The Debacle of Corporate Bankruptcy

Barry Adler and Lawrence Weiss

One image that comes to mind when someone mentions "bankruptcy protection" is that of a debtor who has experienced hard times and faces the prospect of creditors who would take all his property now and in the future. To escape an insurmountable financial burden, the debtor files for bankruptcy, gives up to the creditors all of his assets except those that are essential for survival, and has the bankruptcy court extinguish all remaining unsatisfied debts. Bankruptcy allows the debtor to begin financial life anew, free from the prospect of perpetual servitude.

Whatever benefit bankruptcy offers individuals, however, the notion that bankruptcy "protects" *corporations* is hollow at its core. Corporations do not need protection from creditors the way individuals do. If corporations are pricked, unlike Shakespeare's Shylock, they *do not* bleed. Corporations, despite the name, are not corporeal beings. Corporations are networks of contracts among individuals. Contracts define relationships among people but are not themselves people, the legal fiction notwithstanding. It is utter nonsense to talk about protecting a corporation or providing a corporation with a fresh start.

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Does Corporate Bankruptcy Protect Individual Investors?

Shareholders do not need bankruptcy protection for a fresh start. To illustrate, imagine a corporation that begins its existence with $100,000 in equity capital contributed by shareholders and $50,000 in proceeds from creditors' loans. Assume that the corporation later suffers misfortune and is left with $25,000 in assets subject to the same $50,000 debt, on which it defaults without repaying. If there were no bankruptcy "protection," the creditors would collect all $25,000 of the corporation's assets. With nothing left, the corporation would be an empty shell that some would describe as dead. While the shareholders may experience a financial loss from the corporate debtor's demise, they would receive a fresh start without corporate bankruptcy.

The individual shareholders receive protection from creditors through state corporate law. Under corporation law creditors of a corporation can look only to corporate assets, not to shareholders' personal assets, for collection. So although the creditors in our example receive only fifty cents on the dollar, less the cost of collecting the assets, the shareholders are not responsible for the difference. They may continue their financial lives, free from the creditors' claims. *Corporate law* provides shareholders protection. Bankruptcy law need not.

In Theory Does Corporate Bankruptcy Hurt Anyone?

Under provisions of the bankruptcy code adopted by the Bankruptcy Reform Act of 1978, when a firm fails, the debtor may file a petition for liquidation (Chapter 7) or reorganization (Chapter 11). In theory whether a firm files for relief under Chapter 7 or Chapter 11 depends on whether the firm will be worth more as a going concern than in liquidation.

In principle corporate bankruptcy is innocuous. Using our example, we might explain the consequences of bankruptcy in the following way. Assume that the corporate debtor, with $25,000 in assets and $50,000 in debt, is to be liquidated. The firm's assets will be sold to a third party, who will presumably pay $25,000 for them. The $25,000 less the expense of the sale will be awarded to the creditors in satisfaction of their loans. The corporation, devoid of assets, will cease to exist. The shareholders will receive nothing because they have no fixed right to payment. Shareholders, by the nature of their contract with the firm, agree to accept the value of the firm *in excess* of the amount the firm owes creditors. They are not liable for any unsatisfied corporate debt. In theory bankruptcy does not alter that agreement. The creditors will get the full value of the corporate assets and nothing more.

As an alternative to liquidation, the corporation will choose reorganization if it is worth more as a going concern than in liquidation. In theory bankruptcy reorganization provides a mechanism to continue operating the business, free from unsatisfied prebankruptcy debt. The process can, for example, transfer the equity claim of the firm to the creditors in partial satisfaction of their debts and extinguish the prebankruptcy equity claim. In other words, bankruptcy reorganization transfers *interests* in the firm's assets, rather than the assets themselves, to the firm's claimants.

Continuing with our example, assume that a bankruptcy court approves a reorganization plan that grants the creditors all the equity shares in the reorganized firm and grants the shareholders nothing. The new equity shares are worth $25,000, the full going-concern value of the firm, less whatever the firm spends in the reorganization process to issue the shares. The prebankruptcy shareholders receive nothing from the reorganization, but need not contribute anything either. The result is the same as in the previous situations. The creditors receive the full value of the insolvent firm less the expense of the collection process. There is no ostensible reason to think that the corporation as a business entity is any worse for the reorganization.

In Theory Does Anyone Benefit from Corporate Bankruptcy?

