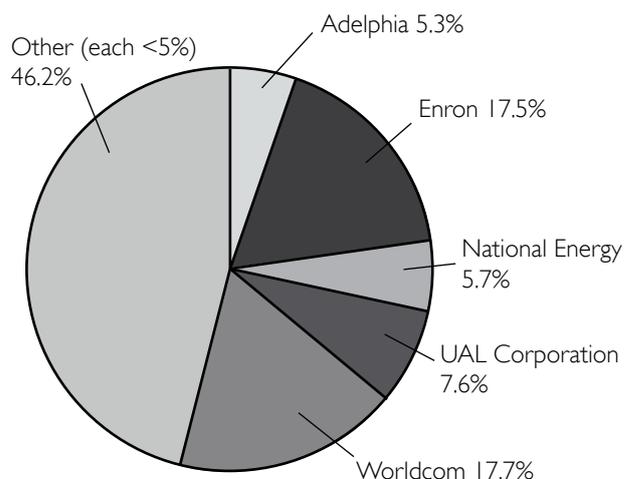
The sample is comprised of 3,909 time entries, representing the work of 2,181 attorneys in chapter 11 cases in from October, 2001 through November, 2003.⁸³ In total, the sample encompasses 552,482.88 billable hours, representing USD 231,703,868.13 in attorneys' fees.

The sample was gathered in early 2004 by a large law firm in connection with litigation regarding its retention in a chapter 11 case.⁸⁴ Paralegals from the firm selected the cases by referring to published listed of the largest chapter 11 cases from the three prior years and hand coding the data from court pleadings, typically interim or final fee applications. Since the firm in question gathered this data to provide context for its own billing practices, the firm was intentionally excluded from the database.

The firm used this approach to generate a sample that would be comparable to the case it was litigating. The sample's obvious limitation is the potential availability bias resulting from the need to construct a sample within the time limits inherent in ongoing litigation. There is no reason to believe, however, that the sample is not at least generally representative of the admittedly rarified world of large, public company bankruptcy cases. And while it is conceivable that the law firm in question might have 'stacked' the sample with cases that favoured its litigation position, the need to establish credibility with the bankruptcy court, especially in light of the specific facts of the case, would seem to argue against such a move. That said, it is important to reemphasise that this sample is not representative of corporate debtors generally, but rather only reflects very large corporate debtors and is heavily tilted toward cases from New York City and Delaware, the leading jurisdictions for these types of very large cases.

The breakdown of the time entries among the chapter 11 cases is shown on Table 1. Each debtor's size, as measured by pre-bankruptcy assets, is also shown. Not surprising, the Enron and WorldCom cases are the largest sources of time entries, each representing just more than 17 percent of the time entries in the sample.⁸⁵ Overall, the four major cases that involved

Figure 1. Time entries by case



noteworthy allegations of pre-bankruptcy managerial misconduct represent 44.1 percent of the time entries in the sample.⁸⁶

There are 33 different law firms represented in the sample, although almost 70 percent of the time entries come from five law firms.⁸⁷ Weil, Gotshal & Manges LLP, lead counsel to both Enron and WorldCom, contributes more than 30 percent of the time entries in the sample. Sixty-five percent of the entries in the sample relate to attorneys who represented the debtors, with the remainder belong to committee attorneys.

More than eighty percent of the time entries in the sample relate to law firms based in New York,⁸⁸ and just over seventy percent of the time entries relate to cases that were pending in the Southern District of New York. Table 2 shows the complete distribution of time entries among districts.

Notes

83 As used in this paper, the phrase 'time entry' refers to an attorney's time reflected in a single fee application, which typically relates to a period of several months, rather than their entry for a single day, which is how the phrase is often used by practicing lawyers. This means that each attorney is typically associated with one time entry per case, although occasionally an attorney can have multiple time entries within a single pleading or case. This occurs, for example, when the attorney's hourly rates change during the period covered by the pleading coded for this sample.

