

# Vanishing Trials: The Bankruptcy Experience

*Elizabeth Warren\**

The federal bankruptcy system provides two critical points of comparison with data about the overall trends of federal lawsuits and trials. The first is the rising number of bankruptcy filings, which indicates that a growing number of collection actions and debtor-creditor disputes are funneled into the bankruptcy system for relatively quick, cheap resolution. The second point of comparison focuses on adversary proceedings, the lawsuit-like subset of disputes that sometimes are resolved within a bankruptcy. The trend lines here suggest that the number of adversary proceedings filed is climbing, while the number of such disputes that are actually resolved by trial is declining. Like the data about the federal court system generally, these data suggest that the trial is quietly vanishing from the bankruptcy system. Data about the number of judges and about business and nonbusiness bankruptcy cases make it possible to explore two competing hypotheses—a Judicial Workload Hypothesis and a Cost Hypothesis—to explain the overall findings. The data are not conclusive, but they are consistent with the view that judicial workloads explain less of the decline in the number of trials than an increase in litigants' costs of resolving disputes in bankruptcy. The data are also consistent with a vision of bankruptcy as an evolving process that is increasingly standardized (and cheaper) for nonbusiness debtors, while it is highly individualized (and more costly) for business cases. If that vision is right, it has implications both for understanding the changing role of the trial and for considering various statutory proposals to

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I am grateful to Peter Eyre, Class of 2005, for his extraordinary work in assembling the data that are reported in this article. His perseverance in locating the data, his inventiveness in disaggregating and analyzing the data, and his general good cheer in undertaking a project that often looked like an impossible task were exemplary. I also owe a debt to William Rule of the Administrative Office of the United States for his patience and willingness to take on a great deal of extra work to help us find and understand these data. Without these two, this article would not have been written. Professor Robert Lawless read an earlier draft of the article and offered several helpful comments, and Professor Kenneth Klee patiently schooled me on changes in bankruptcy practices over the past 25 years. This article does not represent the views of the Administrative Office or anyone who helped on the article. Any errors are my own.

differentiate further the treatment of large business, small business, and nonbusiness cases.

Bankruptcy filings bear many of the aspects of typical lawsuits. Debtors—both individuals and corporate entities—file petitions naming their creditors and the amounts owed to each and asking the court to distribute assets and to order permanent relief from the collection of many of those debts.<sup>1</sup> Petitions are filed with the federal court, signed under penalty of perjury, and accompanied by a filing fee. Each petition creates a case. The federal district court takes formal supervision but, by standing order in all courts, the case is automatically referred to bankruptcy judges who sit as adjuncts to the district courts. During the course of the case, the bankruptcy judge may hear motions and enter orders binding on all the parties. Final orders may be appealed to the district court<sup>2</sup> and, from there, to the court of appeals and Supreme Court. At the conclusion of the case, the judge signs an order dealing with the outstanding debts, typically discharging the debtor from further liability on many of these obligations. The orders are binding in all courts on all listed parties, and they are enforced by a statutory injunction against any further efforts to collect debts so discharged.

Bankruptcy filings also differ from typical lawsuits in substantial ways. Rarely does a bankruptcy case resolve a dispute between only two parties. Instead, virtually every bankruptcy case filed in the United States alters the legal relationships between the debtor and many other parties—home mortgage lenders, car lenders, credit card companies, banks, physicians and hospitals, alimony and child support recipients, student loan servicers, taxing authorities, utilities, inventory financers, trade creditors, inventory lenders, equity investors, tort victims, labor unions, regulatory authorities, environmental clean-up agencies, buyers and sellers of goods, landlords, tenants, equipment lessors and lessees, patent and trademark licensors and licensees, and bond holders—just to name a few. In the average consumer case, about 15 creditors will be listed;<sup>3</sup> in the typical business case, the claims of about 22 creditors will be resolved.<sup>4</sup> Debtors have choices among different legal regimes for the

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<sup>1</sup>A small number of cases is filed each year by creditors who want to bring a debtor under federal bankruptcy jurisdiction to resolve outstanding debts. 11 U.S.C. § 303. The number of such cases, called “involuntary bankruptcies,” is so small that the Administrative Office of the U.S. Courts ceased publishing data on these cases several years ago.

<sup>2</sup>In the First, Sixth, Eighth, Ninth, and Tenth Circuits, the parties may by agreement take an appeal to a bankruptcy appellate panel rather than a district court. Appeals from the BAP and the district court both go to the court of appeals.

<sup>3</sup>Teresa Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *As We Forgive Our Debtors: Americans in Debt* 20 (Oxford, 1989) (reporting an average of 15.1 creditors per consumer case).

<sup>4</sup>Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 *Am. Bankr. L.J.* 499, 515 (1999).

settlement of their debts, with debtors typically choosing Chapter 7 (liquidation), Chapter 13 (repayment-consumer), or Chapter 11 (repayment-business).

Bankruptcy filings provide two possible points of comparison for understanding changes in litigation in the U.S. legal system. The first is in the raw number of filings. A rise or fall in the number of filings indicates whether more or fewer collection actions and debtor-creditor disputes have been funneled into the bankruptcy system for relatively quick, cheap resolution. Since the early 1980s, the number of filings has been rising.

The second point of comparison focuses on adversary proceedings. Adversary proceedings, or APs, are the lawsuit-like subset of disputes that sometimes arise within a bankruptcy case. The trend lines here suggest that the number of adversary proceedings that are filed is climbing, while the number of such disputes that are actually resolved by trial is declining. Like the data about the federal court system generally,<sup>5</sup> these data suggest that even as the number of lawsuits increases, the trial is quietly vanishing from the bankruptcy system.

Further refinements of the bankruptcy data are also possible. Data about the number of judges and about business and nonbusiness cases make it possible to explore two competing hypotheses to explain the decline in trials: a Judicial Workload Hypothesis and a Cost Hypothesis. The data are not conclusive, but they are consistent with the view that changes in judicial workloads explain less of the decline in the number of trials than an increase in the costs of resolving disputes in bankruptcy.

The data are also consistent with a vision of bankruptcy as an evolving process serving different functions for different kinds of debtors. For consumers, bankruptcy is becoming a standardized solution, with lower costs per case and routine responses to oft-repeated problems. For business cases, by contrast, bankruptcy seems to be evolving as a highly individualized solution, with expensive specialized crafting for each case. If that vision is right, it has implications both for understanding the changing role of the trial and for considering various statutory proposals to differentiate further the treatment of large business, small business, and nonbusiness cases within the bankruptcy system.

## I. SHIFTING DISPUTES TO THE BANKRUPTCY SYSTEM

Bankruptcy is essentially the nonlitigation approach to the resolution of unmet legal obligations. Perhaps the most significant way bankruptcy cases differ from typical lawsuits is that the majority of such bankruptcy cases are largely administrative events. That is, the debtor files a petition and schedules its debts, the legal rules are clear, and creditors make no objection to the debtor's discharge or reaffirmation of the

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<sup>5</sup>See, e.g., Marc S. Galanter, *The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts*, 1 J. Empirical Legal Stud. 459 (2004).

debts. About 25 million debts and other claims were discharged in the bankruptcy system during 2003, most with no motions, objections, or other action on behalf of either the debtor or the creditors.<sup>6</sup>

The discharge of 25 million claims does not, of course, mean that 25 million lawsuits were averted by bankruptcy filings in 2003. Because the amounts are often small and the odds of collecting from a near-bankrupt debtor are slim, many of these claims would have been written off as bad debts rather than proceed to lawsuit and trial. But there would have been some legal actions in the mix. For example, about half the consumer debtors were homeowners.<sup>7</sup> Many were in the midst of foreclosure proceedings that were halted by their bankruptcy filings, and many more avoided a foreclosure action by filing for bankruptcy in advance of the lender's suit. At the other end of the continuum, some businesses file for bankruptcy as lawsuits threaten. Particularly famous examples include Dow Corning, A.H. Robins, and Johns Manville, all companies that halted hundreds of thousands of filings when they declared bankruptcy. The precise number cannot be measured, but there can be no doubt that the bankruptcy system diverts some number of disputes that otherwise would have been litigated in the state or federal courts into a more administrative system for resolution.

Records on bankruptcy filings go back to colonial times.<sup>8</sup> For contemporary purposes, however, bankruptcy filings are directly comparable on a year-by-year basis only after 1979. The Bankruptcy Code was revamped in 1978, with the new law going into effect for all cases filed on or after October 1, 1979. Among the many changes enacted in the 1978 Code was a provision to permit husbands and wives to file a single joint petition. Prior to the change, each person and each legal entity was required to file separately; afterward, legal entities continued to file separate petitions, but married couples were permitted to file only one petition. Because there is no way to link up the number of pre-1979 petitions that represented a single household—a filing for a husband and a wife—it is not possible to make direct comparisons of consumer bankruptcy statistics before and after 1980.<sup>9</sup>

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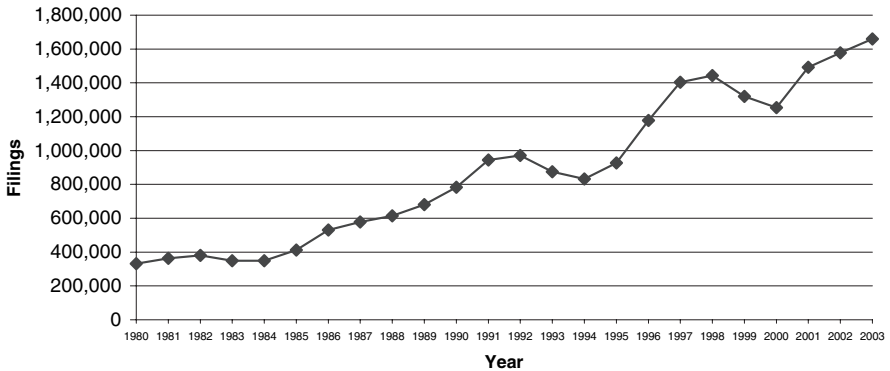
<sup>6</sup>The calculation is based on an estimated 22 claims per business case and about 15 claims per nonbusiness case for the 1,660,220 bankruptcy cases filed in 2003 alone. See *supra* notes 3 and 4 and accompanying text.

