Bankruptcy and Bankruptcy Procedures

Different Approaches to Bankruptcy*

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In the last fifteen years or so, lawyers working in law and economics and economists with an interest in legal matters have turned their attention to the topic of bankruptcy. A large amount of work has resulted, both theoretical and empirical, some of which has been concerned with the functioning of existing bankruptcy procedures and some with bankruptcy reform. Although researchers in this area have expressed different views, I believe that one can identify a consensus on certain issues, e.g., the goals of bankruptcy and some of the characteristics of an efficient bankruptcy procedure. (There is probably less agreement about exactly what the best bankruptcy procedure is or how well existing systems around the world function.) In this paper I will focus on this consensus because I believe it is useful in guiding countries with poorly developed bankruptcy procedures in efforts to improve them.[1] One point I will stress is that it is unlikely that "one size fits all". That is, although some bankruptcy procedures can probably be rejected as being manifestly bad, there is a class of procedures that satisfy the main criteria of efficiency. Which procedure a country chooses or should choose may then depend on other factors, e.g., the country's institutional structure and legal tradition. One can also imagine a country choosing a menu of procedures and allowing firms to select among them.

It is important to recognize that bankruptcy reform should not be seen in isolation: it may be necessary to combine it with legal and other reforms, e.g., the training of judges, improvements in corporate governance and the strengthening of investor rights[2], and possibly even changes in the international financial system.[3] I will not discuss these issues here, although they should be borne in mind in what follows.[4] Also, I will deal only with company bankruptcy and not with the bankruptcy of individuals or governments (local, state or national), even though some of the issues raised are similar.

The need for a bankruptcy procedure

Firms take on debt for several reasons. Probably the most important is that they wish to commit to pay out some of their future cash flow. Whatever the reason, there will be circumstances in which a firm will be unable to pay its debts. Bankruptcy law is concerned with what happens in such situations.

In the absence of a bankruptcy law, a creditor has two main legal remedies at her disposal in countries like the U.S., the U.K., and the rest of Western Europe. First, in the case of a secured loan, the creditor can seize the assets that serve as collateral for the loan. Second, in the case of an unsecured loan, the creditor can call on the court to sell some of the debtor's assets.

This method of debt collection runs into difficulties when there are many creditors and the debtor's assets do not cover his liabilities. Under these conditions, creditors will try to be first to recover their debts. This race by creditors may lead to the dismantlement of the firm's assets, and to a loss of value for all creditors. Given this, it is in the collective interest of creditors that the disposition of the debtor's assets be carried out in an orderly manner, via a bankruptcy procedure.

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[1] My approach will be mainly normative: I will have very little to say about why bankruptcy laws have developed in the way they have. On this, see Berglöf and Rosenthal (1998) and Franks and Sussman (1999).

[2] See LaPorta et al. (1998).

[3] See Rowat and Astigarraga (1999) and the 1999 IMF report.

[4] Among other things, the IMF report suggests that one way to reduce financial distress might be for a firm and its bondholders to include debt renegotiation provisions in their bond contracts. This may be thought of as a private bankruptcy procedure – see below.

In principle, individuals could arrange bankruptcy procedure themselves. That is, a debtor could specify as part of a debt contract what should happen in a default state. Writing such a contract may be difficult, however, given that the debtor may acquire new assets and creditors as time passes. Moreover, the empirical evidence – both the fact that firms rarely write such contracts and that almost all countries have at least a primitive state-provided bankruptcy procedure – suggests that we cannot rely on this "private" solution in practice. In other words, there seems to be a clear case for the govemment at least to provide an "off the shelf" bankruptcy procedure, i.e., one that the parties can use in the event that they do not write their own.

Goals of a bankruptcy procedure

It is hard to derive an optimal bankruptcy procedure from first principles, given that economists do not at this point have a satisfactory theory of why parties cannot design their own bankruptcy procedures (i.e., why contracts are incomplete). In spite of this, economic theory can guide us as to the characteristics of a good procedure.

