Economic Aspects of Bankruptcy

A Perspective

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Capitalism without bankruptcy is like Christianity without hell.
-Frank Borman

Corporate bankruptcies are common. While all entrepreneurs are interested in success, unfortunately, a majority of their ventures fail and many end up in bankruptcy. Entry and exit are fundamental underpinnings of the competitive process. They ensure that a sufficient number of firms remain in an industry, and produce efficiently, in order to satisfy the market demand at a competitive price. The competitive process results in the flow of resources into efficient units and out of inefficient ones - a process which may also be interpreted as 'entry' and 'exit'.

The process of exit, whatever form it takes, is set in motion by either the firm itself (usually the managers) or by its creditors. The more common forms of exit - the flow of resources out of an activity taking place in downsizing and restructuring, mergers and takeovers - are generally planned and implemented by the management on behalf of the firm's owners. But the more drastic forms of exit - entering the bankruptcy proceeding with the possibility of liquidation - are usually forced upon the firm by its creditors or by legal provisions aimed at protecting the interest of creditors.

The bankruptcy procedure is usually triggered off when a firm defaults on its debt. However, the procedure does not necessarily lead to the exit of the firm or even the exit of some production capacity. Liquidation (or exit in the strict sense of the term) is only one option facing the management. In this case, the bankruptcy procedures specify the manner in which the firm in the liquidation process is either sold as a going concern or its assets are disposed off piece by piece, in order to repay the claimants in accordance with the absolute priority rule (APR). Alternatively, the bankruptcy procedures may allow the management to choose the option of 'reorganisation' or restructuring which is aimed at finding a method of rescuing the firm from financial distress and salvaging all or parts of it for the benefit of all claimants. Typically, it involves a process of negotiation between debtors and creditors with a view to establishing a new mechanism for the settlement of claims which may be different from the APR: writing-off some of the claims, injection of new capital, swapping new equities for old ones, exchanging bonds and other debts with new notes, bonds or cash, etc. In short, it amounts to a re-writing of the debt contracts of different groups of claimants and creditors.

Liquidation and bankruptcy are often discussed in the literature as though they are related to the process of dismantling the firm's assets and selling them to new management teams. Liquidation is optimal when the value of the firm's existing resources is in alternative uses. Hence, liquidation should be viewed as a capital budgeting decision that is independent of the way in which the firm is financed. For the past one hundred and fifty years or so, bankruptcy laws have generally attempted to achieve two separate and conflicting ends. The first is to protect creditors and encourage lending by creating greater certainty about debt repayment in the event of a business failure. The second is to encourage and business development with the possibility of providing a second chance in the event of business failure.

The standard microeconomic theory has little to say about bankruptcy. For example, among leading textbooks, neither Samuelson's Economics nor Alchian and Allen's University Economics list the word 'bankruptcy' in their indexes. Alchian and Allen discuss entry but do not list exit in their index. Samuelson lists neither entry nor exit. The theory of atomistic competition accords an important role to entry and exit in adjusting long-run supply and demand and allocating resources efficiently. A theory of **'how firms function'**, which is critical to the formulation of principles for the evaluation of bankruptcy laws, is not found in any of these.

The variety of ways in which assets are restructured in bankruptcy suggests that the traditional distinction between 'reorganisation' and 'liquidation' in the academic literature – and the presumption that asset sales / liquidations generate less value for creditors than reorganisations – has become increasingly less meaningful. This distinction is further blurred when investors buy debt in a bankrupt firm with the goal of exchanging it for a controlling equity stake under a plan of reorganisation. This strategy gives the investor effective control of the assets and economic ownership that is equivalent to having purchased the business directly.

In one word, the market approach to the financial problem is bankruptcy. Firms go bankrupt when they do not have enough revenue to pay their bills. Bankruptcy is a normal part of economic life, covered by laws that guarantee stockholders will be compensated as much as possible. More efficient firms move in to take over what is left of bankrupt firms, buying what can be put to productive use.

Economic implications of bankruptcy

Modern firms are characterised by a web of formal and implicit contracts which integrate and articulate the interests of different parties with claims on a firm's assets. The interested parties, or claimants, include the firm's creditors with varying degrees of seniority: government, banks or creditors with secured collateral, employees, ordinary bondholders and unsecured creditors, customers, suppliers and, of course, managers and shareholders. These formal and implicit contracts are part and parcel of the system of property rights in developed market economies. Their operation is facilitated through the financial system and financial markets.