84 Ultimately, the litigation was resolved without use of the database. See, *supra* note *.

85 As measured by reported assets – an admittedly tenuous figure in both cases – and without adjusting for inflation, these are the two largest chapter 11 cases ever. See <www.bankruptcydata.com/Research/15_Largest.htm>.

86 In addition to Enron and Worldcom, I include Adelphia Communications and Global Crossing in this category.

87 Akin Gump Strauss Hauer & Feld LLP; Skadden, Arps, Slate, Meagher & Flom LLP; Sonnenschein Nath & Rosenthal LLP; Weil, Gotshal & Manges LLP; and Willkie Farr & Gallagher LLP.

88 Chicago and Boston based law firms were the only others with more than 100 times entries each. Regardless of where a firm is based, most of the sample firms would be considered 'national' law firms, and thus have offices throughout the country.

Table I: Time entries by case

	<i>Assets (millions)</i>	<i>Frequency</i>	<i>Percent of Total</i>	<i>Cumulative Percent</i>
ACTERNA Corporation, et. al.	\$978	70	1.8	1.8
Adelphia Communications Corp., et al.	\$21,499	206	5.3	7.1
Allegiance Telecom, Inc., et al.	\$1,441	25	.6	7.7
Amerco, a Nevada corporation, et al.	\$3,773	47	1.2	8.9
ANC Rental Corporation, et al.	\$6,350	71	1.8	10.7
Bethlehem Steel Corporation, et al.	\$4,347	170	4.3	15.1
CONSECO, Inc. et al.,	\$61,392	79	2.0	17.1
DVI, Inc.	\$1,672	37	.9	18.0
Enron Corp., et al.	\$63,300	683	17.5	35.5
Global Crossing LTD, et al.,	\$30,185	143	3.7	39.2
Hayes Lemmerz International, et al.	\$2,812	86	2.2	41.4
K-Mart Corporation, et al.	\$14,630	186	4.8	46.1
Leap Wireless International, Inc.	\$2,163	24	.6	46.7
Loral Space & Communications Ltd., et al.	\$2,693	46	1.2	47.9
Magellan Health Services, Inc., et al.	\$965	103	2.6	50.6
National Energy & Gas Transmission, Inc., et al.	\$2,718	223	5.7	56.3
Northwestern Corporation	\$2,673	12	.3	56.6
NRG Energy, Inc. et al.	\$10,884	56	1.4	58.0
Regus Business Centre Corp., et al.	\$368	84	2.1	60.1
Reliance Group Holdings, Inc., et al.	\$12,598	143	3.7	63.8
Spiegel Inc., et al.	\$1,890	167	4.3	68.1
UAL Corporation, et al.	\$25,197	298	7.6	75.7
US Airways Group Inc., et al.	\$7,941	96	2.5	78.2
USG Corporation, a Delaware Corporation, et al.	\$3,214	4	.1	78.3
WestPoint Stevens Inc., et al.	\$1,369	49	1.3	79.5
Worldcom Inc., et al.	\$103,900	693	17.7	97.2
XO Communications, Inc.	\$7,930	108	2.8	100.0
Total		3909	100.0	

Table 2: Time entries by district

	Frequency	Percent	Cumulative Percent
SDNY	2783	71.2	71.2
Delaware	173	4.4	75.6
ND III	563	14.4	90.0
Nevada	47	1.2	91.2
ED Virginia	96	2.5	93.7
SD California	24	.6	94.3
Maryland	223	5.7	100.0
Total	3909	100.0	

Table 3: Attorney characteristics

		Hourly Rate	Hours Billed	Total Fees Billed	Seniority of Attorney
Not Bankr. Atty	Mean	428.66	115.06	47600.08	1.99
	N	2,960	2,952	2,955	2960
	Std. Deviation	141.57	270.66	114587.01	.876
	Skewness	0.39	6.82	7.41	.013
Bankr. Atty.	Mean	426.73	225.44	96242.75	2.03
	N	949	944	946	949
	Std. Deviation	146.23	416.01	178059.32	.881
	Skewness	0.64	4.78	4.67	-.055
Total	Mean	428.19	141.81	59396.02	2.00
	N	3,909	3,896	3,901	3909
	Std. Deviation	142.70	315.66	134396.51	.877
	Skewness	0.46	6.10	6.32	-.003

