Chapter 8: Hold or Fold -- Bankruptcy

In World Cup soccer, mating among stickleback fish, and business rivalry, no one wins unless someone loses. Success and failure are two sides of competition in sports, biology, and business. The previous chapters concerned how law enables the creation and expansion of successful firms. This chapter concerns how law enables the liquidation and reorganization of unsuccessful firms. Whereas earlier chapters discussed uniting capital and innovative ideas, this chapter discusses separating capital from failed ideas and failed management. As we will show, the same obstacle impedes action in successful and unsuccessful firms: People who need to cooperate have good reasons to distrust each other. And in both cases, good law helps.

When gambling with cards, according to a popular song, “You got to know when to hold ‘em, know when to fold ‘em”.[1] The same goes for gambling with firms. When financial distress strikes, a firm loses money. What is the cause and cure? Managers, employees, stockholders, and creditors often disagree, because they hold different stakes. Shareholders want a high stock price, general creditors want liquidity, secured lenders want unimpaired security, the managers and employees want to keep their jobs, and politicians want to garner power.

Capital markets, contract law, government policy makers, and bankruptcy law determine how much power each stakeholder has over a distressed firm. Scholarship on bankruptcy especially concerns the extent to which law should protect the interests of different classes of stakeholders. The problems of distressed firms in developing countries, however, differ significantly from the problems of distressed firms in many developing countries, especially because of weak legal institutions. The usefulness of bankruptcy law depends on its form and effectiveness, which differs from one country to another. Bankruptcy

[1] For the full lyrics to this riveting song, browse the internet for Kenny Rogers, “The Gambler.”

requires legal proceedings that are costly in every country and ineffective in many countries. In some developing countries, bankruptcy law is so ineffective that firms never use it. Furthermore, in some developing countries, politics pervades the resolution of financial distress, whereas most developed countries constrain its influence to very large firms and banks. We will focus on the special problems of distressed firms in developing countries, but first we briefly explain some general principles of financial distress

Causes and Cures of Financial Distress

A firm encounters financial distress when its capital runs short. In principle, the decision to reorganize or liquidate a firm has the same basis as the decision to start a firm: Start firms with positive expected profits, and reorganize or liquidate firms with negative expected profits. Reorganizing an unprofitable firm could cause it to turn profitable in the future. Alternatively, liquidating a firm could redeploy its resources more profitably.

To guide decision-making, Figure 8.1 summarizes three causes and cures of financial distress. A firm combines capital and ideas under managers. A firm with good managers and ideas often miscalculates the timing of its revenues and costs. Thus start-up firms in Silicon Valley often underestimate how long they will lose money before turning profitable. Similarly, a downturn in the business cycle sometimes causes a cash crisis in established firms that must repay loans on a fixed schedule. If capital runs short in a firm with good ideas and good managers, the firm should seek additional investors. Or a profitable firm may experience an unanticipated shock that demands immediate cash, as when its factory burns down and must be rebuilt.

Alternatively, if a firm with adequate capital and good ideas is unprofitable because management falters, the owners should replace the managers and reorganize it. Thus the founders of firms in Silicon Valley often prove to be poor managers, and changing business strategy in an established firm often requires changing executives.

One of the best ways to reorganize and refinance a company is to sell it. After its purchase, the new owners can apply the cure to the causes of financial distress – bad management and insufficient capital. As we discussed in Chapters 3, the market for organizations moves firms to their most profitable uses, just as the market for consumer goods moves them to the consumers who value them the most.

Finally, most firms are built around a few ideas about what they do best, sometimes called the firm's "core competence." In a startup firm, development of its idea exposes any weaknesses in it. In a mature company, the core idea may become obsolete and the firm may lack the agility to reinvent itself. If a firm's core idea turns unprofitable, so its core competence lacks economic value, the owners should liquidate it.

Figure 8.1. Three Causes and Cures of Financial Distress

cause	**cure**
bad management	reorganize
insufficient capital	refinance
unprofitable idea	liquidate

The best remedy – reorganize, refinance, or liquidate, as the circumstances require -- creates a surplus relative to alternative remedies.[2] In principle, dividing the surplus can benefit all of the stakeholders -- creditors, stockholders, managers, employees, and politicians. Since all can benefit, they can sometimes agree.[3] In practice, however, distress makes different stakeholders in the same firm see themselves as rivals, not as a team. The prospect of losses misaligns the interests of stakeholders in a distressed firm,

[2] D.C. Smith and P. Strömberg, 2004, Maximizing the Value of Distressed Assets, Bankruptcy and the Efficient Reorganisation of Firms, *Discussion Paper*, 42.

[3] In a world without transactions costs, a state bankruptcy procedure would not be necessary. Corporations would conclude fully specified credit contracts with clauses for the assignment of rights and duties to creditors, owners and managers in case of financial distress. This is an application of the "Coase Theorem," which is fundamental for law and economics. In a world with transactions costs, however, bankruptcy law can help to verify assets and liabilities, improve coordination among claimholders, protect third party claimants, maintain the asset value and remove liquidity constraints during the procedure.

whereas the prospect of mutual gains aligns the interests of stakeholders in a startup firm. So the problem of resolving financial distress is to find a process that brings the stakeholders to the best remedy for a bad situation.

Three Processes for Curing Financial Distress

The preceding chapters distinguished relational, private, and public finance. These three approaches apply to the resolution of financial distress in a firm as depicted in Figure 8.2. Reorganization, refinance, or liquidation of businesses owned by families often occurs internally, with little regard to state law. "Relational bankruptcy," to coin a term, minimizes the needs for participation by state officials, including judges. Thus creditors of distressed family-based firms in Asia prefer private workouts rather than in-court procedures, often at the expense of minority shareholders.[4]

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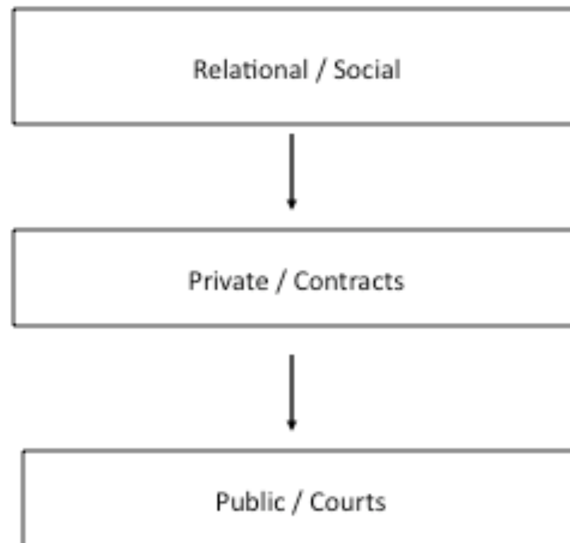
[4] Claessens/Djankov/Klapper, 1999, Resolution of Corporate Distress, Evidence from East Asia's Financial Crisis, *World Bank Policy Research Working Paper,* 2133.

