HOW THE CORPORATE BANKRUPTCY SYSTEM BENEFITS AND HINDERS THE ECONOMY

BY STEPHEN SLIVINSKI

When Richmond-based Circuit City — the second-largest consumer electronics retailer in the nation — declared bankruptcy on Nov. 10, 2008, the company still had some options to keep itself alive. Although the withdrawal of the $1 billion bid for the company by Blockbuster Inc. in July must have been fresh in the minds of the firm's managers, they declared in the bankruptcy filing their intent to emerge from the court proceeding in the first half of 2009.

On paper, the immediate problem that afflicted the company was the massive amount of debt it had accumulated to sustain its operations in the face of slow sales. The managers were hopeful that the company could be valuable to a new owner and scrambled to cobble together a deal with some interested buyers, and the judge in the case set a January date to auction off the firm.

On the morning of January 16, the company's creditors and nearly 34,000 employees found out the end had arrived. That's when Judge Kevin Huennekens agreed to Circuit City's request to close its doors for good and liquidate its inventory.

The firm's demise might not have been much of a surprise to the creditors and vendors who supplied Circuit City's inventory in those dying days. Fearing poor sales at the store's locations in the 2008 holiday shopping season, vendors began to restrict the flow of merchandise as early as November. The creditors of the company, led by Bank

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of America, told the firm's managers they simply could not provide funding to keep the 500-plus locations in operation. Market players seemed to be saying what Circuit City's corporate heads feared: The company was no longer economically viable, unable to compete in a world full of popular online retailers and other low-cost shopping options.

In all bankruptcy proceedings, the most important question is whether a particular company has simply fallen on hard times or whether it's not economically viable anymore, such as a typewriter manufacturer in a world where typing has migrated almost universally to computer keyboards. For many businesses, the day may come when the question their managers have to answer becomes one familiar to poker players: When do you fold? Not to grapple with such a question could cause a variety of firms that should whither away to survive instead, and vice versa. Either outcome would be bad for economic growth.

The institutions in the United States that have been created to officiate the process are the bankruptcy courts. Of course, simply declaring bankruptcy doesn't automatically imply that a company is doomed. The system has two tiers. The form of bankruptcy that Circuit City entered — called "Chapter 11" after the title of the section of the federal Bankruptcy Code that created it — was originally designed to create a means by which firms could reorganize themselves and survive by renegotiating costly contracts or restructuring their debt obligations. That's a distinctly different approach than that taken in Chapter 7 of the Bankruptcy Code in which a company is liquidated. As in the case of Circuit City, liquidation can be the outcome of a Chapter 11 proceeding that does not result in a reorganization or sale of the firm.

There are many companies battered by bad economic times that can still survive if they just have a safe harbor in the storm. Reorganization in Chapter 11 gives them such an option, and it's an important one. But if a company is likely to be liquidated anyway because it simply isn't able to survive in a modern marketplace, why would it go through the hassle and cost of trying to reorganize? And since bankruptcy proceedings ask a single judge to be the arbiter of whether a firm is viable as an economic entity, it's also a concern to some that current bankruptcy practice assumes one person with incomplete knowledge will be able to accurately predict the future contours of the U.S. economy. Firms that probably shouldn't be reorganized might be able to survive for a bit longer if they find a sufficiently sympathetic judge, and that creates economic inefficiency. "There is an opportunity cost to keeping a nonviable firm alive for too long," says Todd Zywicki, a professor at George Mason University Law School. For instance, economists Ricardo Caballero, Takeo Hoshi, and Anil Kashyap have argued that subsidies to money-losing "zombie" firms have helped keep those businesses afloat, while depressing the creation of new competitors.

These concerns have sparked a debate within academic, legal, and economic circles about how bankruptcy functions in the United States. In the view of some, the current system could lead to adverse consequences alongside its benefits.

Railroads and the Logic of Bankruptcy

You can't understand modern bankruptcy law without knowing the story of the 19th century U.S. railroad industry. "If you talk to most legal scholars about Chapter 11, they usually bring up the railroads as the poster children for why we need a law of corporate reorganization," says Douglas Baird of the University of Chicago Law School.

After the Civil War, the American economy became increasingly national in scope thanks in part to the evolution of rail travel. The number of miles of train track more than tripled between 1870 and 1900, allowing the expanded movement of goods and eventually an increase in the number of newly industrialized manufacturing centers.