In the examples we have given corporate bankruptcy neither helps nor hurts shareholders. But bankruptcy reorganization may benefit the creditors by keeping the assets of the insolvent corporation together as a going concern. In theory bankruptcy provides a process for creditors to collect on their debts in an orderly fashion. Without bankruptcy reorganization the creditors might compete with one another for repayment, gain judgments against the firm, individually collect pieces of the firm, and thereby destroy its value as a going concern. In addition, without bankruptcy provisions the creditors, anticipating insolvencies, might expend considerable resources to monitor their corporate loans so that they would be in a position to obtain and execute on judgments before the failing firms' other creditors did so.

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We can thus view corporate bankruptcy as a social institution to coerce self-interested individuals toward a common goal through various mechanisms for enforcing or altering the original contracts. In theory the bankruptcy reorganization process provides substantial benefits by preventing the premature liquidation of viable firms and reducing the costs creditors incur to monitor their loans.

Problems with Corporate Bankruptcy in Practice

The Bankruptcy Reform Act of 1978 was enacted to revise the administrative, procedural, legal, and economic aspects of corporate and personal bankruptcy filings as set out in the Chandler Act of

1938. According to proponents of reform, changing socioeconomic conditions in the United States, worldwide problems of inflation and recession, and transitions in credit policies made provisions of the old act awkward. One of the stated goals of the 1978 act was to reduce the time it takes for a firm to work through the reorganization process and to develop a plan for restructuring its capital financing and rehabilitating its operations. Those changes were designed to reduce the direct costs of bankruptcy.

Our criticism of corporate bankruptcy derives not from the stated objectives of the Bankruptcy Reform Act of 1978 but from the execution of corporate bankruptcy proceedings and the complexities of the real world. Although the bankruptcy code requires management to gain court approval for extraordinary transactions, most bankruptcy reorganization provisions increase management's ability to behave strategically to the detriment of creditors.

Our criticism of corporate bankruptcy derives not from the stated objectives but from the execution of corporate bankruptcy proceedings and the complexities of the real world. Consider a large corporation with $250 million of assets and $500 million of debt. Assume, as is likely, that such a firm has numerous shareholders, each with a small portion of the total equity claim, and numerous creditors, each with a small portion of the total debt. The shareholders are too numerous to manage the firm directly, so they leave management to directors and officers, who have a fiduciary responsibility to the shareholders, at least before insolvency.

Assume that the creditors are not only numerous but have nonuniform interests. That is, some creditors possess claims secured by specific corporate assets so that if the firm does not repay its debt to them, they have a property interest in those assets that is superior to the other creditors' interest. The other creditors, the general creditors, have an inferior (or junior) interest in the firm, although their claims are, of course, superior (or senior) to those of the shareholders.

When such a large, complex firm enters bankruptcy, one could imagine that it will be treated much as the simpler one in our previous example. If the firm is reorganized, the creditors should receive all new interests in the firm and the prebankruptcy shareholders should receive nothing but contribute nothing. The process is not self-executing, however, and this is the source of the problem.

A firm in reorganization typically continues in operation under control of prebankruptcy management. Even if management is to blame for the insolvency that led to bankruptcy, the management team with firm-specific knowledge cannot be easily replaced at the moment of bankruptcy, because replacement with strangers to the firm could result in disastrous disruptions. Thus, the bankruptcy code provides generally that prebankruptcy management will retain control of the firm during the bankruptcy reorganization process. That seems sensible and is not by itself problematic.

Unfortunately, management's incentives create problems. Management is hired as an agent of the corporation's prebankruptcy shareholders. To give management an incentive to work hard on the firm's behalf, the firm often chooses to compensate managers with shares of the firm. So the managers, out of duty or concern over their own holdings, may have interests aligned with those of the prebankruptcy shareholders. The managers know that if the firm has insufficient assets at the conclusion of the bankruptcy process, the creditors, senior to shareholders, will have a right to all the firm's assets, and the shareholders will receive nothing. Thus, in the last example, only if the managers can successfully gamble the assets to increase the firm's value to more than $500 million, will prebankruptcy equity gain a stake in the firm. Moreover, if the gamble pays off, the managers, having so well served equity, will also probably retain their jobs. If the gamble fails, equity and the managers will lose little other than the creditors' money. While the managers might injure their reputations with a failed gamble, they may have little to lose after steering a firm into bankruptcy in the first place. The managers of an insolvent firm are gambling with other peoples' money—the creditors' money.

The problem of management's preference for risk is inherent in the firm's insolvency and cannot properly be blamed on the bankruptcy process.

Indeed, the bankruptcy code requires management to gain court approval for extraordinary transactions, and that somewhat inhibits management's ability to risk the firm's assets. But most of the bankruptcy reorganization provisions increase management's ability to behave strategically to the detriment of creditors.