<sup>7</sup>Elizabeth Warren, *Financial Collapse and Class Status: Who Goes Bankrupt?* (Lewtas Lecture), 41 *Osgoode Hall L. Rev.* 115, 137 (2003).

<sup>8</sup>See Bruce H. Mann, *A Republic of Debtors: Bankruptcy in the Age of American Independence* (2002).

<sup>9</sup>It would be possible, of course, to determine the number of joint petitions filed today and to calculate how many estates they would have represented before the Code was changed in 1979. The difficulty, however, is that pre-1979 practitioners explain that in many cases only one spouse (usually the husband) filed for bankruptcy, particularly if the other spouse had no independent assets and debts. Today, because that same husband and wife can file jointly for one filing fee, practitioners say they nearly always do. The result is that any effort to link pre- and post-1979 data always runs afoul of an overcounting/undercounting conundrum with no identified basis for determining the size of the error. Estimation is therefore problematic.

Figure 1: Total bankruptcy filings.



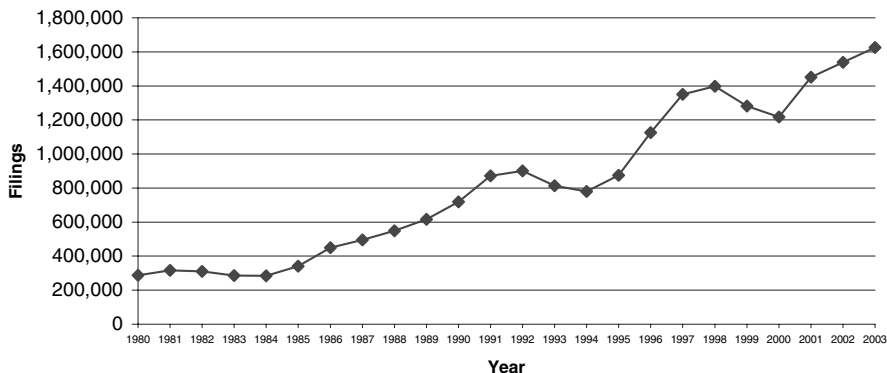
SOURCE: Administrative Office of the U.S. Courts.

The total number of bankruptcy cases filed each year has risen substantially from 1980 through 2003. To the extent that creditors might have turned to the court system for collection and to the extent that either debtors or creditors might have turned to the court system for resolution of their disputes, more claims than ever are being dealt with in the bankruptcy system. As Figure 1 shows, bankruptcy filings jumped from 331,264 in 1980 to 1,625,208 in 2003. If the average number of claims per case remained about the same each year, then the number of claims resolved annually has increased fivefold.

This point is worth some reflection. Millions of obligations—failure to repay borrowed money, employment claims, taxes, tort suits, and so on—are diverted into a largely administrative system for resolution. To be sure, most of these obligations would never have resulted in lawsuits in the absence of bankruptcy, but those that had already filed lawsuits, those that would have filed, and those that never would have become lawsuits were all resolved together, typically by court order through the administrative apparatus of the bankruptcy system. The implication is clear: as bankruptcy filings have risen, the number of lawsuits and potential lawsuits funneled out of the state and federal court system has also risen.

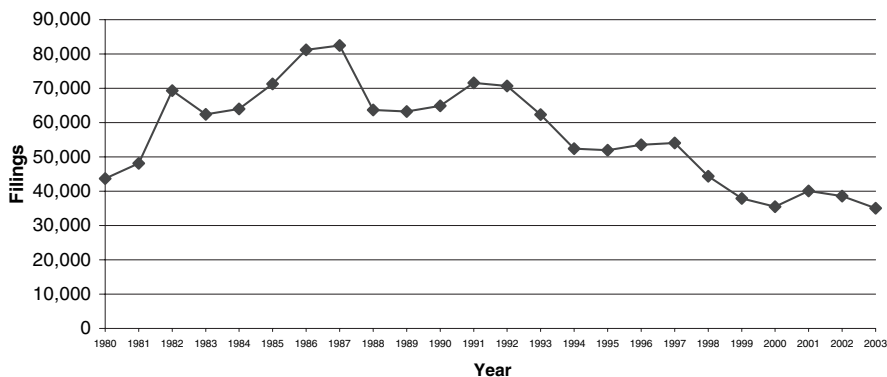
The trend in bankruptcy filings has been sharply upward, but the number of individuals filing for bankruptcy to deal with personal problems has far outstripped the number of corporations, partnerships, and entrepreneurs who file when their businesses get into trouble. As Figures 2 and 3 indicate, disaggregated data show that while nonbusiness filings have risen sharply from around 300,000 in 1980 to more than 1.6 million in 2003, the number of cases designated as business filings has declined from more than 40,000 in 1980 to fewer than 30,000 in 2003. Overall filings have increased, of course, because consumer filings are a larger fraction of total filings.

Figure 2: Total nonbusiness bankruptcy filings.



SOURCE: Administrative Office of the U.S. Courts.

Figure 3: Total business bankruptcy filings.



SOURCE: Administrative Office of the U.S. Courts.

In 1985, for example, filings denominated as business cases were about 17.3 percent of all bankruptcy filings. By 2002, officially reported business filings had dropped to about 2.4 percent of all filings.

The nonbusiness/business distinction in the data separates two very different kinds of cases—families and individuals who file for personal bankruptcy and businesses that seek bankruptcy court protection when they fail. Although the prototypes are clear, the actual nonbusiness/business distinction is tenuous at best. Corporate entities are all classified as business cases. Cases filed by human beings are typically listed as nonbusiness cases, but some cases filed by individuals should be denomi-

nated “business” cases. Debtors who are sole proprietors or partners in failed businesses, for example, might file for personal bankruptcy personally, largely to deal with the fallout from their failed business. The dividing lines between nonbusiness and business cases are not crisp, and there has undoubtedly been some change over time. The Administrative Office of the U.S. Courts once developed and modified guidelines for the local clerks’ classifications of cases as “business” and “nonbusiness.”<sup>10</sup> Currently, the attorney for the debtor fills out a paper to accompany a bankruptcy petition that contains key pieces of information about the case including a designation as “nonbusiness” or “business.” Because cases denominated as “business” may attract more scrutiny, there is every reason in close cases for attorneys to lean toward identifying their human clients as “nonbusiness” cases. There is no such option when the debtor is a corporation, but for individuals, the data may not accurately distinguish between those who are typical wage earners from those who seek bankruptcy protection when their businesses fail.<sup>11</sup>

The option to list entrepreneurs in either the “nonbusiness” or “business” categories suggests a directional bias to the ambiguity between the two classifications. Self-employed persons who file fairly routine bankruptcies with few disputes with their business creditors may slip through the system unchallenged as “nonbusiness” filers, while those who are actively working to save a business or who are engaged in a pitched battle with their business creditors may be more likely to declare their filings as “business.” This directional bias suggests that the nonbusiness/business sorting may work as a rough proxy for separating all bankruptcy filings into two categories: consumer and very small, routine business cases (classified as nonbusiness) and somewhat bigger, more complex or more contentious business cases (classified as business).

The magnitude of the difference in filings between nonbusiness and business debtors cannot be measured with confidence, but the reported data are nonetheless suggestive. The reported changes in filing rates for businesses and nonbusinesses over time suggests that within the overall bankruptcy system, there are different strands of experiences, and that the number of routine cases, denominated as nonbusiness, is multiplying much faster than the number of more complex business cases. The growth of these cases suggests that bankruptcy is serving an important—and growing—role to resolve many potential disputes through a largely routine administrative structure.

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<sup>10</sup>See Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Fragile Middle Class: Americans in Debt* 58, 309 n.92 (Yale Press, 2000); Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *As We Forgive Our Debtors: Bankruptcy and Consumer Credit in America* 40–41, n.1 (Oxford Press, 1989).

<sup>11</sup>For further discussion of the ambiguity of the federal data on the nonbusiness/business distinction, see Robert Lawless & Elizabeth Warren, *The Myth of the Declining Business Bankruptcy Rate* Cal. L. Rev. (forthcoming).

## II. LAWSUITS WITHIN THE BANKRUPTCY STRUCTURE

Parties in the bankruptcy system may sharply dispute either their liability or the amount they owe, but once the debtor has filed for bankruptcy, enthusiasm for pursuing their contests may diminish substantially on both sides. If the debts are all to be discharged or repaid only pennies on the dollar, then the debtor may be willing to admit liability. After all, in that context it makes little difference whether the debtor discharges \$100 in debts or \$200, so admitting and discharging may be one way to resolve outstanding disputes at no cost to the party who is deemed liable. Similarly, creditors may lose their taste to pour more resources into the continued pursuit of their rights if the now-bankrupt estate will be paying little or nothing on outstanding claims. The administrative structure of bankruptcy permits relatively quick, inexpensive resolution of outstanding disputes, and it is reinforced by a practical reality that a bankruptcy filing dulls incentives to pursue any claims. The result is effectively to terminate millions of potential lawsuits before they begin.