Figure 8.2. Processes to Resolve Financial Distress



Private resolution of financial distress relies on contracts to reorganize, refinance, or liquidate a firm. In the event of financial distress, financial contracts often prescribe how to resolve distress it or who should resolve it. The prescribed procedure usually allows the financiers to take charge of the failing firm and minimize their losses. Thus an established firm that suffers financial distress often refinances on terms that give the new investor complete control in the event that the firm fails to return to profitability. The financier can use this power to pry failed executives out of the firm who refuse to quit. Financial distress clauses in contracts often avoid the formal proceedings prescribed in bankruptcy law. Thus startup firms in Silicon Valley often fail and seldom go through legal bankruptcy.

In England, private contracts to resolve financial distress coalesced into something called the “London Approach”. It is a set of standardized private bankruptcy contracts used by banks and corporations. The London Approach includes a “standstill” of all secured and unsecured creditors (no debt collection

for a prescribed period of time), refinancing with “super-priority” for the new lenders (they get paid ahead of all other creditors), a sharing rule for the eventual gains or losses after the standstill, the establishment of a creditors’ committee to make decisions, and a unanimity decision rule for creditors to change the standard terms in their contracts.[5]

Another private device to resolve financial distress is a hostile takeover, where an outsider buys a controlling share of the firm’s stock, gains control over the board of directors, and fires the managers. Hostile takeovers are common in the U.S.A. and United Kingdom, and rare in other countries, especially developing countries. Most countries lack markets for corporate control because of legal obstacles and ownership traditions.

Public resolution of financial distress requires courts, or state organizations like courts, to supervise the refinancing, reorganization, or liquidation of the firm. The bankruptcy procedure usually suspends debt collection for a period of time, which stops creditors from breaking up the firm. Under chapter 11 of the US bankruptcy code, management can apply for reorganization of the company. During the suspension of debt collection, the court appoints a trustee to supervise the firm. The firm or its creditors may propose a plan to the trustee to resolve the distress. When a U.S. firm applies for bankruptcy-reorganization under Chapter 11 of the Uniform Commercial Code, the judge must approve its plans and assure fair treatment for each class of creditors. Managers and large creditors generally know a lot more about a distressed firm than a judge or trustee. By requiring stakeholders to propose plans for the distressed firm, the legal process allows them to apply their superior knowledge. By requiring approval of the judge, the court tries to assure fairness towards the parties.

Bankruptcy-reorganization suspends or extinguishes the claims of some creditors, and changes the priorities for repaying others. The judge may accept a

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[5] J.Armour and S. Deakin, 1999, Norms in Private Insovency Procedures the’London Approach’ to Financial Distress, ESRC, Center for Business Research, University of Cambridge,*Working paper No. 173*, 2.

plan to wipe out current stockholders, replace some managers, suspend repayment of debts to existing creditors, acquire fresh capital from a new investor, authorize repaying the new investor before repaying other creditors, and give the new investor a seat on the firm's board of directors.

Firms have several classes of creditors – commercial banks that made loans, investment banks that bought bonds or preferred shares, suppliers who delivered goods on credit, employees with unpaid wages, accident victims owed compensation by the firm, and so forth. The stakeholders often disagree about the best plan to reorganize the firm. In a common situation in large firms, the shareholders want to reorganize the firm in the hope that it will turn profitable and the stock price will recover. The secured creditors want to liquidate while the specific assets that secure their loans retain value. The unsecured creditors want to reorganize or liquidate, depending on which alternative will repay a larger fraction of the debts owed to them. The managers and employees want to refinance the firm and continue its current operations. And the politicians want to stay in office.

Instead of reorganizing, the stakeholders may present a plan to liquidate a distressed firm. In bankruptcy-liquidation, the sale of assets yields less than the firm's outstanding debts. Like ten vultures on one dead rabbit, there is not enough meat to satisfy everyone. The court must determine how much each creditor gets. In principle, secured creditors get the value of their security, and other creditors get paid according to their priority, as we will see.

We have explained that public bankruptcy requires courts to approve a plan for resolving financial distress. In special circumstances, however, the state may develop and apply its own plan. To illustrate, when many U.S. financial firms became distressed in the financial crisis of fall 2008, the federal government developed and applied its own plans to refinance and organize them.

We have explained that relational procedures for resolving financial distress require little from the state; private resolution requires the state to

enforce the terms of contracts to refinance, reorganize, or liquidate the firm; and public resolution requires courts to approve a plan of action by the creditors or develop a state plan. So the progression from relational to private to public involves more intensive use of the state. The more intensively the process uses the state, the more it strains the competence of public officials.

The extent to which firms rely on state law to resolve their financial distress depends on the law's effectiveness and cost. Judges need to proceed quickly, before the firm's assets disappear. With distressed firms, justice delayed is justice denied.[6] The bankruptcy procedure varies from several months in Singapore, Taiwan and Finland to more than nine years in India, Brazil and the Czech Republic.[7] Delays awaiting trial, uneducated or corrupt judges, political intrusion in legal cases, and unreliable debt collection erode the effectiveness and increase the cost of bankruptcy law. In some developing countries, bankruptcy law is so costly and ineffective that firms never use it, as we will show. As law becomes cheaper and more effective, private bankruptcy supplements relational bankruptcy as a process for resolving financial distress, and public bankruptcy supplements private bankruptcy.

To improve the administration of bankruptcy law and reduce corruption of judges and administrators, some countries have introduced special business courts with well trained and highly paid staff. Training reduces incompetent decision, but high pay does not automatically reduce corruption, as rich people are no less corrupt than poor people. But high pay makes an official hesitate to take a bribe that might cause him to lose his job. High pay reduces corruption in a context where taking a bribe rolls the dice on getting fired, but not where getting fired has nothing to do with taking a bribe.