To complete the overview of the sample, I next look at the hourly rates and hours billed by the attorneys in the database. As shown on Table 3, the attorneys in the sample bill, on average, 141.81 hours per month on the chapter 11 cases in the sample, at an average hourly rate of USD 428.19. Only the difference in mean hours

per month and total fees billed are significant ($p < .01$). In short, there is no significant difference among bankruptcy and non-bankruptcy attorneys with regard to hourly rates or seniority of the attorneys in the respective sub-samples.⁸⁹

Notes

⁸⁹ The seniority measure, which I utilise again in section C, is a three-point scale variable, ranking attorneys based on their graduation from law school, with '1' corresponding to the most senior attorneys. The rankings are standardised by making them relative to the mean date of the fee application. See, *infra* Part II(C).

In general, attorneys working for creditors committees have somewhat lower average hourly rates and number of hours billed when compared to debtors' counsel. There was no significant difference in seniority.

B. Specialisation in chapter 11

As noted earlier, simply measuring the total professional attorneys fees associated with a chapter 11 case overstates the costs that are unique to chapter 11.⁹⁰ Large corporations employ a substantial number of attorneys regardless of their financial condition, and corporations in financial distress are likely to retain a goodly number of attorneys even in the absence of chapter 11. The key question, at least for those who would consider alternatives to chapter 11, is what part of the overall costs of chapter 11 are unique to chapter 11.

As an initial matter, it is helpful to consider the specialties of the attorneys involved in chapter 11 cases. Table 4 shows specialisation information for all 3909 time entries in the sample.

This table shows that in the overall sample corporate specialists outnumber bankruptcy specialists, and litigators are almost as common as bankruptcy attorneys.⁹¹ Tax attorneys are also playing significant roles in these chapter 11 cases. Bankruptcy attorneys make up 23.7% of all attorneys retained by debtors and 29.2% of all attorneys retained by creditors committee, highlighting the fact that non-bankruptcy attorneys are significant contributors to both sides of a chapter 11 case.⁹²

Not surprisingly, litigation attorneys are more common in the four cases with serious allegations of fraud,⁹³ representing about 25 percent of the total attorneys in such cases, as opposed to just under 13 percent of the total attorneys in the other cases. But it is difficult to draw further conclusions from this information, since it is conceivable that the raw numbers are not reflective of the actual amount of work each type of attorney is performing.

This supposition gets some support from Table 5, on which I show further information about the hourly rates and billable hours spent on the bankruptcy cases in the sample. Because the attorneys in the sample

billed their time over different time periods, I have now standardised their total fees and hours on a per month basis.⁹⁴ I also show fees and hours further standardised by the pre-bankruptcy assets reported on Table 1. Table 5 shows these data for the entire sample as well as for the sample as divided between bankruptcy and non-bankruptcy attorneys.

The differences in means among the subgroups on Table 5 are all significant at the .01 level. Accordingly, the average bankruptcy attorney bills almost twice as many hours per month on a case as her non-bankruptcy counterpart, with the predictable result that bankruptcy attorneys represent more than their proportionate share of the debtor's total monthly attorney fees. The standard deviations for all figures are admittedly quite large, especially for the bankruptcy attorneys. And quick glance at the mean and median (not shown) numbers for all attorneys confirms that the hours billed figures are skewed at the upper end.

Committee attorneys spend approximately four hours less per month than debtors' counsel and thus bill less per month on average, as shown in Table 5A. The differences in means on this table are again significant at the .01 level.

