Corporate Bankruptcy Needs a Fresh (Market) Review

by Fred L. Smith Jr.

THE RECENT SPATE OF bankruptcies involving large corporations has triggered a new public alarm. Indeed, it is disturbing to see the number of companies that, faced with impending insolvency, choose this option. In a recent *Fortune* article, Anna Cifelli noted that corporate bankruptcies almost doubled between 1981 and 1982 alone. Cries for reform of the bankruptcy statutes are now being heard, all in the name of protecting society from any deleterious effects of massive bankruptcies. Unfortunately, as is so often the case, proposed political "correction" may only worsen the problem.

It is important to distinguish *bankruptcy*, the situation encountered when an individual or a firm finds itself unable to meet all just claims against it, and *bankruptcy laws*, which provide a public agency with the power to dictate a specific "solution" in that event. In a world of uncertainty and risk, bankruptcy is an unfortunate but always possible contingency. The current corporate bankruptcy laws, however, provide for a number of questionable remedies, including Chapter 11 reorganization or complete liquidation. The former remedy, reorganization, is a type of pre-insolvency bankruptcy that can be invoked when a firm *anticipates* economic disaster. This remedy specifies a detailed procedure whereby a public agency—typically a court—is authorized to suspend all outstanding obligations against the firm, to develop and implement a plan to settle these claims, and then to discharge all further claims against the firm.

In reorganization proceedings, courts have gone far beyond the point of merely defining the law. They are activists. They interpret statutory provisions to decide who are the more worthy lenders, and if it's in the public interest to keep a company going, regardless of why it became insolvent in the first place.

The first key to understanding current bankruptcy laws is defining the role of the court. There is the persistent idea that the courts are neutral third parties who will altruistically act on behalf of justice to decide what should be done in the case of a Chapter 11 declaration. But as economist Gordon Tullock points out, the courts are often as much a part of the government process as the rest of bureaucracy. The proper role of the courts in a free economy is a complex subject, but as the laws provide greater and greater discretionary authority to the judges, it is clear that the court becomes another mechanism for government to modify individual rights in the public interest. Judges, after all, are political officials, and their decisions tend to reflect the prevailing opinions about what is best for society. We should not be surprised to find that most bankruptcy decisions accept a strong, albeit benevolent role for government to adjudicate business insolvency.

Fred L. Smith, Jr.

> *"Especially before the Panic of 1819, the bulk of respectable business opinion stood firmly against bankruptcy laws, regarding them as an illegitimate windfall to profligate and irresponsible merchants and entrepreneurs.... Later, business failure... came to be regarded as the random consequence of uncontrollable economic forces.... What was once regarded as fundamentally subject to individual control and responsibility came to be viewed—no doubt for self-interested reasons—as beyond moral and legal control."*
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> The Transformation of American Law: 1780–1860 by Morton J. Horwitz

The essence of current bankruptcy laws did not arise from common law, which, while establishing precedents for resolving complex debt situations, made no allowances to discharge—or forgive—the debt save those allowed by the creditor. The conflict between contract law and the law of bankruptcy was long recognized and limited the growth of the bankruptcy concept. Discharge features began to be enacted in this country first at the state level. Horwitz notes the tendency of the legal system in the early 19th century to adopt an "economic growth" emphasis. The idea was that the courts should facilitate economic development; nothing should impede that progress.

BANKRUPTCY RULINGS seemed to favor entrepreneurial activity—it put companies back on their feet and in the market again quickly. Creditor rights were important, but perhaps less so than encouraging the more activist debtors, thus the case for allowing debts to be revised under court direction was strengthened. Creditors, especially those preferring swift and certain *partial* repayment to uncertain total repayment, favored granting government the power to force reluctant creditors into an agreement.

Current bankruptcy laws are typical of modern political paternalism.

Bernard Siegen in his *Economic Liberties and the Constitution* notes Chief Justice Marshall's minority dissent on the legality of an early New York bankruptcy law (Ogden v. Saunders). "Essentially Marshall argued that the contracts clause (of the Constitution) secured freedom of contract from molestation by the states. Under this view, the states would have very limited power to regulate commerce." Siegan quotes Marshall: "The Constitution protects all contracts, past or future, from state enactments limiting the commitments sought by the parties."

Marshall's view of the sanctity of contracts did not prevail; nonetheless, it lays out the issue well. Bankruptcy law contravenes the rights of individuals to enter into voluntary agreements. No third party—not even the courts—can "forgive" debts without abrogating the rights of the lender. Yet the bankruptcy courts can and frequently do rewrite debts and other forms of contractual arrangements. The bankruptcy laws limit the ability of

Olympics

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Ueberroth is known as "Peter Ueber Alles"), this must be nothing next to the embarrassment being felt around the national Olympic committees and international sports federations.