To illustrate, in Singapore the "Judges Remunerations Act" regulates the salaries of higher judges. In 1994 the salary for appellate court judges was

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[6] This phrase is attributed to William Gladstone, 19th century British Prime Minister.

[7] Insert cite, probably to Doing Business around the World (2006).

166,000 US Dollars per year,[8] and Supreme Court justices were paid princely salaries[9]. According to Transparency International Singapore is now one of the least corrupt countries in the world ranking on place 5 of the 2005 corruption perception index. Judges do not take bribes, although they allegedly take instruction from politicians in some cases. In contrast, Indonesia reformed bankruptcy law and introduced special commercial courts in 1998. The newly appointed judges received special training and improved pay, but accusations of incompetency and corruption persist.[10]

National Differences in Rights and Powers

Bankruptcy laws differ across countries, notably with respect to the assignment of powers and rights to different groups affected by financial distress. The best assignment from an economic viewpoint balances information and motivation. The firm's insiders, such as its managers and large creditors, generally know a lot more about it than outsiders. Unfortunately, the insiders have motivation to take advantage of minority shareholders and small creditors. Outsider investors have less information than insiders, but, like everyone in business, outsiders are the best advocates for themselves. In contrast, an honest judge or trustee is motivated to treat the stakeholders fairly, but the judge or trustee has relatively little information about the firm. By striking the balance differently among the stakeholders and public officials, different legal systems produce different results, as we will explain

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[8] The Judges Remumeration Act of 1994 fixed the yearly salary of a Judge of Appeal at 253.000 Singapore Dollars, which was then 166 000 US Dollars.

[9] In 1997 "High court judges (received) A$835,020, besides other perks and privileges, like a motor car, a government bungalow at economic rent. The chief justice received A$1,260,000 (equivalent to 700.000 US dollars) per annum, besides an official residence (or an housing allowance in lieu thereof), a chauffeur-driven car, among other handsome perks and privileges of office. Indeed, he received more than the combined stipends of the Lord Chancellor of England, the Chief Justices of the United States, Canada and Australia", F. T. Seow, former solicitor general of Singapore. The politics of judicial institutions in Singapore lecture given in Sydney, Australia in early 1997.

[10] R. Tomasic, 2001, Some Challenges of Indonesian Bankruptcy Reform (Bali), 19.

Managers and Stockholders Versus Creditors

Where bankruptcy law unduly favors managers, failed executives retain control of distressed firms for too long. Under their control, the firm's assets deplete, so creditors get repaid less. This problem allegedly afflicts bankruptcy law in the United States, or use to.[11] To illustrate, when Eastern Airlines filed for bankruptcy under Chapter 11, the company lost a billion dollars as its managers and trustee attempted to reorganize it. Success would have repaid creditors in full, but the actual result was failure in which many creditors received nothing.[12] Similarly, where bankruptcy law unduly favors stockholders, distressed firms also continue in business for too long.

In contrast, the opposite is true where bankruptcy law unduly favors creditors. Good managers tend to lose control too soon, and distressed firms tend to get liquidated too quickly. These problems allegedly afflict bankruptcy law in Germany.[13] A spectacular example is the Borgward bankruptcy, one of the most successful producers of motor vehicles in its time. After a liquidity crisis in 1963, large banks succeeded in liquidating the company and recovering their loans to it. Liquidation revealed that the market value of the firm's assets exceeded the total value of its bank loans. The banks apparently wanted to take no risks when it came to repaying themselves. (They also wanted to tilt competition in favor of other automobile manufacturers.[14])

We have explained the problem of deciding when to liquidate a distressed firm in the U.S. and Germany. Some observers believe that the Swedish

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[11] In the recent past, scholars believed that Chapter 11 bankruptcy-reorganization allowed failed management to retain control over U.S. firm for too long and deplete its capital, but better contracts for refinancing has apparently solved this problem. See Jagdeep Bhandari, S. Lawrence , and A. Weiss, "The Untenable Case for Chapter 11: A Review of the Evidence," in 1992. GET NEW CITES

[12] Add cite,

[13] cite

[14] Banks of Borgward owned large shares of other car manufacturers, which gave them an extra incentive to close down the family-owned Borgward firm. This is in line with more general findings according to which bank block holdings of corporate shares leads them to support market power positions of these firmsG. Cestone and L. White, 2002, Anti-Competitive Financial Contracting: The Design of Financial Claims, *CEPR Discussion Papers*, (RePEc:cpr:ceprdp:3182).

bankruptcy code is superior to others in this respect, including the U.S. and Germany. In Sweden the bankruptcy trustee must compare the sale and liquidation value of the firm. He is obliged to offer the whole firm for sale, and he is also obliged to offer to sell its assets separately. If the bids for the firm are higher than the bids for its assets, the trustee sells the firm to the highest bidder. Conversely, if the bids for the firm are smaller than the bids for its assets, the trustee liquidates the firm and sells its assets to the highest bidders. When following this rule, the trustee relies on market values. He does not have to make his own valuation of the firm or its assets. Nor does he have to rely on valuations in plans offered by the stakeholders. Most economists believe that prices in competitive markets value assets more accurately than state officials. Swedish laws apparently make better use of market prices for valuation in bankruptcy than other legal systems. Note that the Swedish system cannot work without a robust market for firms to generate bids for the distressed company. (Scholars have proposed visionary legal reforms to improve the bankruptcy process further by reducing the burden on judges.[15])

General Creditors Versus Creditors with Priority

We have been discussing the conflict between managers and creditors over continuing the firm or liquidating it. Other conflicts occur among different classes of creditors, who are distinguished according to their security and priority. Before distinguishing classes of creditors, however, consider what happens when law refuses to recognize distinctions.

Roman law gave all creditors equal access to the debtor's assets (*par condicio omnium creditorum*), thus denying the distinctions between secured and unsecured creditors, or between junior and senior creditors. Giving all creditors equal access to the firm's assets tends to make their interests converge. As their

[15] Thus Bebchuk proposed that courts organize an auction for a distressed firm, in which groups of people could present plans to repay the firm's creditors. The highest bidder would win th firm, unless no one bid enough to repay the creditors, in which case the firm would be liquidated.

interests converge, all creditors want to resolve the firm's distress in the same way.

