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Delaware Bankruptcy Capital Status May End With Proposed Law

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By Dawn McCarty and Phil Milford

(Updates with former congressman Michael Castle's comment in 19th paragraph.)

Oct. 18 (Bloomberg) -- Delaware would lose its status as the premier venue for U.S. bankruptcy cases, costing the state's economy an estimated \$100 million a year, under a bipartisan bill sponsored by leaders of the House Judiciary Committee.

Lamar Smith, the Texas Republican who chairs the Judiciary panel, introduced the bill with Michigan's John Conyers, its ranking Democrat. The aim is to prevent court-shopping and make companies reorganize at home "to ensure maximum input from all affected stakeholders," Smith said in a statement. Delaware's Congressional delegation disagreed, citing the Wilmington-based court's expertise.

"When someone has a specific medical problem, they go to a specialist," Representative John Carney, a Democrat, said in an e-mail. "Delaware's courts are our nation's bankruptcy specialists." The state's two U.S. senators, Democrats Thomas Carper and Chris Coons, also oppose the bill.

Under the measure, a corporation may file for Chapter 11 reorganization only in the federal district where its principal place of business or assets are located.

The Chapter 11 Bankruptcy Venue Reform Act of 2011 would thus rule out most of the 90 public companies that since 2006 have sought protection from creditors in U.S. Bankruptcy Court in Wilmington, Delaware, where they are incorporated.

Bill's Supporters

The bill has support from non-Delaware lawmakers seeking "to show they are looking after the interests of their constituents who are attorneys active in the political process and generous with their checkbooks," said Neal Colton, a bankruptcy attorney at Cozen O'Connor in Philadelphia.

Though no companion Senate bill has been introduced, Colton said he considers the House bill "a very serious piece of legislation."

Besides Smith and Conyers, it's sponsored by Howard Coble, the North Carolina Republican who chairs the House subcommittee on courts, and Tennessee Democrat Steve Cohen.

Samuel Gerdano, executive director of the American Bankruptcy Institute, said the bill "has no chance of passing in my opinion."

"Delaware has many supporters within the bankruptcy community, including creditor interests and major banks who have come to rely on the predictability and reliability of practicing there," said Gerdano, whose group has 13,000 lawyers and financial professionals who specialize in bankruptcy as members.

Delaware's Ascendance

Delaware's ascendance as a center for bankruptcy filings came in response to New Jersey's quest more than a century ago to become the U.S. corporation capital, according to University of California, Los Angeles Professor Lynn M. LoPucki in his 2005 book, "Courting Failure."

The Delaware General Corporation Law of 1899 sought to make state regulations less burdensome and develop a more predictable basis of court precedent for business disputes. The reform attracted more companies and, by the 1920s, "no state could best Delaware," LoPucki wrote.

"Nearly all of the large companies that file for bankruptcy in Delaware are incorporated in Delaware," David A. Skeel Jr., a University of Pennsylvania law professor, said last month in testimony to Congress. The proposed legislation "would make it impossible for most to file" for bankruptcy there.

Under current law, a company can file for bankruptcy in its state of incorporation, which for 63 percent of Fortune 500 companies is Delaware, according to the state.

State's Influence

Courts there have often "established the tone and legal direction of corporate governance in America," according to *Directorship*, a magazine for board members.

Wilmington attorney Lewis S. Black, in an article printed and distributed by the state, said Delaware's "advanced and flexible" corporation law, its Court of Chancery and a pro-business attitude among citizens all contribute to its popularity as a place for incorporation. The court's judges hear cases without juries, and punitive damages aren't available to plaintiffs.

Joseph J. Farnan Jr., a retired federal judge who heard bankruptcy cases in Wilmington, said the Smith-Conyers bill may stem from a desire of bankruptcy judges elsewhere to bring business to their areas.

"I think they see the benefits Delaware has seen economically," he said.

Economic Importance

Lawyers and politicians have been complaining about Delaware's bankruptcy dominance for decades, former congressman and ex-governor Michael Castle said in an interview. "It seems to me it had been an ongoing proposition, most of the time I was in Congress."

The political impetus for change probably comes from local attorneys who feel they are missing out on the chance to represent clients with headquarters in their hometowns, Castle said.

The state's economy garners about \$100 million a year in bankruptcy-generated legal fees and spending, according to a database maintained by LoPucki.