Most of the 1.7 million annual filings are resolved as wholly administrative affairs with little or no court involvement; however, a minority of cases involves disputes that require much more court involvement. For example, creditors may challenge an individual debtor's discharge. A debtor may resist, struggling to hang on to the benefits of a discharge, and hard-fought conflicts may arise. In the business context, there are sometimes substantial assets that a creditor can seize if it can prove that it has some form of priority over other creditors, and such efforts may result in intense conflicts with the debtor or other creditors. These and other disputes in bankruptcy may be as hotly contested as in any other part of the court system. Rather than settling their differences as part of a repayment plan or straight discharge, litigants may ask the bankruptcy courts to resolve disputes on which the parties cannot agree. They may request the bankruptcy courts to assist in discovery, to take oral and written evidence, and to issue rulings to resolve their disputes. Losing parties are free to appeal both the findings of fact (to the district court only) and the conclusions of law (to any court in the appellate chain).

In bankruptcy, the challenges filed by aggrieved parties are termed *adversary proceedings*, or APs in the lingo of the cognoscenti. For example, disputes over the debtor's discharge and efforts to revoke a discharge are adversary proceedings. Disputes over the validity of a debt or whether the debt is secured or unsecured also will be brought as adversary proceedings, along with efforts to subordinate a debt or elevate its priority.<sup>12</sup> An AP bears the features of a typical lawsuit, with filing fees, notice to all creditors, and a hearing. At the conclusion of a trial on an AP, a court issues a judgment.

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<sup>12</sup>Bankruptcy Rules, Rule 7001.

AP filings are closely comparable to other lawsuits in the judicial system. The Federal Rules of Bankruptcy Procedure, Rules 7001 through 7087, govern the procedures to be used in AP filings, procedures that closely track the Federal Rules of Civil Procedure. AP filings can be resolved at various stages from the initial bankruptcy filing through the period after a reorganization plan or liquidation has been concluded. Tracking both the number of AP filings and the point of resolution of those APs permits a glimpse into dispute resolution within the bankruptcy system and a possible point of comparison with the evolution of the resolution of lawsuits elsewhere in law.

Bankruptcy cases are replete with voluminous data about each debtor, but the Administrative Office regularly reports only a handful of basic statistics.<sup>13</sup> AP filings are included within those regular reports, but it is important to note that not all trial-level disputes within the bankruptcy system are necessarily listed as APs. Because disputes arise within the context of a pending bankruptcy case, clever attorneys may recast some disputes in forms other than APs, so that courts may sometimes conduct trials over some motions. From a data-collection standpoint, the key difficulty is that there are no known data that capture the number of motions, types of motions, when motions were resolved, or whether the court conducted trials. Although practitioners and judges report that most motions do not result in trials, it is not possible to say with certainty whether some other aspect of the bankruptcy is generating some activity that is closely akin to typical trials in federal courts but that is not captured by the data reported here.

A second difficulty with the data stems from the possibility that very occasionally a single case will produce thousands of APs. This can create a rise at the national level in reported AP filings, even though the higher number does not reflect a systemwide change. As a result, the data about APs can show a one-time variance that is driven by disputes with only one or two debtors.

A third difficulty with comparing AP filings over time involves changes in bankruptcy practices that could affect the number of AP filings.<sup>14</sup> In the early 1980s, shortly after adoption of the new Bankruptcy Code, local rules governed which issues

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<sup>13</sup>These data are reported in total, by circuit and by district each quarter:

- Number of cases filed
- Number of business/nonbusiness filings
- Number of joint/individual petitions
- Number of adversary proceedings filed
- Number of cases closed
- Number of adversary proceedings closed

<sup>14</sup>I am grateful to Professor Kenneth Klee, who explained the details of motion practice and the use of adversary proceedings over the past 25 years.

would be heard by adversary proceedings and which could be heard after a simple motion. In the early 1990s, the Federal Bankruptcy Rules went into effect, making practices more standardized across the county. Many issues that had been resolved by AP in the past were now assigned to resolution by motion. In effect, this means that the number of issues that are eligible for resolution by AP has been shrinking. A direct comparison over time of the number of AP filings inflates the number of AP filings in the early 1980s relative to today because many more issues were resolved by AP then that are left to motion practice today.<sup>15</sup>

At this point, some might give up. The data certainly are not perfect. In the choice between lighting a candle and cursing the darkness, it remains useful to examine the use of AP filings and how those filings are resolved within the bankruptcy system. With the caveats noted, data about AP filings continue to provide the best approximation of trial statistics within the bankruptcy system.

#### A. *Adversary Proceedings*

As bankruptcy's corollary for lawsuits within the court system generally, adversary proceedings provide a comparative glimpse into dispute resolution within the bankruptcy system. A rise or fall in the number of adversary proceedings in bankruptcy shows whether lawsuit-like disputes within the bankruptcy system are following similar patterns to lawsuits in the federal and state legal systems generally. As Figure 4 shows, during the period from 1985 through 2002, the number of adversary proceedings initiated in the bankruptcy system has moved up and down. There were spikes in 1992 and 1998, each of which was produced when thousands of AP filings were made in a single case.<sup>16</sup> The overall trend line shows a modest increase in AP filings from 1985 through 2003.

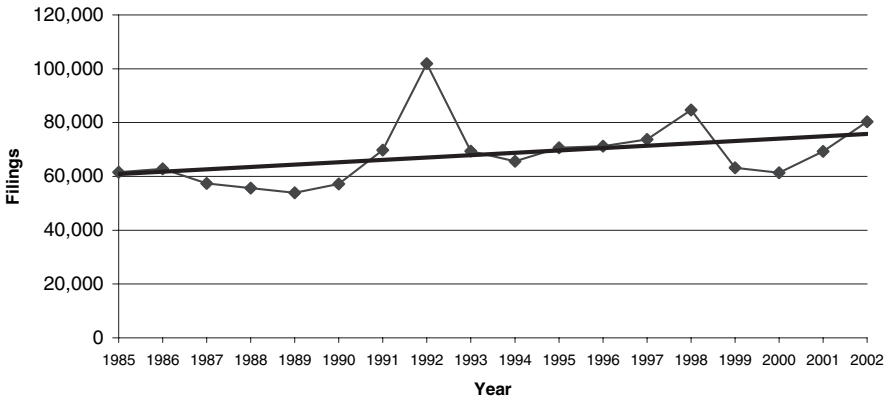
There has been a rise in number of AP filings, but it has not kept pace with the rise in bankruptcy petitions. With the number of bankruptcy filings increasing more rapidly than the number of adversary proceedings, the proportion of adversary proceedings per case in the bankruptcy system has fallen rather sharply. Figure

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<sup>15</sup>Rule changes also permitted some issues, such as subordination, that could ordinarily be accomplished only by adversary proceeding to be included in a plan confirmation without an AP filing. Bankruptcy Rules, 7001. The effect was to limit further the number of issues that could be settled by AP.

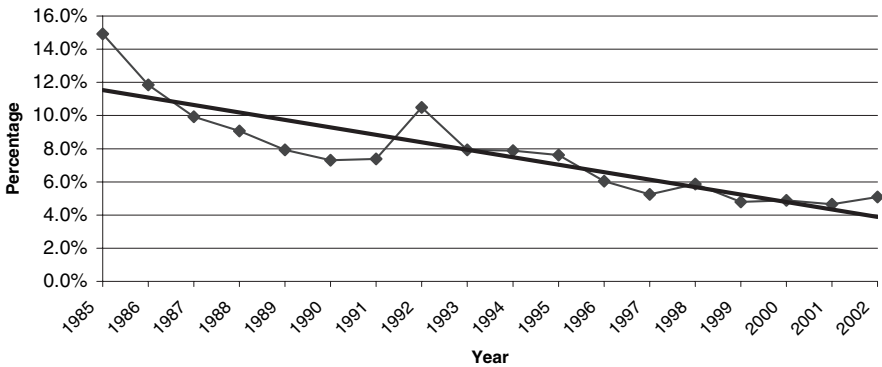
<sup>16</sup>William Rule from the Administrative Office of the U.S. Courts offers a possible explanation for the two large anomalies in the adversary filings data, the first in 1992 and the second in 1998. "The former is attributable to nearly 30,000 recovery money/property adversary proceedings filed in the middle district of Florida in 1992 in connection with the Olympia Holding Corporation bankruptcy, sometimes referred to as the trucking cases. The latter stems from nearly 15,000 recovery money/property adversary proceedings filed in the Northern District of New York in 1998 in connection the Bennett Funding Group bankruptcy. The Bennett Funding Group was accused of operating a 'Ponzi' scheme according to an SEC complaint." Correspondence from William Rule, Administrative Office of the U.S. Courts, Apr. 16, 2004.

Figure 4: Adversary proceeding filings.



SOURCE: Administrative Office of the U.S. Courts.

Figure 5: Adversary proceedings, filings as a percentage of total bankruptcy filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts.

5 shows this change, with the falling number of adversary proceedings per bankruptcy case filed.

The magnitude of the difference is important to note. Each year, about 60,000–80,000 AP filings are made in a bankruptcy system that is now handling about 1,660,000 cases. AP filings have grown, but they remain a small part of the overall system. More importantly, as Figure 5 illustrates, APs are a declining per-

centage of total terminations, as an ever-growing number of cases are resolved with no AP filed.

These data show two things. First, an increasing number of bankruptcy cases are resolved exclusively through the nontrial apparatus of the bankruptcy system, reinforcing the view of bankruptcy as an opt-out from the trial system. Second, each year more parties are initiating AP filings, suggesting that once they are in the bankruptcy system, a small but slowly growing number of parties continue to seek a lawsuit-like alternative to resolve their disputes.