To illustrate, assume that a firm bought a store for 100 by using a first mortgage of 50 and a second mortgage of 50. Following Roman law, assume the law treats both lenders equally, and does not recognize the first mortgage as senior to the second mortgage. If the firm goes bankrupt and it sells the store for 80 to repay its debts, then each of the lenders gets repaid 40. Alternatively, instead of selling its store for 80, assume that the owners could sell the firm, including the store, for 90.[16] In that case, each of the lenders gets repaid 45. Consequently, both creditors want to sell the firm, not to liquidate it.[17]

Following Roman law and recognizing no distinctions among classes of creditors vastly disadvantages the financing of business. As we will explain, contracts to give priority to one class of creditors often serves the interests of all classes of creditors, but first we describe modern distinctions among classes of creditors.

Creditors divide into two broad classes: general and secured. General creditors have a claim against the firm, but not against any of its particular assets. In contrast, secured creditors have a claim against a particular asset of the firm, such as its real property (land and buildings), its movable property (trucks, machines, etc.), or the debts owed to it by others (accounts receivable). Thus a debt of a firm secured by a cement truck entitles the creditor to collect the debt from the firm (like a general creditor), and, if the firm does not pay, to seize and sell the cement truck to satisfy the debt (unlike a general creditor).

Within the categories of general and secured, creditors divide into senior and junior. Senior debt must be repaid before anything goes to junior debt. Return to our example of a firm that buys a store for 100 by using a first mortgage of 50 and a second mortgage of 50. The mortgage documents

[16] The firm's intangible value is 10 and its tangible asset is worth 80.
[17] Under this condition, the best possible procedure lets the creditors decide by supermajority rule to sell or liquidate the firm. Unanimity rule would not be advisable as it leads to one creditor holding up the others.

stipulate that the first creditor is senior to the second creditor. The firm goes bankrupt and its only tangible asset is the store. The firm liquidates itself and sells the store for 80 to repay the debts. The senior lender gets repaid 50 and the junior lender gets repaid 30.

It is easy to see why creditors might prefer for law to recognize different classes of debt. In the preceding example, we showed numerically that legal recognition of two classes of creditors makes senior creditors more secure and junior creditors less secure in the event of financial distress. The greater security of seniority creditors, however, may be necessary at the outset to induce them to make a loan. To illustrate, assume that the firm in question is a startup that needs 100 to buy a store and begin doing business. The owner of the firm is a family that can afford to loan it 50. So the owners need someone else to loan 50. However, an outside lender may reasonably insist on the seniority of his loan to the loan by insiders. In this case, everyone wants the law to recognize two classes of creditors so that they can get enough money to start the business. The general case for recognizing different classes of contractual debtors is the same as the general case for enforcing contracts: The parties enter into voluntary agreements because they expect to gain from them.

We have explained that the interests of the two classes of lenders converge when the loans are made. Later, when the firm gets distressed, their interests may diverge. They may not agree about, say, whether or not to liquidate the firm. In the preceding example, liquidation causes full repayment of 50 to the senior lender and partial repayment of 30 to the junior lender. Instead of liquidating the firm, the owners can sell it for 90. In that case, the senior lender gets repaid 50 and the junior lender gets repaid 40. So the gain from selling the firm instead of liquidating it goes entirely to the junior lender. If selling the firm involves some small inconvenience or risk to the senior lender, he will favor liquidation and not sale, even though the latter is more efficient than the former. To induce the senior lender's agreement, the junior lender may have to make a side payment to the senior lender of, say, 5. This situation is allegedly a problem

in German bankruptcy law, where the banks are senior creditors with much power over the firms, as we mentioned in discussing the Borgward bankruptcy.[18]

We know of no countries that retain the Roman law of equality among creditors, but some legal systems move in that direction by limiting the power of the parties to contract for different classes of debt. Countries whose bankruptcy law is in the French tradition prescribe rights for unsecured creditors that contracts cannot change, or can only change with difficulty. The bankruptcy law protects the unsecured creditors by guaranteeing them a minimum percentage of the firm's liquidation value. This restriction on financial contracts has predictable effects: Creditors demand more collateral to overcome restrictions on it; creditors with incomplete security must monitor debtors more carefully and seek repayment before a bankruptcy procedure begins; and borrowers must rely more on loans from general creditors.

Debtors Versus Creditors

Previous chapters discussed the fact that some national legal systems prevent creditors from repossessing certain kinds of collateral, notably land and dwellings. We also discussed the fact that inefficient and corrupt legal systems can preclude debt collection by the means prescribed in state laws. Excessive protection of debtors erodes the financial markets and results in dead capital.

A study on national bankruptcy laws summaries the relative power of debtors and creditors in various countries.[19] Their bankruptcy laws are ranked on a scale from 1 to 10, which 1 indicating "most pro-creditor" and 10 indicating "most pro-debtor." Figure 8.3 indicates the rankings of bankruptcy laws in various countries.

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[18] Here is another piece of anecdotal evidence: Secured creditors became more interested in reorganizing firms in Germany after a slump in real estate prices in the 1990ies discounted the value of pledged land often below the credit amount.

[19] C. Wihlborg, S. Gangopadhyay, Infrastructure Requirements in the Area of Bankruptcy Law, (2001) p.50. Also see Wood (1995)

Figure 8.3. Debtor-Creditor Orientation of National Bankruptcy Laws

Ranking	Countries
1=most pro-creditor	Former British colonies except S. Africa and Zimbabwe
2	England, Australia, Ireland
3	Germany, Netherlands, Indonesia, Sweden, Switzerland, Poland
4	Scotland, Japan, Korea, New Zealand, Norway
5	United States, Canada except Quebec
6	Austria, Denmark, Czech and Slovak Republics, S. Africa, Botswana; Zimbabwe (last three Dutch-based)
7	Italy
8	Greece, Portugal, Spain, most Latin American countries**
9	Former French colonies, Egypt, Belgium and Zaire
10=most pro-debtor	France
No insolvency law	Liberia, many Arab countries
Unclassified	Russia, Belarus, Ukraine, Khazakstan

Many economists believe that the pro-debtor laws inhibit loans and create dead capital. If this belief is correct, then developing countries with bankruptcy laws modeled on Britain and Germany have a distinct advantage over those modeled on France.