The bankruptcy code gives management or its trustee the exclusive right for 120 days to file a plan of reorganization for financial and operating rehabilitation. While the courts can reduce or extend the 120-day period, they routinely extend the period, provided management complies with procedure. For example, in the recent LTV bankruptcy case the judge extended the exclusive period for over five years. That extension effectively allowed management to hold the creditors' money hostage.

The avowed purpose of the exclusive period is to allow management to work out the difficult details in a reorganization plan. Those details include the decision of how large an interest the secured creditors should receive compared with that of the general creditors. That decision rests on an estimate of the firm's total value and the value of the secured creditors' collateral. It is true that such estimates take time to prepare. But it is not clear why managers, who may wish to undertake overly risky projects or stall for time in hope that the firm's fortunes will change or simply to put off the day the new owners fire them, should have an *exclusive* right to make such estimates and put together a reorganization plan.

It is not clear why creditors are denied the right to present their own plan to one another or to the court so that they might shorten the bankruptcy process and, as the new owners, gain control of the firm. Holding control, the prebankruptcy creditors could replace management if they chose. In any case, after reorganization concluded, management would no longer have so strong an incentive to gamble the firm's assets because the prebankruptcy shareholders of an insolvent firm no longer have any rights to those assets. Even a successful gamble would not then benefit the old shareholders.

To make matters worse, management's strategic advantage in corporate reorganization is not limited to the exclusive proposal period. The advantage extends to the plan-approval mechanism itself. In essence, the bankruptcy code provides that a management plan be presented to all claimants affected by the plan, each of whom has a right to vote for or against the plan. Creditors are divided into classes of creditors with similar interests. Unimpaired creditors, those who are to receive payment in full in cash or have their claims reinstated in full, do not vote on the reorganization plan. All other creditors are deemed impaired. If a plan is accepted by creditors who hold two-thirds in claim amount and a majority in number of the claims voted in each class of impaired claims, the court will, if there are no other objections, confirm the plan. If fewer than the required number of creditors approve the plan, management, as the plan's proponent, can petition the court to confirm the plan over the objection of the dissenters. The court may be able to confirm the plan if it does not discriminate unfairly and is "fair and equitable" with respect to each class that objected. That process is commonly known as a "cram down." The court is not free to cram down a plan in all circumstances, but the variety of situations in which a cram down is permitted provides management with ample opportunities.

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Suppose, for example, that in our example the debtor corporation owes $400 million to a great number of general creditors and owes $50 million each to two secured creditors, each with $50 million worth of equipment as collateral. The general creditors might be in one class, while each secured creditor, dissimilar because of the distinct collateral, would be in its own class. Assume that the corporation is worth about $250 million as a going concern but worth only $100 million if liquidated piecemeal. Also assume that management proposes a plan that would, if confirmed, provide each

"You're bankruptcy? That's even worse!"

secured creditor with 50,000 shares of the reorganized debtor in lieu of its collateral, provide the general creditors with 140,000 shares, and provide prebankruptcy equity with 10,000 shares.

Management's strategic advantage extends to the reorganization plan approval mechanism. Bankruptcy law, in its desire to achieve a consensual agreement among all claimants, allows management to force transfers from unwilling creditors provided management can extract consent of other creditors, no matter how grudging.

If the court determines that the corporation is in fact worth $250 million, it cannot confirm the plan unless both secured creditors and the general creditors holding two-thirds by amount and more than half by number of the general claims accept the plan. If there are 250,000 shares issued in the reorganized corporation worth $250 million (ignoring reorganization expense for now), each share, worth $1,000, should go to satisfy senior claims in full before a junior claimant receives a single share. Thus, once the secured creditors receive their 50,000 shares each—in satisfaction of their $100 million claim—the remaining 150,000 shares, worth $150 million, should all go to the general creditors, to whom the firm owes $400 million. If the general creditors object as a class, then the prebankruptcy shareholders may yet receive what they are entitled to—nothing.

Management may, however, be able to convince most of the creditors to accept the plan, even though creditors would not receive payment in full. Management may be persuasive because, if the general class rejects the plan, someone must propose a new plan. Plans are time-consuming and costly to prepare, and time in reorganization is expensive. There is also the risk that management will use the time to gamble or, distracted by the reorganization process, will otherwise waste the firm's assets. Even with the powerful threat of waste, management might not try to propose a plan in breach of the creditors' right to be paid ahead of equity (called absolute priority) if it had to receive unanimous acceptance of such a plan. In that case management might assume that there would be at least one holdout. Thus, the threat of delay is an effective proshareholder management strategy *because* corporate bankruptcy law does away with the requirement of unanimous consent. The law, in its desire to achieve a consensual agreement among all claimants, allows management to force transfers from unwilling creditors provided management can extract consent of other creditors, however grudging.