### *B. Resolving Adversary Proceedings*

Adversary proceedings, like typical lawsuits, may be resolved at any number of points in time. To support the analysis reported in this article, the Administrative Office reviewed its nonpublic data and assembled a database that made available year-by-year information on the resolution of APs, dating back to 1985. Once again, I offer my thanks to William Rule and Peter Eyre for assembling these data, which otherwise would never have existed in any usable form.<sup>17</sup> The data reported here were taken from reports filed by the clerks of the court for each district across the country. These data make it possible to determine the number of cases resolved at various times in the pretrial and trial process.

The Administrative Office classifies AP terminations:

- Before issue is joined, no other court action
- Before issue is joined, after pretrial motion decided
- After issue joined, but no other court action
- After issue joined, after pretrial motion decided
- After issue joined, after pretrial conference, before trial
- During jury trial
- During court trial
- After jury trial
- After court trial
- Other

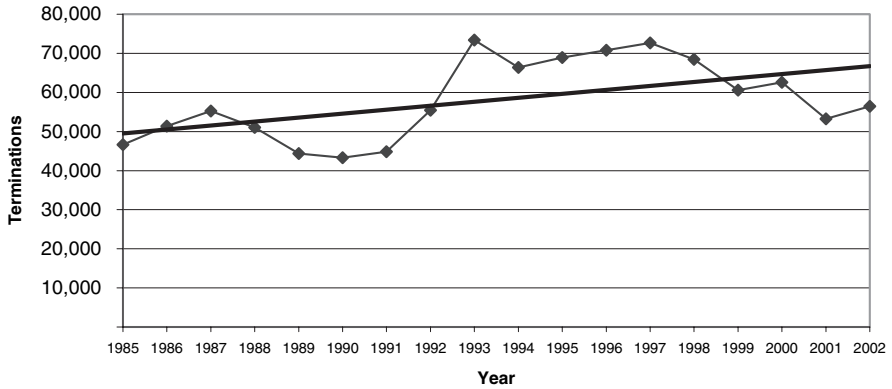
The first five categories can be combined into resolution of AP filings before trial.<sup>18</sup> (Terminations per year in each separate category are in the Appendix, Figures

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<sup>17</sup>See *supra* note \*.

<sup>18</sup>Total terminations obviously mirror total filings, but terminations may lag filings by some months or even years.

Figure 6: Adversary proceedings, terminations pretrial.



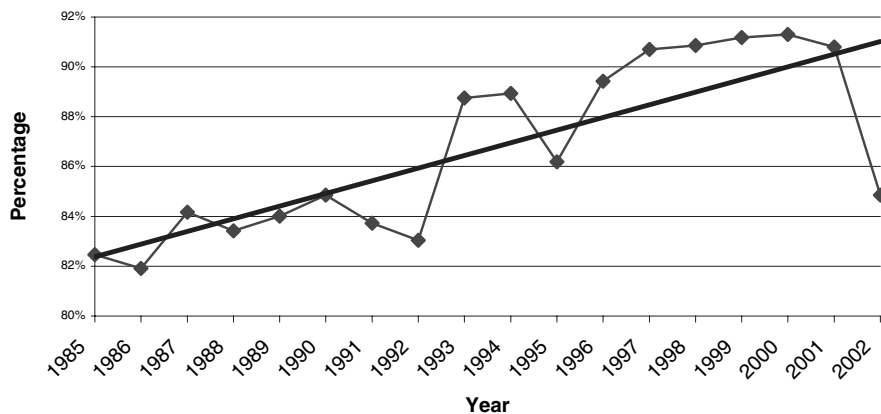
SOURCE: Administrative Office of the U.S. Courts (unpublished data).

A2–A6.) As Figure 6 illustrates, the number of AP filings resolved before trial has increased from 1985 through 2002.

When pretrial terminations are reported as a percentage of total terminations, it is possible to see the shift in how these bankruptcy lawsuits are resolved over time. As Figure 7 shows, from 1985 through 2002, the number of pretrial terminations as a proportion of total terminations has risen sharply, suggesting a change in the resolution of APs over time.<sup>19</sup>

<sup>19</sup>The drop in Figure 9 may appear somewhat exaggerated by the scale, which starts at 80 percent and not at 0 percent. The drop is about six percentage points and is almost matched in the other direction by the 1992–1993 increase of nearly six points. One possible explanation is that the genesis of the movement lies in Delaware. In recent years, the Delaware court has attracted many of the largest and most complex Chapter 11 cases. See, e.g., Lynn LoPucki & Joseph W. Doherty, *Why are Delaware and New York Bankruptcy Reorganizations Failing?* (Symposium: Convergence on Delaware: Corporate Bankruptcy and Corporate Governance), 55 *Vanderbilt L. Rev.* 1933 (2002). The Delaware bankruptcy court was (and remains) under severe pressure of a very heavy Chapter 11 caseload, accompanied by a significant number of APs. The reference from the bankruptcy court to the Delaware district court has been withdrawn from time to time, in part so that the district court judges can assist the bankruptcy judges. When that happens, there may be a sudden increase in the number of judges available to try APs. The number of terminations by trial may have jumped recently as extra judges dug into the pending caseload in Delaware. Some partial supporting evidence comes from the district-level numbers that indicate that the increase in terminations from 2001 to 2002 in Delaware was nearly half the total national increase.

Figure 7: Adversary proceedings, terminations pretrial as a percentage of total terminations.

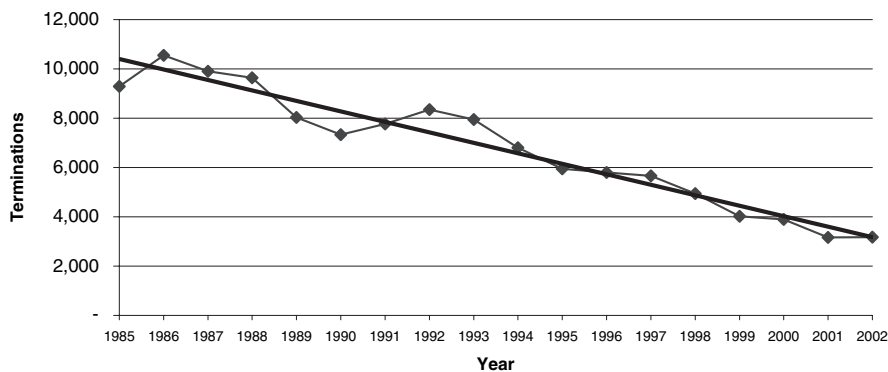


SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

The upward slope on the number of pretrial terminations is matched by a downward slope on the number of terminations during or after trials. (Terminations per year in each trial/posttrial category are in the Appendix, Figures A7–A9.) Terminations during or after trial have dropped by more than half from 1985 to 2002.

As Figure 8 shows, from 1985 through 2002, the total number of terminations that were resolved during or after a trial also has dropped steadily.

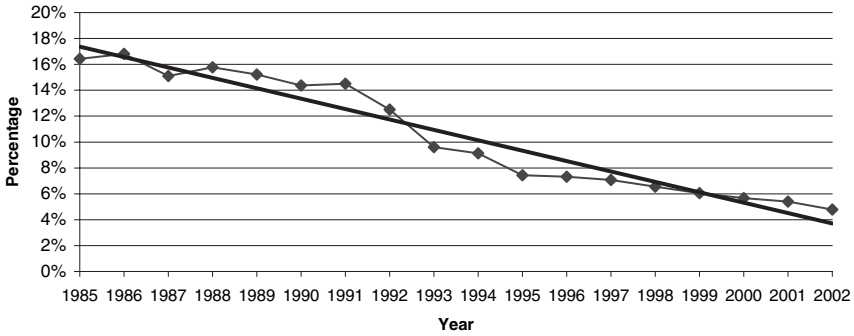
Figure 8: Adversary proceedings, terminations during or after trial.



SOURCE: Administrative Office of the U.S. Courts (unpublished data).

Figure 9 illustrates a similar point. As a proportion of all terminations, terminations during or after trials have dropped steadily from 1985 to 2002. In 1985, 16 percent of all AP terminations occurred during or after a trial; by 2002, the proportion was down to about 5 percent.

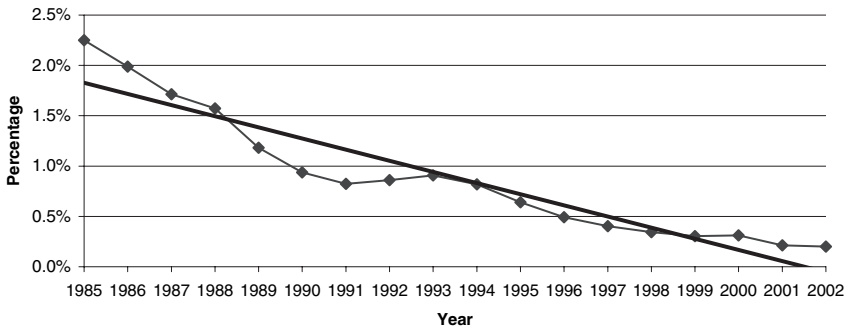
Figure 9: Adversary proceedings, terminations during or after trial as percentage of total terminations.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

If the denominator is total bankruptcy cases, rather than AP filings, the same trend is evident. As Figure 10 illustrates, the number of trials held per bankruptcy filing has dropped steadily. In 1985, about 22 out of each 1,000 bankruptcy cases ended up in a bankruptcy trial. By 2002, the number was down to about 2 per 1,000.

Figure 10: Adversary proceedings, terminations during or after trial as percentage of total bankruptcy filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

If adversary proceedings are taken as the bankruptcy system’s closest analogue to typical lawsuits, the trends are unmistakable. Fewer lawsuits per bankruptcy case are filed. Of the lawsuits actually filed in bankruptcy cases, a growing number are settled before trial. These data demonstrate that even as filings have increased, both the number and proportion of lawsuits that make it to trial within the bankruptcy system are shrinking rapidly.