Some developing countries enacted investor-friendly laws the 1990s, but defects in legal institutions frustrated their application.[20] To see why, consider data on average cost of insolvency proceedings. World Bank collected data on the average cost of insolvency proceedings as a percentage of the value of the bankrupt estate. Countries were arranged into three groups, as indicated in Figure 8.4.

[20] Gelfer/Pistor/Raiser, 2000, Law and Finance in Transition Countries, *Economics of Transition*, Vol. 8, 2.

Figure 8.4. Average Cost of Insolvency Proceedings

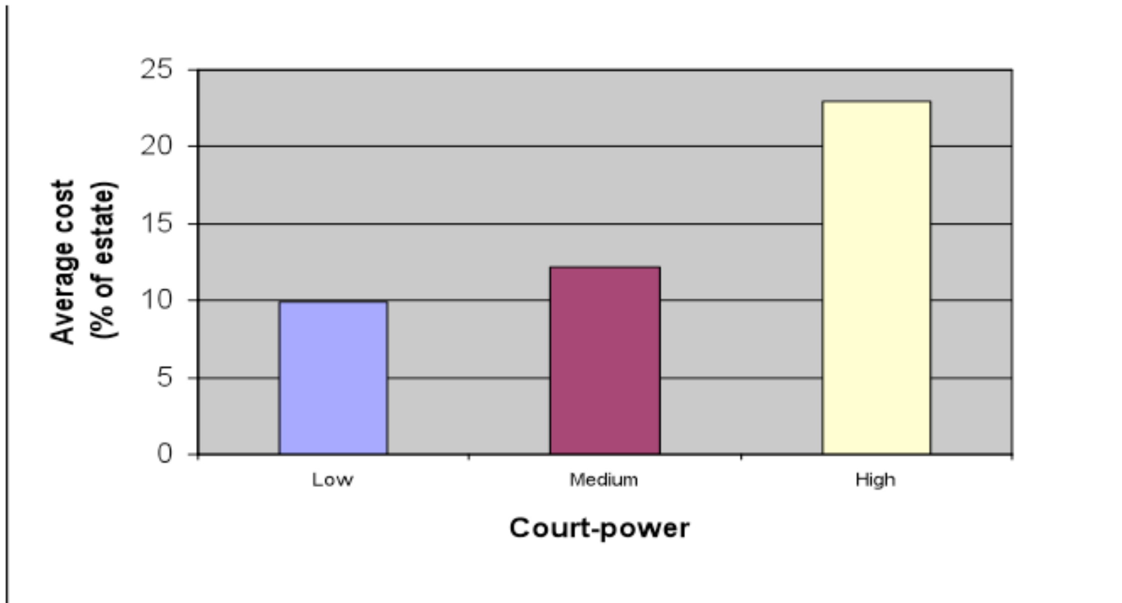
Low Cost	Medium Cost	High cost
Algeria	Argentina	France
Canada	Brazil	Indonesia
Colombia	China	Morocco
Ethiopia	Egypt	Philippines
Germany	Iran	
India	South Korea	
Italy	Mexico	
Japan	Nigeria	
Kenya	Poland	
Nepal	Russia	
Pakistan	South Africa	
Peru	Tanzania	
Spain	Turkey	
Thailand	Uzbekistan	
Ukraine		
United Kingdom		
United States		

Source: World Bank, Doing Business 2005, Stat. Appendix

In an attempt to explain these differences, the countries were also classified according to the power of their courts. In some countries, the law assigns all power to the judge and none to the stakeholders: The court appoints and replaces the bankruptcy administrator without legal restrictions, the trustee reports exclusively to the court and not to the creditors, and the court can decide alone on the adoption a plan for restructuring the company. The cost and length of the bankruptcy procedure increase when courts have too much power over the process.[21] Figure 8.5 shows that the average cost of insolvency proceedings increases with the power of courts. This fact suggests that powerful courts impose expensive proceedings on bankruptcy cases.

Figure 8.5. Average Cost of Insolvency Proceedings In Relation to Court Power

[21] Hart/Nenova/Shleifer, 2003, Efficiency in Bankruptcy, *working paper*, Department of Economics, Harvard University.



Source: World Bank, Doing Business 2005, Stat. Appendix

Politics and Bankruptcy

We have explained how different legal systems resolve conflicts among private stakeholders in a distressed firm. The economic problem of financial distress, however, often becomes a political problem. Instead of applying laws, public officials often participate in curing financial distress. In bankruptcy proceedings, most developed countries constrain the influence of politics to very large firms such as big banks, whereas politics pervades the resolution of financial distress in some developing countries. We will discuss some ways the politics especially affects bankruptcy in developing countries.

Expropriation and Subsidies

Politics intrudes into bankruptcy proceedings of private firms in two distinct ways. First, politicians sometimes use bankruptcy procedures to expropriate firms. Second, politicians often use bankruptcy procedures to subsidize firms. We discuss each form of intrusion in turn.

Under communism in Eastern Europe, the central government's planners assigned production quotas to firms, so firms systematically overstated their production. Under capitalism in Eastern Europe, firms in formerly communist countries were taxed according to the value of their production, so firms systematically understated their production. Foreseeing tax evasion, the state sometimes set tax rates unrealistically high to make up for lost revenues. Unrealistically high tax rates made cheating into a business necessity. As a consequence, many Eastern European firms owe unpaid taxes that could bankrupt them and their owners are susceptible to charges of tax evasion.

In Western Europe tax authorities seldom initiate bankruptcy proceedings for firms, whereas in Eastern Europe the tax authorities initiated most bankrupting proceedings against firms during the transition from communism to capitalism, especially in Russia.[22] The leadership role by tax authorities has positive and negative sides for the economy. The positive side is that tax authorities can force distressed firms to reorganize and restructure. The usual procedure in Russia is for the tax authorities to threaten an investigation, which could lead to criminal charges. To escape the investigation and charges, the firm can agree to reorganize as stipulated by the tax authorities. The negative side is tax authorities replace the firm's owners and managers with the friends of politicians, who obtain control over the firm and claim its future profits. Bankruptcy procedures by tax authorities can be the form by which the state takes private property for political purposes.

So many Russian firms have evaded taxes that most of them are susceptible to pressure from the tax authorities. When tax authorities proceed against a firm, outsiders cannot tell whether the motivation is economic or political. Perhaps the firm is economically unsound and requires better management, or perhaps the firm is economically sound and politicians want to expropriate its value. The most notorious example involved Russia's largest private oil company, Yukos, whose owner was an opponent of the government.