This isn't the first effort to change the law. A similar measure in 2005 sponsored by Senator John Cornyn, a Texas Republican, died in committee.

The UCLA database shows that 155 public companies with assets of more than \$500 million sought bankruptcy protection in Delaware from 2000 to 2011. That is 38 percent of the U.S. total of 405. New York's Southern District, which includes Manhattan, was second with 93 cases, or 23 percent. The New York economy benefitted by as much as \$190 million because of larger cases and higher costs, according to the data.

Gregory J. Wawro, a political scientist at Columbia University in New York, said backers of the bill have an advantage because Delaware is a small state with just one House member.

'Sheer Numbers'

"Based on sheer numbers, they should be able to find a majority in favor of it," he said.

Law firms in Wilmington with bankruptcy practices include Richards Layton & Finger PA and Young Conaway Stargatt & Taylor LLP. National firms with offices in Wilmington include Weil, Gotshal & Manges LLP and Pepper Hamilton LLP.

Some firms might move or shrink if bankruptcies dry up, said Charles M. Elson, director of the University of Delaware's Center for Corporate Governance. The change would cut the state's wage and property tax revenue and hurt businesses like restaurants and copying services -- "an impact we don't need," he said.

The bill was supported in U.S. House testimony last month by U.S. Bankruptcy Judge Frank J. Bailey of Boston.

"At the very heart of the concept of venue is the idea that those affected by a court proceeding should have access," Bailey told the subcommittee on courts.

Magnet Courts

So-called magnet courts in New York and Delaware are accessible only by major creditors, not company employees, local officials, landlords and small vendors, Bailey said.

The judge pointed to the bankruptcies of Polaroid Corp. and Evergreen Solar Inc. as companies closely identified with the people and government of Massachusetts that filed in Wilmington, a six-hour drive away.

Evergreen received \$58 million in state incentives to put a plant in Massachusetts, Bailey said. Polaroid's headquarters were in Cambridge, Massachusetts, from its inception in 1937 until after its first Chapter 11 reorganization in 2001. After being bought by Minneapolis-based Petters Group Worldwide LLC in 2005, Polaroid entered bankruptcy again in 2008 in Minnesota.

Attorney Peter C. Califano, a Cooper White & Cooper LLP partner testifying for the Commercial Law League of America, argued at the House hearing that the bill would move bankruptcies "back to the communities most affected by the outcome."

Home Towns

Colton, the Cozen O'Connor lawyer, disputed the claim that putting cases in the home towns of businesses would boost small creditors' involvement.

"As a general rule, little creditors do not actively participate in bankruptcy cases," he said in an interview. "They don't have the time or the sophistication."

Also opposing the bill is Edward T. Gavin, a principal in the turnaround firm NHB Advisors in Wilmington.

"It's a bad solution to a problem that doesn't exist," Gavin said. Creditors aren't locked into the filing jurisdiction since they can ask that the case be moved, he said.

Bankruptcy judges are appointed to 14-year terms, with the number in each district determined by Congress. Delaware has six. Massachusetts, with seven times the population, has five. New York's Southern District, which includes Manhattan, has 11.

Manhattan Courts

Manhattan courts sometimes handle bigger cases than Delaware's, including those of Lehman Brothers Holdings Inc., the largest in history, with assets of \$715 billion, and Ambac Financial Group Inc., with more than \$19.5 billion, according to the UCLA database.

Delaware's largest case last year was Affiliated Media Inc., with \$2.71 billion in assets listed on the database.

Nicholas Govatos, 58, owns Govatos restaurant a few doors from the Wilmington courthouse on Market Street. His place is sometimes packed with lawyers and briefcases that "take up the aisles," he said.

States like Texas and Nevada that are hungry for bankruptcy business already have "cattle businesses and casinos," Govatos said. "I think they should leave Delaware alone."

--With assistance from Derek Wallbank in Washington and Jef Feeley and Steven Church in Wilmington, Delaware. Editors: Charles Carter, John Pickering

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The reason so many large Chapter 11 cases are filed in Delaware is because the lawyers run the courthouse. The Judges in Delaware let the big law firms have whatever they want. They approve fee applications for absurd amounts of money, with hourly billing rates that are 2 -3 times what they are in the rest of the country.

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