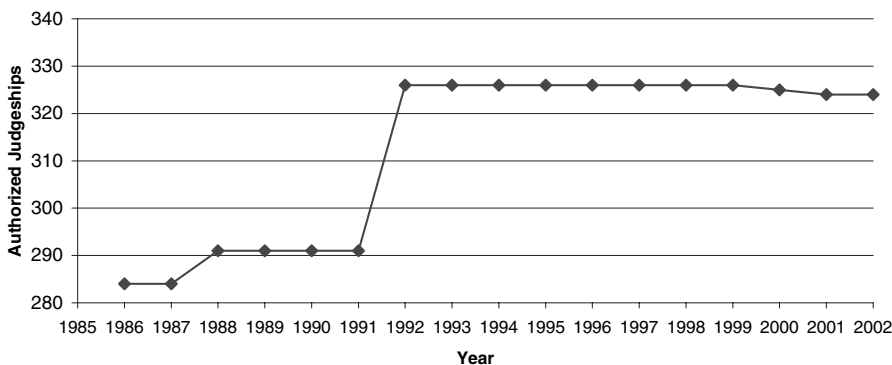
### III. EXPLANATORY HYPOTHESES

#### A. *Judicial Workload Hypothesis*

One possible explanation for the declining number of trials per AP is that the workload per judge has increased substantially so that there are no longer enough judges to try cases. The Judicial Workload Hypothesis would suggest that trials have declined even as AP filings have increased because there are not enough judges to hear the trials. Either the judges themselves or the delays attendant on scheduling trials pushes parties with disputes to settle early in the process. It is possible to assemble some data to test this hypothesis in the context of bankruptcy.

The number of judges in the bankruptcy system has increased over the relevant time period, but the number of judges has not kept pace with the steady rise in the number of bankruptcy filings. As Figure 11 shows, the number of bankruptcy judges remained relatively constant until 1992, when an influx of new judges was added to the system.

Figure 11: Total authorized judgeships.

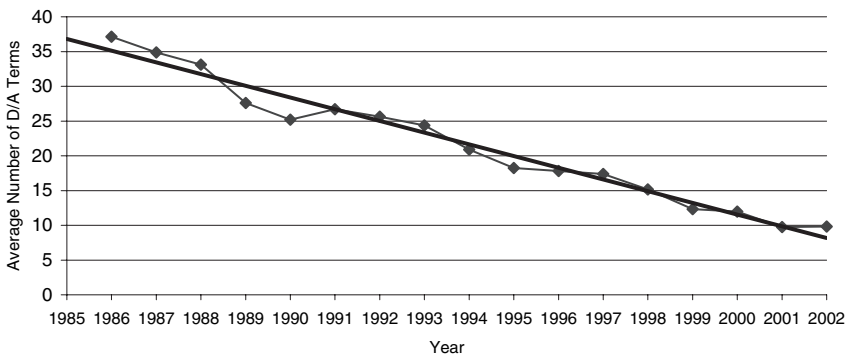


SOURCE: Administrative Office of the U.S. Courts.

Despite the rather two-state constant supply of bankruptcy judges, the number of trials per judge nonetheless shows a relatively steady decline. Figure 12 shows the

steady decline in the mean number of trials per judge from 1985 through 2002. The reason the per-judge resolution data remains relatively steady even as a single, huge influx of judges is added to the system in 1992 has to do with clearing a building backlog of cases.<sup>20</sup> When a burst of new judges was added to the system, they picked up cases that had been lingering in the system.<sup>21</sup> However, the steady decline per judge continued throughout the time period studied. In 1985, bankruptcy judges routinely resolved about 37 cases per year at trial; by 2002, that number had declined to about 10.

Figure 12: Mean number of terminations during/after trial per authorized judge.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

Judges in the bankruptcy system are not handling so many trials that potential litigants are forced to settle. The Judicial Workload Hypothesis seems fairly well contradicted by the data. The number of trials that judges are hearing is simply decreasing.

A possible variation on the Judicial Workload Hypothesis is consistent with the reported data. As courts supervise more and more bankruptcy filings every year, they may have discovered that trials are one of the best places to save time. If litigants can be persuaded to settle their differences or drop their complaints rather than litigate,

<sup>20</sup>See data in Figure A10 in the Appendix. Because bankruptcy courts are not Article III courts, there has been some question over the circumstances under which they could hold jury trials and the extent of their jurisdiction. Parties have learned that certain disputes and demands for a jury will oust the bankruptcy court and replace it with a federal district court. See, e.g., *Granfinanciera, S.A. v. Norberg*, 492 U.S. 33 (1989). It seems unlikely, however, that the finer distinctions whether trials might play out in district court or in bankruptcy court would have a significant effect on the overall AP filing rates.

<sup>21</sup>This effect is evident in the data showing a growing divergence between filings and closings in the years shortly before 1994 and a closer convergence of those data when the new judges were added.

the court will be free not for other trials, but for other aspects of their judicial work. In other words, the other-than-trial workload could be squeezing out trials, rather than a rising trial-per-judge workload. These data shed no light on the details about how judges spend their time—or how they spent their time in 1985—so it is not possible to use these data to confirm or disprove the variant hypothesis. Instead, the only firm conclusion is that trials per judge continue to decline, even as new judges are brought into the system.

### *B. The Cost Hypothesis*

Another hypothesis attempts to explain the decline in trials. If the costs of resolution through trial are increasing, then parties may be more inclined to negotiate their differences or drop their complaints rather than face the costs of a trial. It is possible to develop an indirect glimpse at the cost question by segregating the bankruptcy data into its component parts. Aggregated bankruptcy data may obscure an important difference—the likelihood that different kinds of cases will make it to trial, while disaggregating the numbers into “business” and “nonbusiness” components offers another view of the cost picture.

The overall bankruptcy filing rates for cases denominated “business” and “non-business” have moved in opposite directions, with the former shrinking while the latter expands. Although these distinctions are subject to considerable ambiguities surrounding how attorneys have classified their clients’ cases,<sup>22</sup> they suggest that different groups of litigants experience the bankruptcy system differently—and may use it for different purposes.

The number of bankruptcy cases formally denominated as “business” cases has declined, but there are no data to support the hypothesis that fewer businesses are failing.<sup>23</sup> The relative decline of business cases would seem to have its roots elsewhere in the system.

The increase in consumer cases may be solely an artifact of rising debt loads, joblessness spreading into the middle class, increasing numbers of families without health insurance, and other economic factors independent of the bankruptcy

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<sup>22</sup>See *supra* note 101 and accompanying text.

<sup>23</sup>According to the Small Business Administration, from 1990 through 2002, the number of small business terminations in the United States increased from 531,400 to 584,500. SBA Office of Advocacy, *Small Business Economic Indicators for 2002* at 17, tbl. 3 U.S. Business Measures, 1980–2002 (2003). Longitudinal data on small-business failure is difficult to assemble. According to the SBA website (and confirmed by telephone), the Small Business Administration Office of Advocacy has been compiling numbers on business failures from 1990–2002 and currently plans to continue that practice. See <<http://www.sba.gov/advo/stats/sbei02.pdf>>. Prior to 1990, the Census Bureau, as reported in the annual *Statistical Abstracts of the United States*, relied on Dun and Bradstreet for reports on business failure, but those reports are no longer available. There apparently is no one source using a consistent metric to determine business failures for the years 1980–2003.

system.<sup>24</sup> But the Cost Hypothesis may help explain why families turn to bankruptcy for help rather than do battle with their creditors outside the federal system. Unlike business cases, which tend to be custom-tailored to the peculiarities of the failing business and its prospects for survival, consumer bankruptcy cases tend to be off-the-rack solutions. Variation among consumer cases is much smaller, and a high-volume, standardized law practice has grown up to deal with consumer cases. Once the debtor files for bankruptcy, the variation among most consumer cases is small. Creditors' rights are extremely limited, and if the debtor stays within fairly well-worn channels in terms of assets and liabilities and plans for dealing with the creditors, then a consumer bankruptcy is a routine affair, involving relatively little professional time from attorneys. Because typical consumers have even fewer assets than their business counterparts, the pressure to contain costs is correspondingly much greater. In effect, consumer bankruptcy has evolved into a low-cost, high-volume operation to help individuals in financial trouble.

The cost of a routine consumer bankruptcy filing today is quite modest, often well under \$1,000.<sup>25</sup> To accomplish resolution through negotiations with 15 creditors outside the bankruptcy system would likely cost a great deal more in attorney time alone. This means that out-of-bankruptcy negotiations would substitute a higher-cost alternative for the resolution of outstanding debt for most consumers. As a result, consumers in financial trouble may be more likely to continue to turn to bankruptcy as a way to resolve their financial difficulties. The rising number of nonbusiness filings to deal with consumer financial problems is consistent with the Cost Hypothesis.

The falling number of cases denominated as business filings is also consistent with the Cost Hypothesis. Unlike their consumer counterparts, variations among business cases remain high. Once they file for bankruptcy, the range of options for debtors and creditors alike opens up. No low-cost, standardized approach dominates. Even small businesses in Chapter 11 face creditor votes to confirm a plan. They may need to recover voidable preferences or reject executory contracts in order to have a chance at survival. And the U.S. Trustee pays much closer attention to business cases than to their consumer counterparts, demanding regular operating reports and making various inquiries to determine whether further investigations should be brought. The debtors' legal maneuverings require sophisticated legal advice, a commodity that can be quite costly. Although the expenses may be quite modest relative

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<sup>24</sup>For two discussions of the reasons families are in so much economic trouble, see Elizabeth Warren & Amelia Warren Tyagi, *The Two-Income Trap: Why Middle Class Mothers and Fathers Are Going Broke*; and Sullivan, Warren & Westbrook, *The Fragile Middle Class*, *supra* note 10.