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[22] K. Pistor, 2005, Who is tolling the bells to firms? Tales from Transition Economies, *Comparative Law and Economics Forum* (CLEF).

State action against Yukos for tax arrears served the political purpose of punishing an outspoken enemy of President Putin. In addition, state action against Yukos punished a firm that used dubious means to acquire vast natural resources owned by the state. The Russian government seems intent on using the threat of prosecution for tax evasion and other crimes to re-establish state ownership of natural resources that were privatized in the 1990s.

Having explained how politicians use bankruptcy to expropriate firms, we turn to how politicians use bankruptcy to subsidize them. When a politically powerful organization runs out of money, it negotiates with politicians to get more. Very large firms are sometimes "too big to fail" -- they have enough political clout to make the state rescue them from financial distress. Political clout may come from interdependencies that ripple through industries and endanger the economy, as happened in the financial meltdown in New York in the fall of 2008. Or political clout may come because the firm employs many workers and provides them social services such as health, schooling, and housing. When such a firm goes bankrupt, its workers lose their jobs and more.

An example of bankruptcy-induced subsidies is Indian's "Sick Industry Act" of 1985. This law aims explicitly to resurrect sick industries by giving low priced credits to existing management. The result of such practice is often a soft budget constraint for firms. Given soft budget constraints, an efficiency oriented bankruptcy procedure becomes unworkable. Chapter 6 on finance already discussed the problems of soft budget constraints, especially in China and India.

National Guarantees for Private Bankruptcy

Besides subsidizing failed businesses, governments in developing countries sometimes guarantee foreign lenders against default by domestic creditors. Thus a German bank may make loans to an industrial developer in Tanzania, and the government of Tanzania may guarantee repayment. The German bank charges interest on the loan to reflect the risk of default. Without the guarantee, the German bank would increase the interest rate on the loan by the risk of the *debtor's default*. With a government guarantee, the German bank

would increase the interest rate on the loan by the risk of the *government's default*. The risk of default by the debtor is presumably higher than the risk of default by the government. So a government guarantee enables the domestic firm to borrow from foreigners at a lower interest rate. The lender, the borrower, and the politicians benefit from the guarantee. The only loser is the taxpayer, who will bear the burden of repaying the loan if the debtor defaults.

To appreciate the problem, recall our explanation in Chapter 7 of how corporate law separates the liabilities of the firm and its owners. If the firm fails to repay its debts, the creditors cannot collect from the firm's owners. And if the firm's owners fail to repay their debts, their creditors cannot collect from the firm. Nothing comparable to this separation exists for government guarantees of international debt. Government loan guarantees unite the debts of borrowers and the wealth of taxpayers. The government can pledge away the assets of taxpayers to international creditors almost without limit.

Government guarantees for loans are especially insidious because taxpayers have limited information about the risks that government shifts to them. The United States is a democracy where the media widely distribute information about the government to its citizens. Even so, U.S. officials extended explicit and implicit loan guarantees for massive amounts of very risky mortgages after 2000. These guarantees lowered the interest rate on mortgages and enabled relatively poor people to buy houses. Unfortunately, many of the buyers defaulted on their mortgages, which triggered the financial disaster of 2008. U.S. taxpayers will pay the cost of those guarantees for years to come. As the financial crisis of 2008 unfolded, many Western European countries found themselves similarly situated to the U.S.

Mature democracies in the U.S. and Europe cannot resist the insidious undercurrent of government loan guarantees, so we should not expect developing countries to do so. Such guarantees have contributed to government indebtedness of developing countries. New research has shown that interest payments on international loans by over-indebted developing countries crowd out

public social spending and investment, which impacts economic growth, life expectancy, and poverty.[23]

Sovereign Bankruptcy

We distinguished the causes of distress in firms into bad management, insufficient capital, and an unprofitable idea at its firm's core. For a firm, the cures for financial distress are to reorganize, refinance, or liquidate. Selling the firm may be the best way to reorganize and refinance it. Similarly, when a sovereign state becomes financially distressed, the causes can be bad leadership, insufficient capital, and bad ideas about economic policy. However, the state cannot cure the problem by liquidating or selling itself. Instead, the state must reorganize and refinance. We will briefly describe three international insolvency procedures for reorganizing and refinance a state.[24]

In the first procedure, the distressed state negotiates an ad hoc agreement with other states. Like international treaties, the process and outcomes are free form. An example is the London debt contract between Germany and Allied countries of1953, which excused 50% of Germany's international prewar debt.

In the second procedure, the distressed state follows customary procedures to negotiate an agreement with other states. Thus the "Paris Club" is a small group of rich OECD countries that lends to other states. Its members are officials who represent their national governments and take orders from them. When a crisis makes debt servicing temporarily impossible, the debtor may ask the Paris Club to reschedule credits, provided the debtor and creditor are both states. The Paris Club usually grants a standstill on collecting debts and extends

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[23] For a survey of this research see Loko/Mlachila/Nallari/Kalonji, 2003, The Impact of External Indebtedness on Poverty in Low-Income Countries, *IMF Working Paper 03/61*.

[24] Anne Krueger, the first deputy managing director of the International Monetary Fund proposed in 2001 to help countries with unsustainable debt by a statutory bankruptcy procedure for sovereign debt. Since then the debate is about whether poor countries need statutory bankruptcy provisions, to be included in the IMF articles of agreement or whether a procedure should evolve by market forces and contracts between sovereign lenders and creditors. No compulsory international regime for sovereign bankruptcy has been accepted.

the dates for repayment ("roll-over"). The debts persist until repaid. They are not forgiven, with few exceptions.[25] The members of the Paris Club usually agree with each other because they are a small group who gain from continuous cooperation. (The terms in government bonds and bond guarantees issued in London or New York require the resolution of distress by procedures resembling the Paris Club.[26])

The third procedure applies to the International Monetary Fund, which now includes almost all the world's nations. This organization formed at the end of World War II to develop and stabilize a world financial order. Among its other activities, the IMF loans money to financially distressed member-states. The IMF imposes conditions on the loans to stabilize the currency, increase exports, reducing imports, and constrain government spending. These reforms improve the country's ability to repay it foreign debts.