Tables 4 and 5 together show that while the proportion of attorneys in chapter 11 cases who are bankruptcy specialists is low, these attorneys do result in more than their proportionate share of costs to the estate. This may be indicative of a practice, apparently unique to bankruptcy departments, of concentrating work into a smaller group of associates. Whether this is a strategic decision or simply a reflection of the fact that bankruptcy departments are probably smaller than other departments in major law firms is unclear.

Using the numbers in Tables 4 and 5, it is possible to estimate the portion of overall chapter 11 expenses that are unique to chapter 11, using the admittedly crude measure of bankruptcy attorneys as the unique costs.⁹⁵ Thus, of the average of the almost USD 15,000 per month these debtors spent on attorneys, just over USD 6,000 relates to bankruptcy attorneys. The unique costs of chapter 11 accordingly represent about 40% of the total monthly attorneys' fees these debtors incur.

Alternatively, using the size standardised figures, we can say that bankruptcy attorneys contribute USD 1.13 of the USD 2.53 per million dollars of assets that large corporate debtors spend each month on attorneys

Notes

90 See *supra* n.4 and text.

91 If intra-case duplicates are taken out of the sample, the number of bankruptcy attorneys drops to 535 (21.1%) out of a total sample of 2538.

92 These percentage figures exclude attorneys with missing specialisation data.

93 Appendix A shows the information on Table 4, broken down by case type (*i.e.*, fraud and no fraud cases). Approximately 44% of the total time entries in the sample relate to the four cases involving serious allegations of fraud.

94 Cf. Table 3.

95 It is certainly likely that bankruptcy attorneys perform some amount of non-bankruptcy work and vice versa, but I assume for simplicity that these effects cancel each other out.

Table 4: Time entries by department

	<i>Frequency</i>	<i>Percent</i>	<i>Cumulative Percent</i>
Bankruptcy/ Restructuring/Etc.	949	24.3	25.5
Corporate	1123	28.7	55.7
Employment/ Benefits	102	2.6	58.4
Environmental	17	.4	58.9
IP	30	.8	59.7
Labor	19	.5	60.2
Litigation	713	18.2	79.4
Other	84	2.1	81.6
Real Estate	95	2.4	84.2
Tax	423	10.8	95.6
Telecom.	53	1.4	97.0
Trade Practices/Antitrust	112	2.9	100.0
Subtotal	3720	95.2	
Missing	189	4.8	
Total	3909	100.0	

Table 5A: Represented party

		<i>Fees Per Month</i>	<i>Hours per Month</i>
Debtor	Mean	\$15,694.12	36.6410
	N	2560	2560
	Std. Deviation	\$23,619.66	51.0404
Creditor Committee	Mean	\$13,573.38	32.1329
	N	1340	1340
	Std. Deviation	\$20,729.14	45.5632
Total	Mean	\$14,965.46	35.0921
	N	3900	3900
	Std. Deviation	\$22,687.80	49.2679

Table 5: Fees & hours

		<i>Fees Per Month</i>	<i>Hours per Month</i>	<i>Standardised Monthly Fees (per month/assets)</i>	<i>Standardised Monthly Hours (per month/assets)</i>
Non-Bankr. Atty	Mean	11754.14	27.99	1.8529	0.0043
	N	2954.00	2954.00	2954.0000	2954.0000
	Std. Deviation	18809.51	42.31	7.6200	0.0172
	Std. Error of Mean	346.08	0.78	0.1402	0.0003
Bankr. Atty	Mean	24993.19	57.28	4.6624	0.0117
	N	946.00	946.00	946.0000	946.0000
	Std. Deviation	29753.89	61.41	12.3988	0.0328
	Std. Error of Mean	967.38	2.00	0.4031	0.0011
All Attys	Mean	14965.46	35.09	2.5344	0.0061
	N	3900.00	3900.00	3900.0000	3900.0000
	Std. Deviation	22687.80	49.27	9.0932	0.0222
	Std. Error of Mean	363.30	0.79	0.1456	0.0004

while in chapter 11. Or, stated conversely, about 55% of the attorneys' fees are arguably exogenous to chapter 11 by this measure.