In fact, the railroad companies would become the first modern corporations in U.S. history. Before 1860, the railroads were financed mainly by the farmers and merchants who benefited from the lines. After 1860, however, railroad companies had to seek capital from New York financial houses. This effectively made them a trans-state operation in terms of capital structure as well as in the services they provided.

Between 1865 and 1890, railroad competition intensified. Cartels formed and collapsed. Then the early 1890s witnessed one of the United States' worst economic downturns at the time. By the mid-1890s, many railroad companies were unable to make the payments on their bonds, leading judges to reckon with how to deal with high-cost operations that had numerous investors.

The approach the courts took was a reorganization of the companies. The goal was to rearrange the capital structure and allow a firm to provide ongoing value to creditors beyond the temporary economic tumult. The only other alternatives would have been to sell the firm to

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new owners or to terminate the company's operations, tear up the railroad tracks, melt them, and sell them for scrap. The second option would have destroyed a tremendous amount of economic value. The railroad companies were surely still more valuable than the sum of their parts.

But capital markets were relatively undeveloped at the time and that made it very difficult to engineer a sale at a price acceptable to both parties. So the simplest way to save the company was to reorganize it and allow the railroad, as the legal scholars say, to retain the value it had as a "going concern."

Also, there was the sticky matter of the type and number of creditors. "One of the reasons that it was compelling to reorganize the railroad companies is because they had massively chaotic capital structures," says Baird. "The Atchison, Topeka and Santa Fe Railroad Company, for instance, issued over 40 different types of bonds held by thousands of bondholders all over the universe."

The disparate nature of this large group of creditors meant they would not have been able to collaborate and agree on whether to sell the company or how to restructure it. The transaction costs of working out a reorganization agreement would have been very high. "One of the main reasons to have a collective procedure is that the creditors can't work together outside of bankruptcy," explains Baird.

That alone seems like a big enough problem. But imagine what might happen if a group of creditors decides they don't want to restructure and rush to stake their claim to the railroads assets? That could set off a rush to disinvest in the company, throwing it further into financial straits and leaving those who are late to the feeding frenzy without much to show for it. A system of bankruptcy that provides a "safe harbor" for firms is important in such an environment.

So it should be no surprise that the railroad example is one of the most common historical examples in the literature on bankruptcy law. But there's a catch, argues Baird: It's really hard to argue that the logic of the example applies to the modern world. "The traditional justification for reorganization is that the firm cannot be sold as a going concern, there's a lot of firm-specific value at risk, and the creditors cannot cooperate outside of bankruptcy. Reorganization can only be justified if all three of those are true at the same time. Today, in many cases, they are not all true."

Baird suggests that most firms today don't own specialized assets that are only valuable in their current firm-specific context. Most companies own or lease assets, like machinery — or, in the Circuit City example, retail space — that would indeed have valuable alternative uses to another firm. In fact, much of the value of many modern firms is portable: It consists of the human capital of the employees.

Business success instead rests largely on the originality of a company's approach. "Today, bankruptcy law can affect your capital structure, but it can't make you successful in the marketplace. That depends on your business model," explains Robert Rasmussen, dean of USC Gould School of Law.

The specter of the collective action problem has been lessened in the modern world too. It's rarely the case that a single firm has a large number of creditors. "If you look at many firms filing for bankruptcy today, there is often one creditor that has a revolving credit line and that person or firm is basically making many of the important decisions. There's no coordination problem there," says Baird. In fact, many corporations have been able to renegotiate their debt contracts outside of court and never have to declare bankruptcy.

The Rules and Costs of the Bankruptcy Game

Even if the traditional railroad paradigm were applicable today, the bankruptcy proceeding may still have shortcomings as a result of its structure. Like any legal proceeding, the bankruptcy process has its own unique set of rules and players.

As Zywicki notes, the players with the most power in the bankruptcy process are the firm's managers. While creditors can force a company into a bankruptcy proceeding, those cases tend to be rare. Instead, it's usually the firm's managers that are in the driver's seat. "They control when the bankruptcy is going to happen and they control where the bankruptcy will be declared," Zywicki says. Because current law doesn't require companies to declare bankruptcy in the state where they are incorporated, managers retain the ability to "forum shop" and scope out the landscape for a friendly judge.

Once a firm's managers choose to declare bankruptcy, they have a set period of time in which to present a reorganization plan that must win the approval of the creditors. If they don't approve the plan or they can't get a buyer for the firm, then the company could head to liquidation.