First, there is a strong argument that a bankruptcy procedure should deliver an ex post efficient outcome, that is, it should maximize the total value (measured in money terms) available to be divided between the debtor, creditors and possibly other interested parties, e.g., workers. (We call this Goal 1.) Specifically, a firm should be reorganized, sold for cash as a going concern, or closed down and liquidated piece-meal according to which of these generates the greatest total value. The reasoning is that, other things equal, more is preferred to less; in particular, if a procedure can be modified to deliver higher total value, then, given that each group receives an adequate share of this value (see the discussion of Goal 3 below), everyone will be better off.

Goal 1: Ceteris paribus, a good bankruptcy procedure should deliver an ex post efficient boutcome.

Although Goal 1 will be readily accepted by most economists, it is worth noting that it goes against much informal thinking on the topic. lt is often taken for granted that debtors will favor a pro-debtor bankruptcy procedure and creditors will favor a pro-creditor bankruptcy procedure. The informal view misses the point that if, say, a pro-debtor bankruptcy procedure is chosen, then debtors will have to pay higher interest rates to compensate creditors in non bankruptcy states.

The second goal concems ex ante efficiency. As we have noted, probably the most important reason a firm raises funds by borrowing money rather than, say, issuing shares is to commit itself to pay out future cash flow. For such a commitment to have any force, there has to be some punishment if the commitment is not fulfilled. This punishment can take various forms. Shareholders can be punished by having their claims wiped out (see Goal 3 below). Managers can be punished by making it less likely that they can hold onto their jobs. But without any adverse consequenees at all, there is very little incentive to pay your debts.

Goal 2: A good bankruptcy procedure should preserve the bonding role of debt by penalizing managers and shareholders adequately in bankruptcy states.

Next we turn to the way value is divided among the claimants. A simple way to penalize shareholders in bankruptcy is to respect the absolute priority of claims (i.e., senior creditors are paid off first, then junior creditors, and finally shareholders). Adhering to absolute priority of claims has other advantages. First, it helps to ensure that creditors receive a reasonable return in bankruptcy states, which encourages them to lend. Second, it means that bankruptcy and non-bankruptcy states are not treated as fundamentally different: contractual obligations entered into outside bankruptcy are respected to the full extent possible inside bankruptcy.

However, an argument can be made against absolute priority. As a number of scholars have pointed out, if shareholders receive nothing in bankruptcy, then management, acting on behalf of shareholders, will have an incentive to "go for broke," i.e., they will do anything to avoid bankruptcy, including undertaking highly risky investment projects and delaying a bankruptcy filing. For this reason, there may be a case for reserving some portion of value in bankruptcy for shareholders.

Goal 3: A good bankruptcy procedure should preserve the absolute priority of claims, except that some portion of value should possibly be reserved for shareholders.

Existing procedures

Although there are many different bankruptcy procedures around the world, they fall into two main

categories: an asset sale (or cash auction) on the one hand and structured bargaining on the other hand.

Asset Sale (Cash Auction)

The simplest bankruptcy procedure, some version of which can be found in almost all countries, consists of a sale of the firm's assets, supervised by a trustee or receiver. Often the assets are sold piecemeal; in other words, the firm is liquidated (having been closed down). Sometimes, however, the firm is sold as a going concern. Whichever occurs, the receipts from the sale are distributed among former claimants according to absolute priority (usually secured debt, then varlous priority claims, then unsecured debt, then subordinated debt and finally equity); however, absolute priority is not an essential part of the procedure.

From a theoretical perspective, a cash auction has an attractive simplicity. lf capital markets work well, the procedure should generate an ex post efficient outcome. In particular, if the firm is worth more as a going concern than liquidated, a bid to keep the firm together will dominate a set of independent bids for the parts. On the other hand, if the firm is worth more closed down, then a set of independent bids for the parts will dominate a bid for the whole.

A cash auction has another advantage. There is no haggling among the claimants about who should get what: the firrn is transformed into a pile of cash, which is distributed according to absolute priority (or some other agreed-in-advance rule).

Although there is little clear-cut evidence about whether cash auctions for firms work well in practice[5], there is plenty of indirect evidence suggesting that debtors, creditors and society generally do not trust them. There have been discussions in many countries in the last fifteen years or so about bankruptcy reform, with new procedures being introduced in some countries, but, as far as I am aware, all of the discussion and changes have been in the direction of introducing a Chapter 11-type structured bargaining procedure (see below); none of the movement has been in the direction of cash auctions.[6] In fact, I'm not aware of any group – management, shareholders, creditors, or workers – who is pushing for cash auctions. Thus, it seems to be a fact of life that countries are not prepared to rely on cash auctions as a bankruptcy procedure.