More precisely, these numbers can best be seen as the upper bounds of the financial distress costs that are external to chapter 11. Within the approximately 60% of costs associated with non-bankruptcy attorneys is undoubtedly some dead-weight loss associated with the added complexity of the Bankruptcy Code.⁹⁶ For example, a litigator representing the debtor in some ancillary dispute will spend some time learning the new language of 'adversary proceedings' and the Federal Rules of Bankruptcy Procedure.⁹⁷ Thus, the costs exogenous to chapter 11 are probably slightly below the 60% or 55% figures reported, although the precise

degree is a matter of pure speculation, since these costs are likely undetectable in attorney fee records.

But suppose that these costs represent 15 percent of the costs associated with non-bankruptcy attorneys. Or about USD 1,350 of the almost USD 9,000 per month the average chapter 11 debtor spends on non-bankruptcy attorneys. Exogenous costs still represent more than half of the total attorney fees associated with chapter 11.⁹⁸

In the second part of this paper (Volume 4, No. 2), I examine what these data tell us about the staffing of large chapter 11 cases. I then return to the question of the chapter 11 specific costs of financial distress and the implications for theoretical arguments about this most controversial feature of American bankruptcy law.

Notes

96 This complexity has only increased as the result of the poor drafting seen in the 2005 amendments to the Code. See Bankruptcy Abuse Prevention and Consumer Protection Act, Pub. L. No. 109-8 (2005). For example, the new version of § 1112(b) apparently allows conversion to chapter 7 only when the creditors would not want it, new § 503(c), dealing with executive compensation, is virtually indecipherable, and § 1141(d)(5)(C) may be charitably described as a sentence fragment. *Cf.* In re Sosa, NO. 05-20097-FM (Bankr. W.D. Texas 2005) (dismissing a consumer provision of the 2005 amendments as 'inane').

97 See Fed. R. Bankr. P. 7001; see also 10 Collier on Bankruptcy § 7001.01 ('Adversary proceedings are separate lawsuits within the context of a particular bankruptcy case and have all of the attributes of a lawsuit, including the filing and service of a formal complaint and application, with certain modifications, of the Federal Rules of Civil Procedure, as provided in Part VII of the Bankruptcy Rules.'). See generally Elizabeth Warren, 'Vanishing Trials: The Bankruptcy Experience', 1 *J. Emp. Legal Stud.* 913 (2004).

98 The calculation is as follows: $(9,000 - 1,350) \div 15,000 = 0.51$.

Appendix A. Tables 4A & B (Time Entries by Specialty; Fraud and No Fraud Cases)

Table 4A: (No Fraud Cases Only)

	<i>Frequency</i>	<i>Percent</i>	<i>Cumulative Percent</i>
Bankruptcy/Restructuring/Etc.	565	25.9	27.8
Corporate	613	28.1	57.9
Employment/Benefits	88	4.0	62.2
Environmental	15	.7	62.9
IP	23	1.1	64.0
Labor	19	.9	65.0
Litigation	277	12.7	78.6
Other	60	2.7	81.5
Real Estate	78	3.6	85.4
Tax	250	11.4	97.6
Telecom.	13	.6	98.3
Trade Practices/Antitrust	35	1.6	100.0
Subtotal	2036	93.2	
Missing	148	6.8	
Total	2184	100.0	

Table 4B: (Fraud Cases Only)

	<i>Frequency</i>	<i>Percent</i>	<i>Cumulative Percent</i>
Bankruptcy/Restructuring/Etc.	384	22.3	22.8
Corporate	510	29.6	53.1
Employment/Benefits	14	.8	53.9
Environmental	2	.1	54.0
IP	7	.4	54.5
Litigation	436	25.3	80.3
Other	24	1.4	81.8
Real Estate	17	1.0	82.8
Tax	173	10.0	93.1
Telecom.	40	2.3	95.4
Trade Practices/Antitrust	77	4.5	100.0
Subtotal	1684	97.6	
Missing	41	2.4	
Total	1725	100.0	