A related strategy exists even if management is unsuccessful, at least at first, in convincing all classes to accept a reorganization plan. Assume that the management plan just discussed is accepted by the secured creditors but rejected by the general creditor class. By shifting tactics, management may still attempt to have the court confirm the plan. Management can argue that the firm is worth more than $250 million. If management can convince the court that the firm is solvent (worth at least the $500 million it owes creditors), then the prebankruptcy shareholders will be entitled to a share in the reorganized firm—a share that reflects the firm's value in excess of its debt. One might think that it would be difficult in our example for management to convince a court that the firm is worth in excess of $500 million—or more than twice its actual value. But certain courts are notoriously optimistic about the future of corporations in reorganization. One might refer to an American bankruptcy court as a Pollyanna oracle. In any case, to succeed management need not convince the court that the firm is worth $500 million. Management can succeed if it merely convinces the required number of creditors holding

the requisite amount in claims that it will waste much of the firm's resources while *trying* to convince the court of that inflated valuation.

Another strategic advantage for management is its substantial flexibility in shopping for a judge with a history of decisions in management's favor. Basically, a firm may file for bankruptcy in any court district where the firm is incorporated, has its head office, or conducts a substantial portion of its business, or where a subsidiary has already filed. Large firms have many districts from which to choose. It is even possible for management to have a subsidiary file for bankruptcy in one district and wait to see which judge is assigned to the case before having the parent corporation file. If management does not like the judge assigned to the subsidiary's case, it can have another subsidiary file in another district. Eastern Airlines, for example, filed for bankruptcy protection in the Southern District of New York six minutes after its subsidiary filed there. The Southern District of New York is well known for having judges who favor management and equity. Similarly, LTV, Manville, and Orion each arranged to have their bankruptcy cases heard before the same judge, the Hon. Burton Lifland, in the Southern District of New York.

Thus, through these and other means the deck is stacked in management's favor. Moreover, it is easy to imagine situations in which management can use its strategic weapons to wrest benefits for managers instead of for the shareholders generally. Bankruptcy reorganization is fertile ground for breaches in absolute priority. Consequently, one expects creditors to get less from a firm in reorganization than the amount to which they are contractually entitled. Indeed, Weiss recently showed that bankruptcy reorganization yields precisely that result. In a study of New York and American Stock Exchange firms, priority of claims (providing full payment to senior claimants before junior claimants receive any payment) was violated in twenty-nine of thirty-seven cases. As our examples suggest, the breakdown in priority of claims occurred often between unsecured creditors and shareholders.

The Costs of Corporate Bankruptcy Reorganization

Because creditors *know* that they may lose if their debtor undergoes corporate bankruptcy reorganization, they adjust the terms of their loans to compensate for the potential loss. Thus, the victims of bankruptcy reorganization are not the creditors alone. Corporate bankruptcy reorganization harms all investors, shareholders, and creditors alike, because of the extraordinary expense and strategic conflict of the reorganization process. Put simply, the expense of bankruptcy reorganization reduces the size of the pie being divided. The cost of doing business, which includes the risk of bankruptcy, is greater to the same extent, regardless of whether shareholders or creditors bear the costs.

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The costs of bankruptcy reorganization fit into two categories: direct costs and indirect costs. Direct costs encompass the legal and administrative fees, primarily lawyers' and accountants' fees. Indirect costs include a wide range of difficult-to-measure opportunity and management distraction costs, such as lost sales, increased operating costs, and reduced competitiveness.

Weiss recently showed that the direct costs of bankruptcy reorganization for large firms average approximately 3 percent of the debtor corporation's total assets. That amount is similar to the costs of issuing debt or equity. Under any insolvency process, in settling up with creditors a firm must bear some costs if it cannot pay in full. For large firms with many unconnected creditors that settling up will always be complicated and would be difficult to accomplish for much less than 3 percent of a firm's value. But the direct costs of reorganization may well be insignificant compared with the indirect costs of management's risk-taking and general waste.

A Case of Waste

The recent Eastern Airlines bankruptcy case is perhaps the most spectacular example of how the bankruptcy system can waste assets. Eastern filed

for bankruptcy on March 9, 1989, and ceased operations almost two years later, on January 18, 1991. At the time Eastern filed for bankruptcy, the corporation was solvent, and the unsecured creditors were promised that they would be paid in full. Today, it appears unlikely that they will receive even *1 percent* of their more than $2.3 billion claim.