The distressed firm may embark on formal or informal negotiations with its creditors with a view to working out a programme of rehabilitation by rescheduling its debts and rearranging its financial status. Such programmes usually involve a restructuring of the firm including downsizing and the closure of loss-making operations. Here, too, there will be some '**exit of resources**' from the industry. Another possibility facing the financially distressed firm, of course, is its liquidation - the physical exit of the firm from the market - which is embarked upon when all other venues are closed.

A central tenet in economics is that competition drives markets toward a state of long-run equilibrium in which firms remaining in existence produce at minimum average costs. Economic theory suggests that bankruptcy should serve as a screening process designed to eliminate only those firms that are economically inefficient and whose resources could be better used in some other activity.

A challenge confronting policymakers around the world is: *How to facilitate bankruptcy process to maximise economic positives and minimise its negative economic effects.*

Time spent on bankruptcy procedure

The cost of bankruptcy is positively related to the length of time spent on the bankruptcy procedure (*Bebchuk, 2000; Bris et al, 2006*). In a liquidation bankruptcy, a fast procedure allows the quick reallocation of assets of failed firms to better uses. At the same time, a fast procedure can provide an entrepreneur with a new opportunity to start a new business. If a firm files reorganisation bankruptcy (such as Chapter 11 in the United States), a fast procedure may protect the value of the assets of the firm and improve its chances for an eventually successful turnaround (*Bebchuk, 2000*).

A lengthy process characterised by an uncertain outcome, however, may make business partners (such as buyers and sellers) reluctant to maintain their business relationships. This, in turn, may reduce earnings and the value of firm assets (*LoPucki and Doherty, 2002*).

In sharp contrast to the transitional economies of Central and Eastern Europe which are characterised by 'creditor passivity', the creditors in a developed market economy have direct and strong incentives to insist on the implementation of the appropriate legal provisions when faced with a defaulting debtor.

Cost of bankruptcy procedure

In addition to the lengthy time, the actual cost involved in filing bankruptcy may also make entrepreneurs procrastinate about filing bankruptcy (*Bris et al, 2006*).

Direct costs: are the legal, administrative and advisory fees that the firm bears as a result of entering the formal bankruptcy process. Warner (1977) estimates the direct cost to be around 4 percent of the firm's pre-bankruptcy value. The World Bank's Doing Business Report finds that in the United States, the direct cost is approximately 7 percent of the assets of the firm. This underscores Mason's (*2005:1523*) argument that costly bankruptcy 'can cause sluggish economic growth.' In other words, high bankruptcy cost may discourage firms to file bankruptcies even when at the societal level; it may be more valuable for them to go bankrupt so that resources and employees can be channeled towards more productive use.

In theory, direct bankruptcy costs should not be confounded with liquidation costs. The former is the cost associated with using the legal mechanism to resolve financial distress, and the magnitude of this cost is important to assess the impact of bankruptcy on corporate financial policies. The latter is the cost incurred in selling off a firm's assets and closing up the firm's operations.

Indirect costs: Potentially more significant and substantial are the indirect costs of financial distress and bankruptcy. These costs can be viewed as opportunity costs, in that they collectively represent the outcome of suboptimal actions by corporate stakeholders when the firm becomes financially distressed. Thus, costs that arise because of inter-group or intra-group conflicts of interest, asymmetric information, holdout problems, lost sales and competitive positions, higher operating costs, and ineffective use of management's time all potentially represent the indirect costs of bankruptcy.

Several studies claim the indirect costs of financial distress to be significant and positive. For example, Altman (1984) measures the indirect costs of bankruptcy as the decline in the sales of bankrupt firms relative to others in the same industry and as the difference between the realised earnings and the forecasted earnings. On that basis, the author argues that indirect bankruptcy costs on average range from 11 percent to 17 percent of firm value up to three years before bankruptcy. However, this study does not clearly distinguish costs attributable to financial distress from those attributable to economic distress.

The empirical magnitude of the indirect costs is central to the consequence of corporate bankruptcy. A common sentiment is that the indirect costs are substantially larger than the direct costs. However, these costs are difficult to observe and measure.

