Are Judges Randomly Assigned to Chapter 11 Bankruptcies? Not According to Hedge Funds

By Hüther and Kleiner

Sasha Indarte
Wharton, UPenn

AIM
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Summary

- **Question:** are corporate bankruptcy judges randomly assigned to cases?

- **Approach:** test whether presence of **unsecured** hedge funds (as creditors) predicts judge propensity to convert Ch 11 $\rightarrow$ Ch 7 (restructuring $\rightarrow$ liquidation)

- **Main Findings:**
  - Presence of **secured** hedge fund creditors **doesn't** predict judge conversion propensity
  - But **unsecured** hedge funds—who fare better under restructuring—predicts **lower** judge conversion propensities
  - Predicted effect is large: 3.3% point difference (a 33% relative effect)
  - Mechanism appears to be **strategically timing** filing, based on undesirable judge workload

Motivation

- Important question! Answer has implications for both the bankruptcy process and a popular identification strategy

- **Fairness:** do firms (or creditors) receive equal treatment under the law?

- Random assignment of judges (with varying leniency) is a widely used **source of variation** for estimating the causal effects of bankruptcy outcomes

- **Comments:** plausibility, inference, advice for applied economists, and normative implications

Plausibility: Why don’t firms shop for lenient judges?

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- Generally, we'd expect both firms and unsecured creditors to prefer restructuring
  - Why aren't bigger firms hiring good bankruptcy lawyers that advise them on timing?
  - In general, firm characteristics don't seem to predict judge leniency
(Chang and Schoar, 2013; Iverson et al., 2017; Bernstein et al. 2019 x2; Antill, 2021)
  - **Why does it take a hedge fund's encouragement to get firms to act in their own interest?**

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  - **Why does it take a hedge fund's encouragement to get firms to act in their own interest?**

- And do any other unsecured creditors appear to have similar sway?

Inference in the Presence of Multiple Testing

Multiple Testing

- Why focus on unsecured hedge funds? Why start here?
  - Were other characteristics considered in early stages of the paper?

- How do we interpret these results in the presence of many balance tests done in other papers? E.g., Iverson et al. (2017)

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  - **Problem:** when testing m null hypotheses, we're more likely to have a false positive (type 1 error) as m grows large
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- P-value of 4e-5 $\Rightarrow$ reject null at 5% level for $m < 1351$ (multiple testing issues unlikely)

Implications for Applied Economists

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- Unlikely a threat to identification for small firm and consumer bankruptcies

- But what to do when studying large firms using a judge IV?
  1. Control for presence of unsecured hedge funds
  2. Modify IV construction

- For control approach, must hope we've found all endogenous predictors...

How to Modify Judges IV? (1/2)

- **Suggested approach:** recentered IV (Borusyak and Hull, 2021)
- Suppose we're interested in the effect of treatment x_i on y_i
- If we specify/assume the process generating the exogenous variation in x_i, we can simulate/calculate expected treatment μ_i
- Can construct a valid IV for x_i as $\widetilde{x}_i = x_i - \mu_i$
- Intuition: IV $\widetilde{x}_i$ is random "excess" treatment relative to what i would typically experience

How to Modify Judges IV? (2/2)

- Knowing more about how firms/creditors manipulate judge assignment can guide design of appropriate IVs

- Given strategic timing documented in paper, relative leniency of judge pool when filing may be an appropriate counterfactual

- **Suggestion:** more discussion of implications for judge IV users could $\uparrow$ impact of paper

Normative Implications: Efficiency vs Fairness

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  - ...but could other changes to the bankruptcy process ameliorate both inefficient liquidation and judge assignment manipulation?
  - Some courts use statistical models for sentencing—is this desirable for bankruptcy?
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  - Some courts use statistical models for sentencing—is this desirable for bankruptcy?
  - Could incorporating predictive models reduce gains from manipulation?
- **Suggestion:** discuss trade-offs of manipulation. Any further guidance for policy?

Conclusion

In conclusion...

- Important question and thorough analysis!

- Sheds light on possible manipulation in the bankruptcy process, with implications for a widely-used empirical strategy

- Future work: normative implications of creditor influence on bankruptcy process

Thanks!