The ones feeling the pinch are those very officious officials so plastered with pins and patches that they resemble their own steamer trunks. A certain amount of freeloading used to be traditional. French Committeeman Henri Courtine, an old Ueberroth acquaintance, says just a little ruefully, "He's the kind of man who succeeds in life. Sometimes, I must say, his way of doing things shocks people. We [Europeans] talk a little less about money, even if we manipulate it. His methods are based on efficiency. In Europe, we don't work that way."...

EXCEPT FOR THE shooting area, finally settled in San Bernardino County, every venue has been set up on schedule and under budget. Several have staged dress rehearsals and checked out smartly. The Atlantic Richfield Co. funded $5 million in improvements to the 60-year-old Coliseum (Olympic capacity: 92,516), including a state-of-the-art synthetic track of German-made red Rekortan. Lacking the three to five years for the soft surface to shake down, the committee has been vacuuming up excess granules.

As to the two new venues, both outdoor $3 million facilities, neither the swimming pool on the USC campus two miles from downtown nor the velodrome at Cal State-Dominguez Hills 17 miles away could be called opulent. Both are handsome. "It's for athletes," says Aquatics Commissioner Jay Flood. "It isn't for the architects." This seems a perfect motto for the Games."...

Come July, 10,000 athletes and 2,000 coaches from 150 other nations are expected in Los Angeles, along with 8,200 accredited members of the media, the largest force that has ever covered anything. If anyone needs a sheaf of copy paper, two freight-carfuls are ordered. Ueberroth's staff, which began as one, then became three, will have swelled to perhaps 45,000.

A Los Angeles research firm estimates the Games will mean almost $4 billion to the state and local economy. The LAOOC will have generated another billion in commerce, and while accepting no charity, will have promoted millions for youth organizations. If the most joyful ambition of the Games is realized, a 10,000-man-woman-and-child relay team of torchbearers will connect the country—from 1912 Olympian Abel Kiviat to retired baseball star Johnny Bench to the ordinary jogger in the street—and along the way $30 million could be the gain for youth.

Forty-three independent but "tasteful" licensees, peddling all manner of Olympic-embossed merchandise, are expected to return $20 million to the committee. If there is a profit on the Games—and the jauntiest guesses run to $50 million—the money will be shared by the USOC, youth groups and amateur sports federations.

To whatever extent future Olympic hosts will permit these transactions to be copied, Ueberroth is hopeful, like De Coubertin, that something of what he has learned will endure. Ueberroth swears that he does not wish to be President of the U.S. and does not even care to be baseball commissioner. Still, around this time next year he will be looking for another challenge of Olympic proportion. "I don't know if there is one," he sighs. "This is so much more difficult than anything you can imagine."

There are both charm and sadness in a job, one gigantic piece of work, that need be done only once, that can be done only once, and then it is over. On second thought, this time next year, Ueberroth and his associates will probably still be shaking, maybe tingling. ●

Bankruptcy

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all reorganizations are successful; most end in liquidation. Private-sector options might well better this record.

The bankruptcy laws are typical of modern political paternalism. When the consequences of corporate or individual decisions are painful, someone—the courts, Congress, a bureaucracy—is supposed to intervene and see that things are put right. The fact that the marketplace is characterized by risk, by profit *and* loss, is immaterial—it's up to government to correct the unfairness of economic change. The fact that property rights and contract rights are violated is also irrelevant—it's the *group* interest that must be protected.

THE LEAST THAT could be done to correct these flaws is to introduce changes that would permit corporations and lending institutions to specify legally enforceable arrangements that would prevail in the event of bankruptcy. This minimum freedom is essential to provide the experiential basis necessary for a more vigorous private-sector alternative to emerge.

In brief, the bankruptcy laws are non-market procedures for resolving economic problems. They are justified, as are most such interventions, as more efficient, less prone to destructive results, and more likely to yield an equitable solution than the market. Like other government interventions, the structure of regulations and laws that has emerged reflects the interests of major creditors and debtors rather than that of the individual. Too often such interference becomes nothing more than a subsidy or protection for the unlucky or imprudent businessman.

Insolvency is a difficult issue, but one far too important to be viewed as "outside the market." Scholars and policy analysts should take the current opportunity to explore the topic creatively so that in this next round of reform efforts the free market option is at least considered. ●