Mergers as a substitute for corporate bankruptcy

The use of M&A in bankruptcy has increased dramatically in recent years; that the rise of M&A has blurred traditional distinctions between 'reorganisation' and 'liquidation'. The cost criterion for bankruptcy system and the elaboration of that criterion above, lead to a consideration of mergers as an alternative to bankruptcy. Mergers are one of the mechanisms in the capital market for the reallocation of resources to uses in which their value is rehabilitated or conserved. The possibility of a merger also increases the range of prospective buyers for a firm.

Post-bankruptcy firm performance

The fundamental economic efficiency question about the bankruptcy law is whether the law effectively rehabilitates economically efficient but financially distressed firms and liquidates economically inefficient firms. Carefully planned, surgical bankruptcies or pre-packaged bankruptcies increase the probability of successful outcomes.

The maximisation of creditor overall proceeds from the bankruptcy

The maximisation of the creditors' overall proceeds from the bankruptcy has clear ex-ante efficiency benefits and requires the explicit allocation of the ownership rights of the insolvent firm to the creditors before the reorganisation plan is selected. This enables the creditors to allocate on the market only the controlling stake of the insolvent firm, and in doing so maximise the proceeds from the reorganisation.

Creditor passivity

The existence of bankruptcy laws will not, in themselves, ensure their application. Laws can only be applied if creditors have an incentive to pursue the debtors and demand their claims. Creditor passivity is one of the main obstacles to the faster restructuring of enterprises on the one hand and the relatively small number of bankruptcies on the other. In many cases, banks prefer to wait and retain some chance of recovering their claims (or parts of them) rather than push the debtor into bankruptcy and receive nothing or very little. More importantly, the loans are part of the 'assets' side of the banks' balance sheet, and their writing off will reduce the value of the bank - which is not in the interest of banks' managers. The banks expect that, in the end, enterprise debts will be written-off by the government and the banks will be recapitalised, thus the incentive to wait rather than embark on the bankruptcy process. This approach of the banks leads to economically inefficient fall out for the firms under financial stress.

The indirect contribution of the bankruptcy process

Direct measures of the impact of bankruptcy process underestimate its importance in contributing to national prosperity. This is because they fail to account for the 'enabling' role played by the bankruptcy system and procedures. This role includes creating an environment that is conducive to entrepreneurship and appropriate risk-taking, while safe-guarding creditors. The bankruptcy system is a very sophisticated and complex institution. One purpose of the bankruptcy process is to certify the change in contractual obligations that insolvency necessitates.

However, more important from an economic standpoint, the legal process seeks to scrutinise the obligations, position, and prospects of the bankrupt firm with a view to contributing to allocate efficiency and growth.

The option value of the bankruptcy

Debtors' right to file for bankruptcy can be expressed as a put option. If debtors' future wealth turns out to be high, they repay their debts in full; but if their future wealth turns out to be low, they can exercise their option to 'sell' the debt to creditors by filing for bankruptcy. The price of exercising the put option is the cost of filing plus the amount that debtors are obliged to repay in bankruptcy.

Conclusion

Since all businesses which avail themselves to bankruptcy protection do so with the spectre of ending in liquidation in which case all economic activities previously associated with that business ceases, and as if it was never in business for the purpose of measuring economic activity and impact. Conversely, when a business is restructured there is a potential for jobs to be retained, continued positive economic activity, equity maintenance and even wealth creation. Effectively, this is no different than if a new business had come into being for the first time.

It is worth noting that many bankruptcies arise from temporary circumstances, such as economic downturns, which can cause businesses to fail. However, downturns and market changes may reverse over time, which may, in turn, allow the business to prosper once again. It is therefore enjoined upon all the parties involved in the bankruptcy process to look at the micro and macroeconomic dimensions and effects of bankruptcy with a view to ensuring an economically efficient and effective culmination of the exit process.

Bankruptcy law affects not only financially distressed corporations and their creditors but also their workers and competitors but the entire economy. What is crucial for the economy is that firms with a chance of survival should not go bankrupt prematurely. The optimum rate of is one that involves the least cost to the society as a whole, and results in the preservation of firms over a longer period than that dictated by short-term financial considerations.

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