The IMF's stated goal is macroeconomic stabilization, but empirical research finds little stabilizing effects from its loans.[27] A more cynical view holds that the IMF bails out countries to protect private lenders, especially American banks. Historical research on bailouts confirms that large IMF loans in the last century went to countries with large debts to American banks.[28] Bailing out private banks undermines their incentives for cautious and constrained lending, just as bailing out indebted countries undermines their incentives for cautious

[25] Thus Indonesia (1969), Poland (1991) and Egypt (1991) were forgiven 50 per cent of their debts.
[26] The bonds contain clauses for changing the repayment schedule, which differ somewhat in London and New York. For bonds issued in London, a supermajority of bondholders of 75 percent can decide on changes of payment[26]. In New York unanimous consent is necessary for changes of the terms of payment. Creditors holding commercial papers issued in the USA consequently have no legal incentive to abstain from suing a defaulting country, whereas creditors from the UK have no possibility to do so. M.J. White, 2002, Souvereigs in Distress: Do they need Bankruptcy? *Brookings Papers on Economic Activity*, 1, 287-319.
[27]Present evidence suggests that the severity of financial crises has changed little in emerging markets from the pre-1914 era to the present. A with-without comparison of countries receiving IMF assistance during crises in the period 1973–98 with countries in the same region not receiving assistance suggests that the real performance of the former group was possibly worse than the latter.M.D. Bordo and A.J. Schwartz, 2000, Measuring real economic effects of bailouts: historical perspectives on how countries in financial distress have fared with and without bailouts, *Carnegie-Rochester Conference Series on Public Policy*, Vol. 53, Issue 1, 81-160.
[28] Insert cite

and constrained borrowing. Some observes concluded that the IMF should stop lending to poor countries altogether.[29]

We regard the IMF as a financial fire department: It hoses down the flames when international financial disorder breaks out. Fire departments are necessary, even though they increase the incentive to play with matches. Instead of abolishing the IMF, critics have proposed various reforms. One proposal would restrict IMF loans to a level where the debt is sustainable. Implementing this proposal requires defining benchmarks for non-sustainable debt.[30] A second proposal is to make IMF loans contingent on the state rescheduling its debts to private creditors. Under this proposal, private banks would help the IMF to save distressed states, instead of the IMF helping the distressed states to save private banks. A third proposal advocates a formal bankruptcy procedure for sovereign credits.[31] Even without an international agreement on sovereign bankruptcy procedures, the continuing evolution of standardized terms in financing contracts such as the London Approach will continue to develop sovereign bankruptcy law. A more formal bankruptcy procedure could reduce the danger that private lenders exploit a nation's financial distress.[32]

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[29] A. Meltzer, 1998, Asian Problems and the IMF, Testimony Prepared for the Joint Economic Committee, US Congress.

[30] The IMF-approach yields a threshold value of 43% for the debt-to-GDP ratio, 192% for the debt-to-exports ratio, and 288% for the of debt-to-government revenue ratio. Such benchmarks can help to base international sovereign bankruptcy procedures more on legal rules rather than on political discretion. International Monetary Fund and International Development Association, Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications, Prepared by the Staffs of the IMF and the World Bank, Approved by M.Allen and G. Nankani, February 3, 2004.

[31] A. Krueger, Vicepresident of the IMF proposed a Souvereign Debt Restructurting Mechanism (SDRM), IMF June 6, 2002.

[32] Private lenders are a diffuse group of self-interested firms, not a "club." "Rogue creditors" can sometimes exploit particular situations to their advantage. To illustrate, Elliot Associates, a private investment firm, bought publicly guaranteed Peruvian commercial loans for $20 million. When the commercial firms defaulted, Elliot obtained a judgment in a USA court permitting it to seize Peruvian assets in Europe and the USA. The Peruvian government eventually settled the debt with Elliott for 58 million dollars. M.White, 2002, Sovereigns in Distress: Do They Need Bankruptcy?, *Brookings Papers on Economic Activity*, 1, 287-319.

Odious Debts[33]

Chapter 6 explained that bankers were reluctant to lend money to Napoleon because he had the power to cancel his debts. Modern dictators have Napoleon's problem. Since dictators make and unmake national law, no can rely on national law to enforce their debt. Where national law fails, international law rescues the dictators. Under international law, a dictator can borrow for his country without the citizens' consent and spend the money without benefitting the nation, yet the debt remains valid. International law does not allow a subsequent government to renounce national debts contracted by previous dictators, no matter how odious.

The regime of Saddam Hussein in Iraq provides a grotesque example. Hussein never submitted to elections, terrorized his citizens, and plundered his country. He also borrowed money internationally, especially from Russia and France. After a coalition led by the United States invaded and overthrew Hussein in 2003, the Iraqi nation remained liable under international law for the national debts that he contracted. (The Paris Club cancelled most debts that Iraq owed to its members in November 2004, which amounted to 80 percent of Iraq's state-to-state debts of $37 billion.[34])

Reformers want to change international law by recognizing the principle of 'odious debt'. This principle holds that an odious government cannot contract internationally for the nation.[35] The USA used these ideas to cancel debts

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[33] We benefitted from reading Yvonne Wong's PhD dissertation on odious debt, which she completed at Berkeley in 2008 under Professor Cooter's supervision.

[34] The IMF report for the Paris Club says that it cancelled Iraq's debts for concern about their long-term sustainability, not their idiousness. International Monetary Fund, Iraq—Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding, Baghdad, September 24, 2004. "IMF staff completed debt sustainability analysis (DSA) for Iraq in May which, in our opinion, shows that Iraq will need substantial debt reduction (in the neighborhood of 90% to 95%) to reach external and fiscal viability." This analysis is not credible for a country with the second highest oil reserves in the world. It disguises the forgiveness of odious debts in an attempt not to set precedence.

[35] P.Adams, 1991, Odious Debts: Loose Lending, Corruption, and the Third World's Environmental Legacy, London, Earthscan.

contracted by the slave-holding states that attempted to secede in its Civil War,[36] and to cancel debts that Cuba owned to Spain after the USA defeated Spain in the war of 1898.[37] The treaty of Versailles (1919) used the same principle to relieve the Poland from all debts owed to Germany and Russia, who had divided and occupied Poland for more than a century. In the 1920s an arbitration court repudiated Costa Rica's debt because its dictator had used the loan for private purposes and the lender had not acted in good faith. In the 1920s Alexander Sack, professor in Paris and a former czarist minister, developed the concept of "dettes odieuses" to justify the cancellation of Russia's foreign debts after the Russian Revolution.[38]

What makes a debt odious? The concept finds support in contract principles.[39] Chief Justice Taft, who arbitrated the dispute over Costa Rica's debts (1923), used two tests: exploitation and good faith. He used the exploitative test determine the percentage of the debts that were squandered or used for illegal purpose. He used the good faith test to check whether or not the creditor knew this. The two tests identify the fraction of loans that are odious and void.