Structured bargaining

Because of the concern about the effectiveness of cash auctions, a number of countries have developed alternative procedures based on the notion of structured bargaining. The idea behind these procedures is that the firm's claimants are encouraged to bargain about the future of the firm – whether it should be liquidated or reorganized and how its value should be divided-up according to predetermined rules. The leading example of a structured bargaining procedure is Chapter 11 of the U.S. Bankruptcy Code; however, U.K. administration is based on similar ideas, as are procedures in France, Germany, and Japan.

The basic elements of Chapter 11 are as follows. A stay is put on creditors' claims (that is, they are frozen: no creditor is allowed to seize or sell any of the firm's assets during the process); claim holders are grouped into classes according to the type of claim they have (secured or unsecured, senior or junior); and a judge supervises a process of bargaining among class representatives to determine a plan of action and a division of value for the firm. During the process, incumbent management usually runs the firm. An important part of the procedure is that a plan can be implemented if it recelves approval by a suitable majority of each claimant class; unanimity is not required.

U.K. Administration was introduced in 1986 as "the British version of Chapter 11". An important difference between U.K. Administration and Chapter 11 is that the U.K. administrator (who is an insolvency practitioner) runs the firm during bankruptcy. The bankruptcy law enacted in France in 1985 is also somewhat like Chapter 11. However, the court, through an administrator, has considerately more power than in the U.S. or U.K.: it can accept a reorganization plan without the approval of creditors (or workers), provided it best ensures the maintenance of employment and the repayment of creditors.

Chapter 11 has been criticized for being time-consuming, costly, too friendly to debtors and for not respecting absolute priority. The procedure could undoubtedly be modified to deal with some of these criticisms. However, there are two fundamental problems inherent in Chapter 11 and structured bargaining procedures like it. These problems arise be-

[5] But see Pulvino (1998).
[6] Countries in which a Chapter 11-type structured bargaining procedure has been introduced recently include Australia, Indonesia, Thailand and Argentina.

cause a structured bargaining procedure tries to make two decisions at once: what to do with the firm, and who should get what in the event of a restructuring of claims. Unfortunately, restructured firms do not have an objective value. Consequently, it is hard to know what fraction of the post-bankruptcy firm's securities each group of creditors is entitled to receive. This is true even if there is no dispute about the amount and seniority of each creditor's claim. As a result, there can be a great deal of haggling.

Perhaps even more serious, there is a danger that the wrong decision will be made concerning the firm's future. The voting mechanism is fixed in advance, which means that those people whose payoff ought not to be affected by the outcome (either because they are fully protected anyway, or because they are not entitled to anything) may end up controlling the pivotal votes.

As an example, consider a firm whose debts are approximately equal to its liquidation value. Creditors will push for a speedy liquidation (since they will be close to fully paid), while shareholders will hold out for a lengthy reorganization (since they enjoy the upside potential, but not the downside risk). Depending on the circumstances, a good firm may be terminated if creditors have the pivotal votes; or a bad firm may be kept going if shareholders have the pivotal votes.

In spite of these problems, Chapter 11 has its supporters. However, it is far from clear that a country embarking on bankruptcy reform should choose Chapter 11, rather than trying something new.

Bankruptcy reform

In this section I will describe a class of procedures that have some of the same features as structured bargaining, but are simpler. In particular, they allow the claimants the choice to restructure the firm; but they avoid haggling about the division of the proceeds. All of these procedures involve an automatic debt-equity swap. They may or may not also include an auction for the firm's assets or a formal vote on what should happen to the firm. The merit of these procedures is that they replace bargaining among claimants who have different objectives with a vote by a homogeneous group of shareholders.

Basic Procedure: When a firm goes bankrupt, its debts (most or all of them) are canceled. The former creditors become the (principal) new shareholders in the firm. A decision about the firm's future – whether it should survive as a going concern or be closed down – is made by the new shareholders. The firm then exits from bankruptcy.

There are two aspects to the procedure: the decision about whether to reorganize or liquidate the firm and the debt-equity swap. We discuss these in turn.

Decision about the firm's future

There are several ways of deciding the firm's future. We present three possibilities.