<sup>25</sup>In 2001, 53 percent of the individual debtors filing for bankruptcy paid \$1,000 or less to their attorneys. Data from 2001 Consumer Bankruptcy Project.

to the services they receive,<sup>26</sup> they are not in the \$1,000-and-under range. Business bankruptcy as a solution to financial difficulties may increasingly be priced out of the reach of struggling small businesses.

Companies such as Enron and Worldcom, or even their multimillion-dollar smaller sisters, may be able to sustain substantial professional fees, but the much smaller businesses, such as restaurants and independent contractors who make a large fraction of the business bankruptcy filings, may not be able to afford the legal help necessary for a business bankruptcy. A detailed study of business cases that filed for bankruptcy in 1994 revealed that the median business debtor in Chapter 11 owed total debts of only about \$351,000, suggesting that if they were bankrupt over such amounts, they were not large concerns.<sup>27</sup> To be sure, the amount the businesses owed was considerably more than the median consumer debtor, who in 1991 owed about \$34,800 in total debts.<sup>28</sup> Even so, these small businesses are a far distance from the big bankrupt companies that can support substantial legal fees. These smaller businesses may not negotiate to reorganize their debt outside bankruptcy or within the bankruptcy structure; instead, they may simply disappear with further attention, leaving their creditors to write off the unpaid debts without a trace in the legal system.

Some troubled businesses may die without bankruptcy help, but it is also possible that a growing number may survive without bankruptcy as well. As the law becomes more settled, the easy cases—those with few disputes or with a single problem to be solved—can be negotiated effectively in the shadow of the law. The phenomenon of a “workout” has become fairly standard in the bankruptcy field. Parties restructure, and sometimes forgive, outstanding debts in order to maximize total returns. As the law becomes clearer and as a growing number of lawyers who serve both debtors and creditors are familiar with the basic treatment of certain claims in bankruptcy, some parties have less need to turn to judges to resolve their

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<sup>26</sup>For an analysis of the costs of a typical bankruptcy, see, e.g., Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. Empirical Legal Stud. 11 (2004); Robert M. Lawless & Stephen P. Ferris, *Professional Fees and Other Direct Costs in Chapter 7 Business Liquidations*, 75 Wash. U. L.Q. 1207 (1997) (study of direct costs in 98 cases filed in Chapter 7 in six cities in six districts and open from 1991 through 1995); Robert M. Lawless, Stephen P. Ferris, Narayanan Jayaraman & Nil K. Makhija, *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. Ill. L. Rev. 847 (1994) (a study of professional fees in 57 small-firm bankruptcies filed in Memphis in Chapter 7 or Chapter 11 that were completed in 1991 and 1992). For a discussion of costs to reorganize some of the biggest companies, see, e.g., Stuart C. Gilson, *Transactions Costs and Capital Structure Choice: Evidence from Financially Distressed Firms*, LII, 1 J. Fin. 161 (1997) (examining the transactions costs of out-of-court restructuring vs. bankruptcy restructuring for 165 companies filing 10-ks); Jerold B. Warner, *Bankruptcy Costs: Some Evidence*, 32 J. Fin. 337 (1977) (study of management turnover in 11 railroad bankruptcies from 1933 to 1955). Another view of cost comparison is available in G. Ray Warner, *Interim Compensation and the Routine Holdback: A Doctrine in Search of a Rationale Part II*, 1 Bankr. L. & Prac. 441 (1992) (study of routine fee holdbacks from ABI survey of lawyers and judges).

<sup>27</sup>Financial Characteristics, *supra* note 4, at 538, tbl. 8.

<sup>28</sup>Fragile Middle Class, *supra* note 10, at 66, tbl. 2.4.

differences. They know, within narrow ranges, how their disputes are likely to be handled. A solution can be reached without turning to the formal system of bankruptcy.

Finally, it is possible that the number of cases denominated as “business” filings is shrinking because more entrepreneurs and self-employed debtors are listed as “nonbusiness” than in past years. The cases most likely misclassified are those that are more like the consumer cases than the business cases. In other words, the misclassified business cases are likely to have assets much lower than the typical business case, which both constrains the debtors’ resources to litigate and constrains the creditors’ incentive to pursue the debtor. There is some evidence that reporting has changed over time,<sup>29</sup> with more self-employed debtors sliding through the system as consumer filers. If that is so, then the smallest business cases, the ones most likely to fit the cookie-cutter model of the consumer bankruptcy practice, may be shifting into nonbusiness filings. This depletes the total number of business filings, while it also changes the mix of business cases remaining.

The Cost Hypothesis posits that the cost of resolving business failures out of bankruptcy relative to the costs in bankruptcy may be falling for some business, leaving them to work out their differences outside bankruptcy. For debtors with complex problems and few assets, the high costs of bankruptcy may mean fewer filings as well, as those businesses expire without a filing. That leaves fewer businesses in bankruptcy, which is consistent with the currently reported data.

### *C. Disputes in Business and Nonbusiness Cases*

If the Cost Hypothesis is sound, then the number of denominated business and non-business cases that file for bankruptcy might change over time. The easy cases—cases in which the parties could work together or cases in which assets were too small to support further disputes—might be resolved either outside bankruptcy or as routine “nonbusiness” cases. The mix of cases in the bankruptcy system then would shift to those seeking routine treatment in nonbusiness cases and those in which there are more difficulties among the parties and some assets worth fighting over, which, when they involve small businesses, would be more likely to remain identified as business cases.

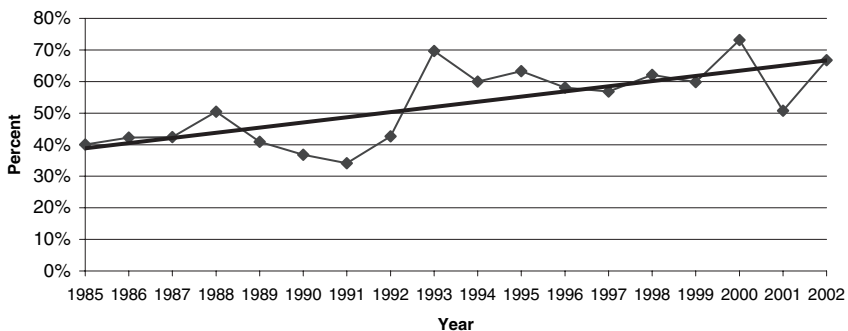
The disaggregated bankruptcy data offer some additional support for the Cost Hypotheses. The AP filing data show that the number of lawsuits filed and trials held within the bankruptcy system has changed in ways that suggest that the mix of business and nonbusiness cases is changing substantially.

The Administrative Office also collected data going back to 1985 on the number of AP closings divided by business/nonbusiness classifications of the debtors. As Figures 13 and 14 illustrate, the proportion of AP filings per business case have increased, while AP filings per nonbusiness case have declined.

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<sup>29</sup>See Lawless & Warren, *supra* note 11.

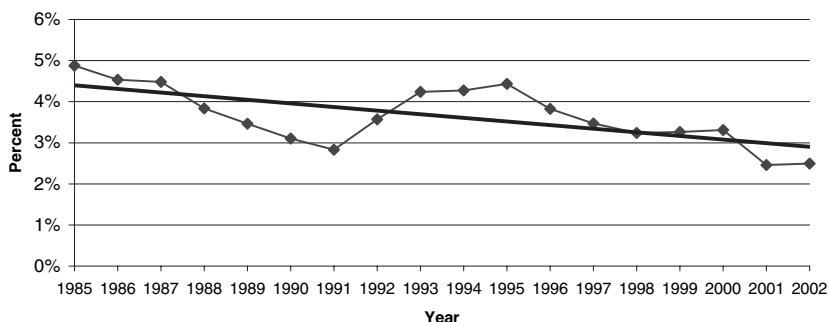
Figure 13: Total business adversary proceedings, terminations as a percentage of total business bankruptcy filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

These data are consistent with a conclusion that the cases denominated as “business” cases today are producing far more litigation per case than they once did, rising from about 40 percent ending with an AP termination in 1985 to nearly 70 percent resulting in an AP termination in 2002. Cases labeled as nonbusiness cases have always been far less likely to produce APs, but the change over time is notable. In 1985, about 5 percent of nonbusiness cases involved an AP termination, but by 2002, nonbusiness terminations occurred in only about 2.5 percent of the cases. Both findings are consistent with the Cost Hypothesis.