According to economist Michelle White of the University of California at San Diego, these rules create the wrong incentives and cost the economy in the process. "In Chapter 11 there is a tendency for too many firms to be saved," she says.

The main reason is that the firm's managers should be expected to know more about the actual state of the firm than the creditors or stockholders. If a firm is actually in worse shape than the creditors realize, the managers have an incentive to get them to agree to a reorganization plan rather than liquidate the firm. Inability to do so might result in those managers losing their jobs and equity in the company. "It gives an incentive for bad firms to pretend they're good firms," says White. "Those voting on the reorganization plan may not know which type the firm is."

If the current system leads to keeping alive too many firms that should be liquidated, it could lead to capital being trapped in a less-efficient use. This deadweight cost to the economy has been estimated by White as potentially 20 times as big as the amount of money spent on direct costs like lawyers' fees.

The success rate of corporate reorganizations has come into question by other scholars. Finance professor Edith Hotchkiss of Boston College found that one-third of the firms that successfully restructured in Chapter 11 required further restructuring in three years. "Her results are consistent with a model in which some inefficient firms reorganize even though they should liquidate," points out White in a 2005 working paper for the National Bureau of Economic Research.

So, much of the debate over bankruptcy law really does come down to the effective use of information. The ultimate decisions in a bankruptcy proceeding are made by a single judge. But a single judge is unlikely to have all the decentralized information that markets can summon, or even know how to best utilize that information even if he had it.

"Bankruptcy puts the judge in a position to play central planner," says Zywicki. "The fundamental decision the judge is making is whether the current deployment of assets is more valuable than an alternative deployment of assets in the economy." By that standard, current bankruptcy reorganization procedures may be suboptimal.

Making Bankruptcy More Efficient

Each year, hundreds of thousands of firms fail. In fact, most firms' managers never see the inside of a bankruptcy courtroom. According to the Small Business Administration over 540,000 businesses fail each year. By contrast, the number of firms that enter bankruptcy is only a tenth of that.

Those that do enter bankruptcy, however, are facing a whole new set of realities. Baird argues that over time Chapter 11 proceedings have become the most useful when they serve as a controlled environment in which to conduct the speedy sale of a company, not to haggle over a reorganization.

A similar approach to bankruptcy is one when Chapter 11 becomes merely a vehicle by which to auction off the firm. In this "mandatory auction" scenario, bidders — some of whom could have better information than a typical bankruptcy judge or corporate debtor — would vie for the ownership of the firm as a going concern. At that point, the decision whether to liquidate or reorganize would be made by the new owner.

In any case, the assumptions of corporate bankruptcy laws would need to change. "In an ideal world, bankruptcy law would aim to reduce the cost of capital," says Rasmussen. "You'd want to have a system that effectively flushes the losers and salvages the winners. If you could do that, it should lower the cost of capital because people know the system won't burn money trying to resurrect companies that are not viable." Making auctions the main purpose of bankruptcy proceedings would do that.

Rasmussen favors making the system even more decentralized. He advocates what he calls a "menu approach" to debtor-creditor contracts. If legal rules affect investment decisions and the cost of capital, then uncertainty about what might happen during a bankruptcy proceeding in the future would have an influence on the risk premiums charged by creditors today. So why not allow the rules to be set by the companies themselves in their charters?

"You can imagine a world where a company can agree at the front end to limit its options if it falls into financial distress," says Rasmussen. An example would be a debt contract that gives the primary creditors more control over business decisions in periods of economic distress or other similar scenarios. Venture-capital investments are often structured in this way.

This option, however, is difficult to achieve in the current bankruptcy regime. No company can legally bind themselves never to resort to the bankruptcy courts. Still, this hasn't stopped many firms from finding some rather sophisticated ways of contracting around this prohibition, although the costs of doing so are quite high. Rasmussen's alternative would make reorganization within bankruptcy courts one of many options, not the mandatory default.

How policymakers deal with the "creative destruction" that leads economically unviable companies to fold and allows the resources to be reallocated by the market to something more useful is important. What mechanisms we use to assist that transition in an evolving modern economy are vital. Making sure those same mechanisms don't hinder that process is potentially even more crucial. So perhaps, as critics of the current bankruptcy regime argue, it is about time we get more creative with our approach to the legal mechanisms of creative destruction. **RF**

Readings

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