Version 1:[7] The firm is put up for auction (someone, e.g., a judge, supervises this). Cash or noncash bids are allowed. In a noncash bid, someone offers securities instead of cash. For example, incumbent management might offer the former creditors (the new shareholders) a combination of shares and debt in the post-bankruptcy firm. Thus, a noncash bid embraces the possibility of reorganization and/or recapitalization of the firm as a going concern. The new shareholders vote on which bid to select.[8]

Version 2:[9] The supervisor of the bankruptcy procedure, a trained bankruptcy practitioner (BP), say, takes over the running of the firm (she replaces the board of directors). The BP draws up a plan (or plans) for the future of the firm. The plan might be to reorganize the firm, to sell it as a going concern, or to close it down. (In fact, a plan is just like a cash or noncash bid.) The plan is implemented as long as it receives majority approval by the new shareholders. (The bankruptcy practitioner may choose to put more than one plan to shareholders and see which one receives greatest support.)

Version 3:[10] There is no formal auction or vote. Instead the choice of what to do with the firm is determined by the new shareholders via standard corporate governance procedures. In particular, soon after the debt-equity swap, an election is held for a new board of directors. (Any staggered board provisions are eliminated.) Takeover bids are also allowed through the elimination of all anti-takeover defenses (e.g., poison pills).

[7] This is based on Aghion et al. (1992).
[8] It may be efficient for incentive purposes that management retain an ownership stake in the post-bankruptcy firm. Such an ownership stake can be part of a noncash bid.
[9] This is based on Aghion et al. (1995).
[10] This is in the spirit of Bebchuk (1988).

The versions differ according to the level of involvement by outsiders, e.g., the courts, with Version 2 having the most outsider participation, and Version 3 the least. Less outsider participation comes at a cost: managers' jobs are most on the line in Version 2 and least on the line in Version 3. However, all the versions put management under some pressure, i.e., they go some way toward satisfying Goal 2.

The versions also meet Goal 1. The firm's future is decided by a homogeneous group – the new shareholders – who have a strong incentive to vote for an outcome that maximizes the firm's net present value.[11]

The Debt-Equity Swap

The other part of the scheme involves how debt is converted into equity. Again, there are several ways of doing this. If all debt has the same priority (e.g., it is unsecured), it is natural to allocate all the equity to the creditors on a pro-rata basis, possibly reserving a portion (10 percent? 20 percent?) for former shareholders.

Matters become more complicated if there is senior and junior debt. The reason is that it is not clear what fraction of the equity each group is entitled to. The leading example of senior debt in practice is secured debt. One possibility is to leave the secured debt in place, and just convert the unsecured debt into equity.[12] This turns the firm into a solvent one since the value of the firm is at least as great as the value of its physical assets (which are collateral for the secured debt).

Version A: Suppose there is a single class of unsecured creditors and some secured creditors. Then the secured debt is left in place, and the unsecured creditors become the new shareholders (with some of the shares possibly being reserved for the old shareholders).

Version A deals quite well with secured debt, but less well with other kinds of senior debt, e.g., preferred debt. Preferred debt refers to claims that society has decided should have priority over ordinary debt, e.g., unpald wages of workers and taxes owed to the government. In practice, unpaid wages are not a great burden and the post-bankruptcy firm can pay them off by new borrowing. Taxes can be much more significant, but a simple solution here is to remove the government's priority and treat taxes owed to the government as unsecured debt.[13]

Another approach to dealing with debt of different securities, including secured debt, has been suggested by Bebchuk (1988). Bebchuk proposes eliminating all debt, and allocating shares to the senior creditors and options to buy shares to the junior creditors and shareholders. Specifically, junior creditors are allocated options to buy equity from senior creditors by paying what these senior creditors are owed. (In effect, they buy out their claim.) Similarly, shareholders are allocated options to buy back their equity by paying off all creditors. Note that this is a decentralized process: each option holder acts independently.

Version B: Suppose there are several classes of debt plus equity. Then the most senior class is allocated all the shares. A junior claimant (including a shareholder), owning X percent of her class's claims, is allocated the option to buy (up to) X percent of the equity from senior claimants by paying X percent of the total amount those senior to her are owed.