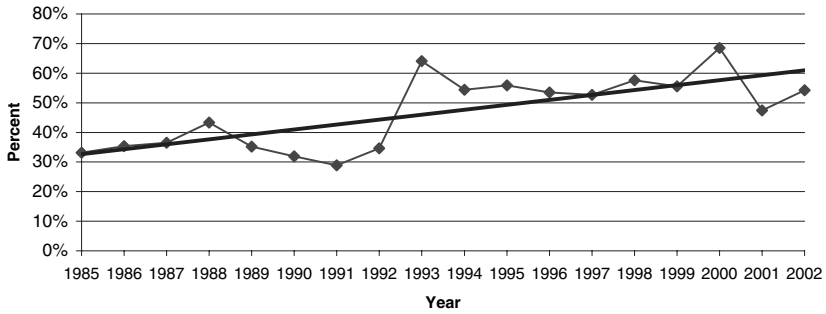
Figure 14: Total nonbusiness adversary proceedings, terminations as a percentage of total nonbusiness bankruptcy filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

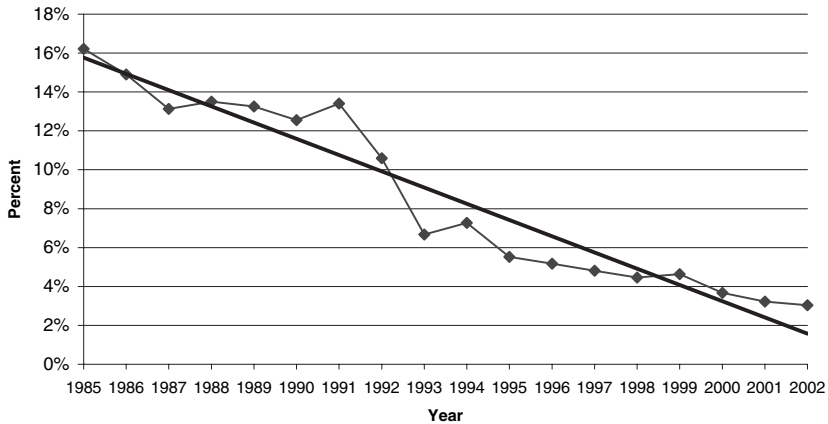
The disaggregated data also confirm the overall picture of a growing split between the number of disputes resolved pretrial and the number resolved during

Figure 15: Business pretrial terminations as a percentage of total business bankruptcy filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

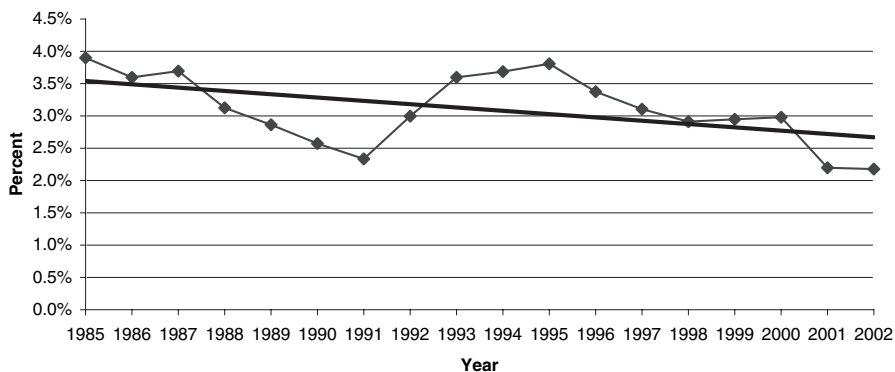
Figure 16: Business terminations during or after trial as a percentage of total business filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

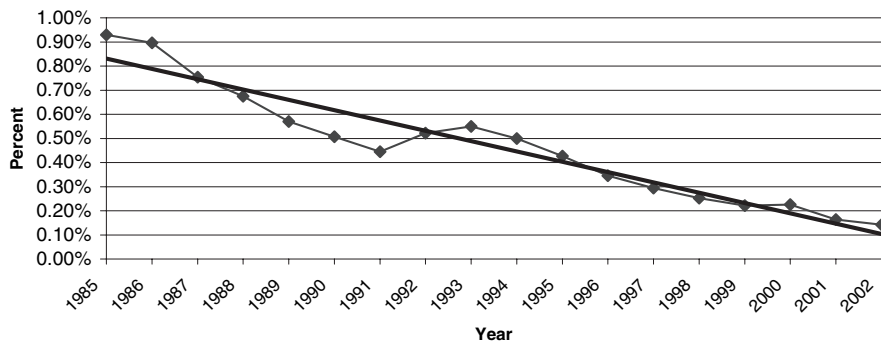
or after trial. The closing data show the point at which each AP filing was resolved—at various pretrial stages or during/after a trial began. For business cases, the data are quite distinct: as Figure 15 shows, from 1985 through 2002, in business cases the number of AP filings that were resolved pretrial increased, while the number of AP filings resolved during or after trial decreased. The decrease is particularly startling; in 1985, about 16 percent of all APs filed in business cases resulted in a trial; by 2002, that number had fallen to about 3 percent.

Figure 17: Nonbusiness pretrial terminations as a percentage of total nonbusiness filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

Figure 18: Nonbusiness terminations during or after trial as a percentage of total nonbusiness filings.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (including unpublished data).

Once again, these data fit with the Cost Hypothesis: among the cases that end up in bankruptcy and for which AP filings are initiated, the likelihood has increased that such lawsuits will settle before parties incur the added expense of a trial.

As Figures 17 and 18 show, the nonbusiness cases show declines in the rates both of AP resolutions pre- and during/after trial. This decline is in part an artifact of the rapidly increasing number of nonbusiness filings in which no AP is filed. Even

in nonbusiness cases, however, the differences between pretrial and during/after trial resolution is substantial. Among nonbusiness filings, the posttrial resolutions are falling much faster than pretrial resolutions.

Overall, the business/nonbusiness data lend some support to the Cost Hypothesis, suggesting that the bankruptcy alternative functions differently in business and nonbusiness cases, even as both types of cases face their own cost pressures.

#### IV. CONCLUSIONS

The bankruptcy data show that an increasing number of debtors—people who are disproportionately susceptible to being defendants in lawsuits—are filing bankruptcy. They now resolve an estimated 25 million claims per year through the bankruptcy system. Some fraction of those claims would otherwise have been state or federal lawsuits, but they are now resolved through a largely administrative process. The bankruptcy system functions interactively with other parts of the legal system, resolving some disputes that outside bankruptcy would have become lawsuits, even if the degree of substitution in treatment of cases is impossible to specify.

The data also suggest that the bankruptcy system is evolving to serve businesses and consumers differently, providing a low-cost, standardized solution for nonbusiness and self-employed debtors, but a more costly, individualized alternative for businesses in trouble. Those differences in turn may affect the mix of debtors filing for bankruptcy and the classifications of those debtors.

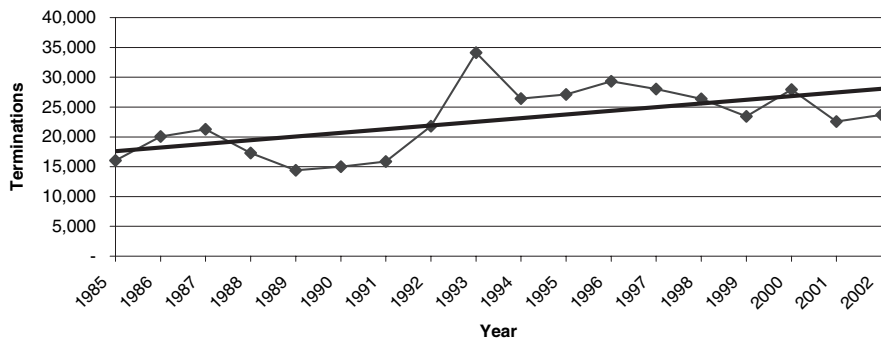
Within the bankruptcy system, adversary proceeding filings, the bankruptcy system's closest analogue to a lawsuit, have followed the pattern revealed elsewhere in the federal court system. The number of AP filings has increased, but a growing number are settled before trial while the number of resolutions during or after trial has sharply declined. The bankruptcy data point toward the Cost Hypothesis as the principal reason for this change.

These data suggest that the trial may be vanishing from the bankruptcy system as it vanishes from other parts of the federal system as well.

## APPENDIX

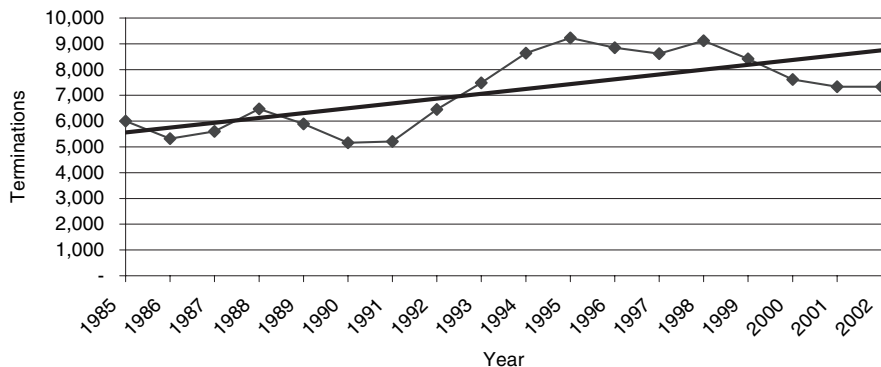
### *Adversary Proceeding Terminations*

*Figure A1:* Number of adversary proceeding terminations before issue is joined, no other court action.



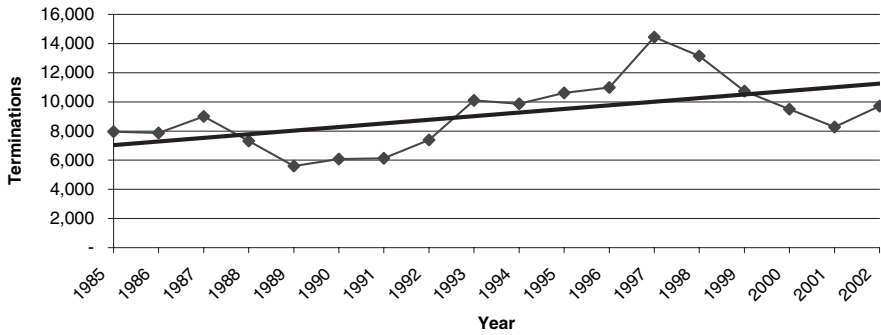
SOURCE: Administrative Office of the U.S. Courts (unpublished data).

*Figure A2:* Number of adversary proceeding terminations before issue is joined, after pretrial motion decided.



