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Bankruptcy in America

The firms that can't stop falling

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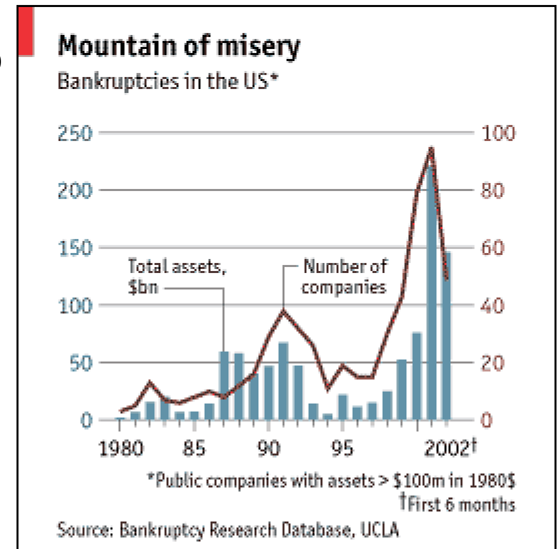
Chapter 11 of America's bankruptcy code may not be working quite as advertised

AT LAST, a new growth industry in America: corporate bankruptcy. Last year, 95 big, publicly owned companies filed to restructure themselves under Chapter 11 of America's bankruptcy code. Failing telecoms firms, energy traders and airlines should set fresh records this year. This week, UAL, the parent company of United Airlines, hastily hired a new boss as it struggled to stay out of bankruptcy. Of the ten biggest bankruptcies since America introduced the modern version of Chapter 11 in 1978, seven are in the courts now.

These warm bodies promise years of feasting for the lawyers, accountants, financial advisers, public-relations firms and consultants who specialise in the “restructuring” business. For a typical filing, this industrious little cottage industry can expect to leech fees worth 1-2% of a bankrupt company's assets. By this yardstick, America's bankruptcy industry could book sales of $6 billion this year.

In return for what? Managers of bankrupt firms, the business press and the restructurers themselves all suggest the work is worthy. With the precision of a skilful surgeon, company doctors cut rot from the corporate body, lift the burden of debt from sagging shoulders and discharge their patients, healed and refreshed, into the world again. Jobs are saved, value preserved and the economy reinvigorated in a cycle of destruction and re-creation. Such is Chapter 11's restorative reputation that European bosses, lacking their own version, whine that it hands American firms an unfair trading advantage.

The facts tell a less uplifting story. Lynn LoPucki, a professor at the law school of the University of California, Los Angeles, has built a database of all public companies with assets of over $100m (in 1980 dollars, to adjust for inflation) that have filed for Chapter 11 bankruptcy since 1980. Most firms get second chances: in only 83 out of 569 cases did a restructured company fail to emerge from bankruptcy. Lots of these new companies, however, went on to fail again. Mr LoPucki looked at the fortunes of firms that emerged from bankruptcy between 1991 and 1996. Within five years, 29% had gone out of business, with two-thirds of these liquidated or merged in distress. In each of those five years, on average, the typical firm in Mr LoPucki's sample racked up losses equivalent to 2% of its total assets.



Other researchers tell a similar story. On a broad definition, says Edith Hotchkiss of Boston College, more than half of Chapter 11 restructurings fail. LTV, a steel company, first went bust in 1986. After spending seven years (and $270m) in the bankruptcy courts, LTV went bust again, and liquidated itself last year. Memorex, an electronics manufacturer, refiled twice, dragging, like the case of *Jarndyce v Jarndyce* in Charles Dickens's "Bleak House", "its dreary length before the court, perennially hopeless". As in *Jarndyce*, the lawyers eventually consumed the estate, and Memorex melted to nothing. Planet Hollywood, the Grand Union Company, Trans World Airlines and Harvard Industries are other celebrated serial failures.

One explanation is that big bankruptcies tend to cluster in certain troubled industries, such as steel, airlines and, most recently, telecommunications and energy trading. The liberal use (or misuse) of Chapter 11 may itself be a cause of overcapacity problems in the steel and airline industries. Industry weaklings seek court protection, shed debts, renegotiate union contracts and emerge as new, low-cost producers. Overall capacity is thus preserved, and the new companies drive down prices, triggering another round of bankruptcies. This was the pattern set by LTV and Continental Airlines, another serial bankrupt.

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It may also say something depressing about the future of America's telecoms industry, in which more than 50 publicly owned firms (including WorldCom and Global Crossing) are now in Chapter 11. "Some of these companies will emerge from bankruptcy," says Ivan Seidenberg, chief executive of Verizon, a big American telephone company. "They will fail again. They should be liquidated."

Another line of attack, favoured by Mr LoPucki, blames the bankruptcy courts, especially the one in Delaware, whose restructured firms refile for bankruptcy more often than those in other jurisdictions. Before 1990, Delaware had handled just one big bankruptcy case, in 1983. By 1996, it had an 87% share of the national market. Mr LoPucki says that Delaware's judges have attracted new filings by pioneering a laisser-faire attitude to their cases: creditors and debtors are left to sort things out among themselves, despite the judge's duty, under the 1978 bankruptcy act, to confirm that restructuring plans are likely to succeed. The Delaware approach has serious drawbacks: everybody fights for his share, and nobody looks after the interests of the estate as a whole. The good news, says Mr LoPucki, is that recent evidence shows bust Delaware firms are refiling less often, perhaps as the court responds to criticism. The bad news is that refilings are rising elsewhere, especially in New York, as other courts copy Delaware.

The common thread to these problems is management. As the SEC's website candidly points out, the reason why public companies almost always choose Chapter 11 restructuring over Chapter Seven liquidation is that, in Chapter 11, incumbent management keeps a grip on the company. Which is not to say that the old managers never resign. They often do: but more usually at the end of the bankruptcy process than at the beginning. Even if they do go at the beginning, they usually get to appoint new management, which is, in this sense, beholden to the old lot.

Old (or the new, less-than-independent) managers cannot be the right people to make arms' length decisions about how to restructure their companies, or to whom to sell assets, and at what price. Incumbent managers have their own battles to fight, such as preserving their pensions, rewarding their friends and, most pressing recently, staying out of jail. The bankruptcy of Global Crossing is in the hands of John Legere, who ran the firm before it failed. More extraordinary still are events at WorldCom, whose current boss, John Sidgmore, helped to cheerlead the company alongside its former chief executive, Bernie Ebbers, through the late 1990s. With their company in tatters around them, some board members are now waking up to just how bad this smells. The disgrace is that it has taken them so long.

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