Bebchuk's scheme deals ingeniously with the general case of multiple debt classes. In effect no junior claimant (including shareholders) can complain that he is being underpaid since, if he thinks that those senior to him are getting more than they are owed, he can always buy them out at the face value of their debt. However, Bebchuk's scherne has the undesirable feature that junior claimants must put money in (i.e., exercise their options) to get money out (to be paid). This may be a problem if junior claimants are wealth-constrained. One possible solution is for the bankruptcy procedure supervisor (a judge or bankruptcy practitioner) to create a market for the firm's options and shares, so that junior claimants can sell their options. The sale of securities in this market can also be used to pay off some creditors. For a detailed proposal along these lines, see Hart et al. (1997).

To sum up, we have presented two ways of carrying out the debt-equity swap, both of which are in line with Goal 3. Combined with the three ways of deciding the firm's future, this means that we have six possible bankruptcy procedures. (Further variations on

[11] To the extent that the firm is worth more as a going concern than liquidated, putting the firm's future in the hands of shareholders should also lead to the preservation of workers' jobs.
[12] To be more precise, an appraisal would be made of the collateral underlying each secured claim. If the appraised value is more than the secured creditor's debt, the debt is left in place (it is fully secured). If the appraised value is less, then only the secured part is left in place; the residual is treated as unsecured debt and is converted into equity.

[13] An even more radical approach is to eliminate the priority of secured debt too, i.e., treat all debt as unsecured. For a discussion of this, see Bebchuk and Fried (1996).

these procedures are obvlously possible.) All of these procedures avoid the haggling problems that beset Chapter 11.[14]

Which procedure is best? The answer probably depends on the circumstances. For example, Version 2 of deciding the firm's future, combined with version A of the debt-equity swap, might work well in a country with trained bankruptcy specialists (e.g., the U.K.). On the other hand, Version 3, combined with Version A, might work well in a country where the judicial system is not very developed and/or the macroeconomic environment is such that there are too many bankruptcies for the courts to handle.[15]

In fact, because it is unclear which procedure is best, a country could select a (limited) menu of schemes and let firms pick from them in advance (e.g., as part of their corporate charter or debt contracts).

A final important point concerns whether the state bankruptcy procedure should be mandatory. There seems to be no compelling reason why it should be. lf a firm and its creditors wish to opt out of the state system and write their own bankruptcy procedure – tailored to their own situation – why not let them do so?[16]

Concluding remarks

In conclusion, it is worth briefly touching on an important "political economy" issue that arises in any country that is considering bankruptcy reform: the transition problem. Although we have argued that a debtor and creditors should jointly favor a more efficient bankruptcy procedure, this may not be the case in the short run given that firms will have debts in place negotiated under a previous regime.

For example, some countries currently have pro-debtor bankruptcy laws and are thinking of making them more pro-creditor. Debtors resist the changes because they are already paying the "cost" of pro-debtor procedures through high interest rates. One way to deal with this problem is to leave the current procedure in place and introduce the new bankruptcy procedure as an option, i.e., debtors can choose whether or not to switch to it (if they switch, they have to do so on all their debt contracts). In the short run debtors may choose not to switch. However, in the long run, as their old debts expire, they are likely to switch if the new procedure really is more efficient: they face a choice of paying high interest rates under the old procedure or low interest rates under the new procedure.

In fact, this example illustrates the desirable feature of a menu of procedures more generally. With a menu there is a "market" test. lf several procedures are available, then in the long run the efficient ones are likely to be chosen by debtors and creditors; the others will eventually be discarded.

[14] These procedures also avoid the need for special "debtor-in possession" financing. This is because both Versions A and B of the debt-equity swap turn the firm into a solvent one, which should be able to raise capital given a profitable investment opportunity.
[15] I am grateful to Joseph Stiglitz for this observation.
[16] An interesting example of parties writing their own procedure is Administrative Receivership in the U.K. Under Administrative Receivership, an important creditor – typically a bank – contracts with the debtor to be granted what is called a "floating charge." This glves this creditor the right to appoint a receiver when the firm defaults. The receiver takes charge of the firm and decides whether to sell the assets piecemeal or maintain the firm. As Franks and Sussman's interesting paper (1999) shows, Administrative Receivership is best seen as a privately negotiated contract between a debtor and its creditors. There seems no reason to interfere with such a contract.

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