We recommend eliminating the exclusive period during which only management can file a plan of reorganization. To combat forum shopping, we recommend giving the general creditors the right to change the venue under certain circumstances. Finally, we recommend that creditors have the ability to force a vote on converting a reorganization case to a liquidation case without managerial or judicial interference.

To be sure, only part of the blame for Eastern's dramatic failure lies with the bankruptcy process. Most of the management proposals and bankruptcy judge's decisions were unopposed by the creditors. At the start of the case no one could have predicted the Persian Gulf War, increased oil prices, a decline in air traffic, or the prolonged bitter nature of an employee strike. It is, however, beyond question that the bankruptcy process limited the ability of Eastern's creditors, whose money was at risk, to affect the outcome of the case. As late as two months before the airline ceased operation, the bankruptcy court ignored the creditors' plea to stop the hemorrhaging. The court allowed Eastern to use funds from an escrow account (created from prior asset sales) to continue operations over the creditors' strenuous objections. That decision alone cost Eastern's estate over $150 million.

The Eastern bankruptcy case documents not only the large direct costs (with professional fees to date over $100 million) and indirect costs, but also the costs to other firms and the general economy. Eastern's continued survival not only hurt its own creditors, but also caused other airlines to lose many millions of dollars. Efficient airlines suffered because they had to compete with the excess supply of services provided by the bankrupt Eastern, a firm whose management—intent on gambling—was able to use a wealth transfer from creditors to set air travel prices below true cost. The result of such subsidy pricing is a deadweight loss as resources are diverted away from more valuable uses. The magnitude of all those costs underscores the potentially negative impact the bankruptcy process can have on the firm, its creditors, other firms in the industry, and the economy generally.

Proposal for Reform

Are there alternatives to our current corporate bankruptcy system? Certainly. The firm could, at the creditors' request, be turned over to a trustee or group of creditors until the reorganization process was worked out. The risk of losing control, and their jobs, would dampen managers' appetites for strategic behavior. A simpler approach would be to sell the firm in its entirety through an auction at the request of any creditor whom the equity holders and other creditors do not repay in cash in full. Adler has even suggested that the best solution in theory is to abolish the bankruptcy process and amend nonbankruptcy law so that it facilitates contractual alternatives.

Those alternatives would involve major changes to the current system. Any change would surely meet with substantial opposition by those who gain from the current regime. The greater the proposed change, the greater the likely response, and the less likely the success of reform. Smaller modifications might be possible, however, while a debate on and battle over a major overhaul of the corporate bankruptcy process is underway.

First, we recommend eliminating the exclusive period during which only management can file a plan of reorganization. Creditors should be allowed to propose their own plans in place of or in competition with management's plan. It is, after all, the creditors' money that management controls while it considers the appropriate reorganization plan for an insolvent firm. The creditors' increased control of the process should accelerate the filing of a plan of reorganization, shorten the length of time the firm remains in bankruptcy, and lower the fees and other costs.

Second, to combat forum shopping, we recommend giving the general creditors, who stand to gain or lose the most from the reorganization process, the right to change the venue when a firm

files in a district where it does not have a principal place of business or its headquarters or when the company asks to be attached to the case of a related company that is substantially smaller in size. That would limit the influence of judges who are considered to favor management or equity.

Finally, we recommend that creditors have the ability to force a vote on converting a reorganization case to a liquidation case without managerial or judicial interference. Creditors could then ensure the movement of resources to their most valuable use and discourage management's potential to waste or gamble the creditors' assets in bankruptcy.

Conclusion

In theory bankruptcy law honors creditors' claims while preventing the premature liquidation of a viable firm. In practice, as we have argued, the law is not working as it should and appears tilted toward management to the detriment of investors collectively and society generally. Congress should begin removing management's stranglehold on the bankruptcy process. That would increase the prospects that resources will move to their most valuable use and limit the waste that all too often results from the corporate bankruptcy process.

Until Congress reforms the process, judges should be more aware of whose property they control in corporate bankruptcy. The property does not belong to the debtor or to society. The debtor is a set of contracts—a conglomerate of investors' interests. If the firm is insolvent, the firm's assets belong to the creditors, and it is to the creditors that the bankruptcy process should be responsible.

Unfortunately, positive action on the part of Congress or the courts seems unlikely, at least right now. Recent proposals in Congress for bankruptcy reform foretell moves largely in the wrong direction. There is, for example, a proposal to provide for faster reorganization of small businesses. And while faster is better in general, the proposal includes provisions that would *weaken* the creditors' position in opposition to breaches in absolute priority. Moreover, with that sort of lead from Congress, courts are unlikely to alter their practices and uphold creditors' contracts. We hope, however, that it is not too late to change minds with arguments such as those we have presented.

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Selected Readings

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