In retrospect, the exploitation test seems inadequate, since many democratic governments squander money without benefitting their citizens. In any case, the test can be refined. [40] The harder questions concern its implementation. Two alternative implementations are a sanctions approach and

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[36] The USA used the unconscionability doctrine during and after the civil war, when Southern slaveholder states tried to finance their coalition with credit. The 14th amendment stated that ". . . neither the United States nor any State shall assume or pay any debt or obligation incurred in aid of insurrection or rebellion against the United States . . . all such debts, obligations and claims shall be held illegal and void."

[37] After the war against Spain (1898) the USA employed the doctrine of Unconscionability to Cuba's Spanish debts, because "they were imposed upon the people of Cuba without their consent and by force of arms"Ibid, 2.

[38] A. N. Sack, 1929, La Succession Aux Dettes Publiques D'Etat, in Recueil des Cours, vol. 23; quoted in P. Adams, op. cit., 18.

[39] Specifically, the principles of unconscionability, "good faith," "fair dealing," and "exceptio doli generalis." The Vienna convention on the law of treaties between states includes the principles of "good faith" and "free consent"

[40] Perhaps a government is odious by modern standards when it borrows without the consent of authorization by the citizens and spends the money without benefitting them. And a loan is odious when the lender knows, or ought to know, that the borrower is an odious government.

a contract approach.[41] Under a sanctions approach, an international authority could declare that the law will not enforce future loans to a particular country. Under this approach, creditors know for certain whether or not a government is odious when they make the loan. Alternatively, under a contract law approach, a new government can ask a court to determine whether or not the previous government's debts are odious. Under this approach, creditors do not know for certain whether or not international law will enforce a government's debt until after a new government succeeds it and brings suit.

Either approach should sharply curtail lending to governments that are odious.[42] The contract approach, however, should also curtail lending to governments that are *possibly* odious. The majority of the states in the world, which are undemocratic or insufficiently democratic, are possibly odious. Under the contract approach, the lenders bear the full risk that a new government will sue to renounce the debt of the previous government.

Both approaches – the sanction approach and the contact approach – require an international decision maker to apply the principle of odious debt. The decision maker might be an international court set up by the United Nations, the IMF or the WTO. Alas, these organizations have the usual frailties and susceptibilities of political bodies. Thus a recent study on the International Court of Justice concluded:

> The data suggest that national bias has an important influence on the decision making of the I.C.J. Judges vote for their home states about 90 percent of the time. When their home states are not involved, judges vote for states that are similar to their home states—along the dimensions of wealth, culture, and political regime.[43]

[41] S. Jayachandran and M. Kremer1, 2005, Odious Debts Discussion Paper, 1-20.

[42] After the UN imposed trade sanctions on South Africa in 1985 the country continued to borrow from private banks. In Croatia in 1997 president Tudjman looted public funds and the International monetary Fund as well as Western countries broke off economic relations. But banks continued lending 2 billion Dollars. A declaration that these governments were odious might have curtialed these loans.

[43] E.A. Posner, 2004, Is the International Court of Justice Biased? *John M. Olin Law and Economics Working Paper,* 234 (2D Series).

A realistic view of international bodies implies that odious debt must be a political concept, not a purely legal concept. To defend implementing the principle of odious debt, its proponents should fall back on the same reasoning that Winston Churchill applied to the United Nations: "The U.N. was set up not to get us to Heaven but only to save us from Hell."

Conclusion: Recycling Capital

Innovation unites capital with good ideas and separates capital from bad ideas. In innovative economies, some firms succeed spectacularly and many fail. To speed innovation, capital must recycle quickly from failures to successes. Unlike plastic bottles and metal scraps, recycling capital among firms involves reorganizing offices and roles, which alters the status and wealth of people. People do not lose status and wealth passively. The firm's stakeholders systematically disagree about the best business plan according to their role in the firm -- managers, employees, stockholders, general creditors, secured creditors, and politicians. Even so, relationships and contracts resolve most of their disagreements over financial distress. With time, private contracts change their shape, which alters the process of bankruptcy. The main role of state law is to enforce their agreements.

Besides enforcing contracts, officials resolve financial distress of some firms through state bankruptcy proceedings. Bankruptcy law is one of the most important state institutions for innovation. Delays, incompetence, and corruption preclude or limit the use of state courts for bankruptcy proceedings in some poor countries. Where courts offer no practical remedies, distressed businesses must rely on relational and contractual solutions. Where courts offer practical remedies, differences in the legal theory of bankruptcy lead to favoring different stakeholders. The law should resolve conflicts among stakeholders by applying rules that maximize liquidity in financial markets. Favoring debtors over creditors dries up business loans. Favoring unsecured over secured creditors reduces loans to risky borrowers. Favoring insiders over outsiders discourages small

investors. Favoring managers and employers over taxpayers perpetuates business failures. And so on.

"To win a war, promote officers who win battles and demote officers who lose battles," according to a prescription attributed to Winston Churchill.[44] How else can the head of state tell good officers from bad ones except by their victories and defeats? Similarly, an economy must put resources under the control of the best entrepreneurs, and the best way to identify them is by how much money they make. Profitability reveals itself over time and with random errors. Guessing about the future prospects of a firm is like guessing next month's weather in foreign city where you have never been. Private investors make the best guesses when using their own money, whereas state officials make bad guesses when using the taxpayers' money. So the best bankruptcy law enables entrepreneurs to recycle capital quickly by enforcing their private agreements to deal with financial distress. When private agreements fail, the parties fall back on the state process of bankruptcy. State bankruptcy law should avoid favoritism towards the stakeholders and make financial markets work, so resources recycle quickly and the cycle of innovation shortens.

[44] Did he say this? We don't knonw. "Great sayings migrate to the mouths of great people." – Nelson Polsby.