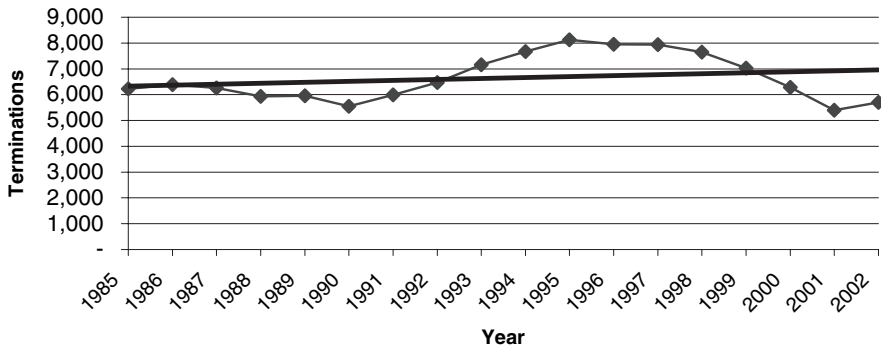
SOURCE: Administrative Office of the U.S. Courts (unpublished data).

Figure A3: Number of adversary proceeding terminations after issue joined, but no other court action.



SOURCE: Administrative Office of the U.S. Courts (unpublished data).

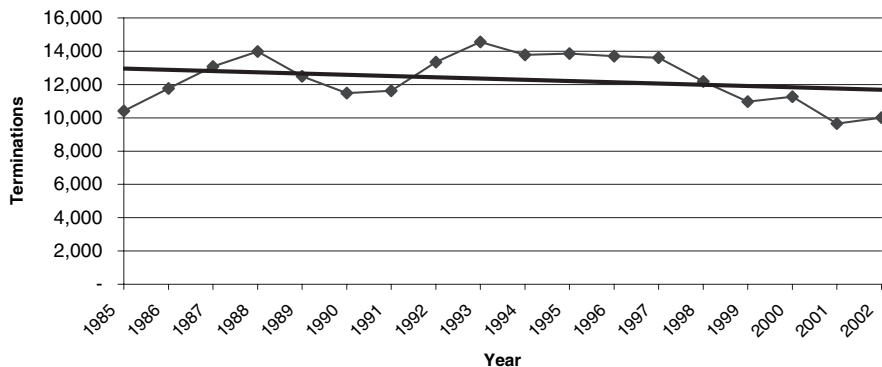
Figure A4: Number of adversary proceedings after issue joined, after pretrial motion decided.



SOURCE: Administrative Office of the U.S. Courts (unpublished data).

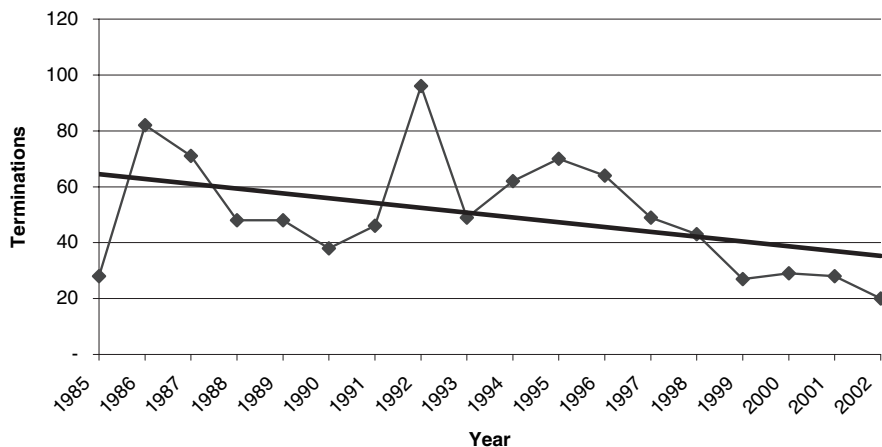
*Trial Terminations*

Figure A5: Number of adversary proceedings after issue joined, after pretrial conference, before trial.



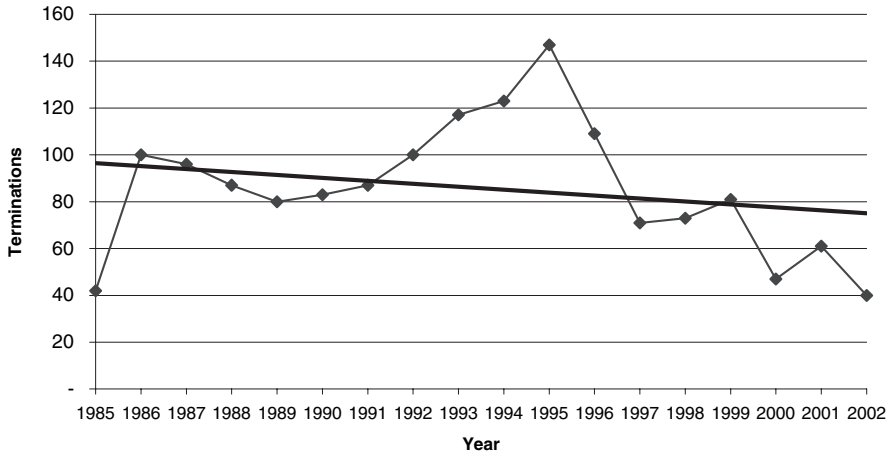
SOURCE: Administrative Office of the U.S. Courts (unpublished data).

Figure A6: Number of adversary proceeding terminations during jury trial.



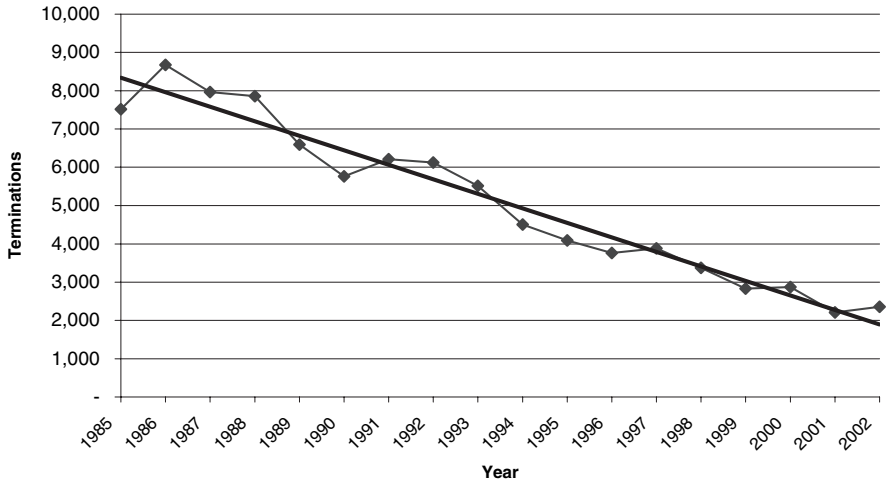
SOURCE: Administrative Office of the U.S. Courts (unpublished data).

Figure A7: Number of adversary proceeding terminations after jury trial.



SOURCE: Administrative Office of the U.S. Courts (unpublished data).

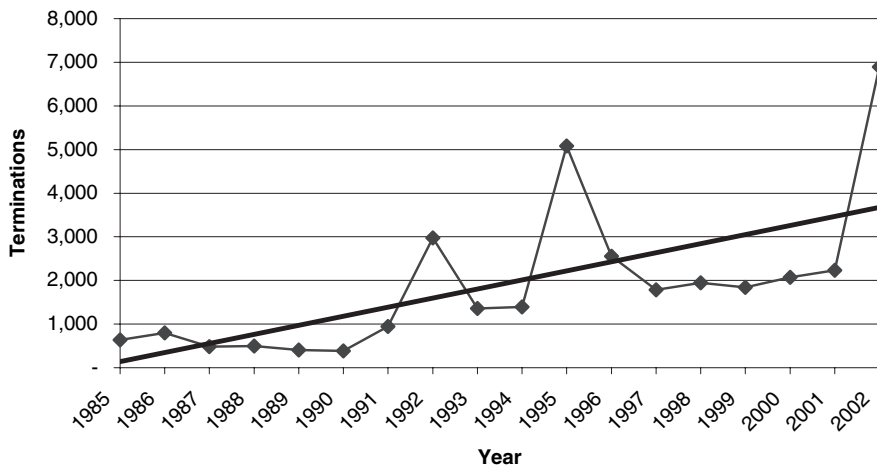
Figure A8: Adversary proceeding terminations after court trial.



SOURCE: Administrative Office of the U.S. Courts (unpublished data).

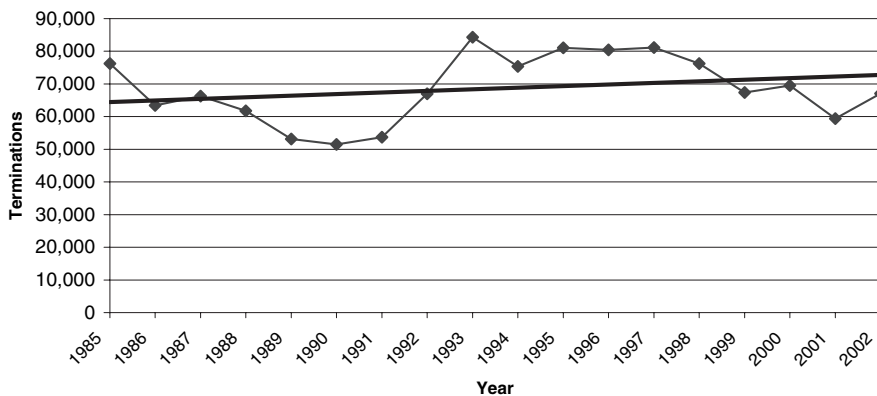
*Other Terminations and Total Terminations*

Figure A9: Adversary proceeding terminations, other.



SOURCE: Administrative Office of the U.S. Courts (unpublished data).

Figure A10: Total adversary proceeding terminations.



SOURCE: Calculated from data, Administrative Office of the U.S. Courts (unpublished data).

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