Rehabilitation of the Bankrupt Firm: Property Rights and Entrepreneurship

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In this chapter I present some reflections on the dilemma of liquidation–reorganization in bankruptcy proceedings, leading to the conclusion that the idea of rehabilitating at high-cost those companies that are not able to stay in the market on their own can be inefficient and collides with some

It was not easy to stand for the principles of a free market economy in Spain in the early 1980s. The socialist party won the general election of 1982 with a program prone to higher taxes, higher public expenditure and even the nationalization of some basic sectors of the Spanish economy. Fortunately, the most radical proposals of its manifesto were never put into practice. But the mood was certainly favorable to liberal ideas, neither in politics nor in the universities.

There were however some small groups of businessmen and academics going against the current ideas. In the Complutense University of Madrid Professors Lucas Beltrán and Pedro Schwartz were members of the Mont Pelerin Society. Beltrán was a former student and friend of Friedrich Hayek and Schwartz

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of the basic principles of business economics and the role that the entrepreneur should play in the firm.

Bankruptcy plays an important role in market economies. Although bankruptcy procedures are usually very complex, due to the conflicting interests of different groups—debtors, creditors, workers, and the government—and to the many regulations by which they are affected, their economic rationality is clear: bankruptcy is a collective action procedure whose goal is to get a better allocation of resources and move capital and labor to areas in which social productivity is higher (Jackson, 1986). When collecting their credit from of a bankruptcy procedure, creditors play a non-cooperative game, in which each individual maximizing strategy produces an inefficient outcome. Social costs increase when each creditor tries to get the highest possible amount of money from debtor's assets. These strategies reduce the net value of the debtor's estate and generate the inefficient outcome characteristic of a prisoner's dilemma. Bankruptcy law prohibits such strategies and incentives cooperation of creditors to avoid such unwanted effects.

The foundations of bankruptcy law were established within an economic framework which was characterized by a prevalence of private law contracts freely undertaken by both parties and by a low level of government control of the economic activity. This is the way that this institution is still designed in most countries. However, it would be tantamount to closing one's eyes to real life to not accept that important changes have taken place in the framework in which bankruptcy law is currently developed, with a higher level of government control and a greater relevance of the role played by the stakeholders.

The efficiency of bankruptcy procedures has been widely discussed in recent years. And the present COVID crisis puts in the foreground the

had studied in London with Lionel Robbins and Karl Popper. In 1978 a free market think tank was formed, the Instituto de Economía de Mercado. Jesús Huerta de Soto, as an undergraduate, was already involved in the group of businessmen and publishers that was trying to spread the principles of Austrian economics in Spain. He joined soon the Complutense group and wrote his two PhD dissertations under Beltrán and Schwartz. I met him for the first time in those years. I remember being a member of his dissertation committee and to have shared with him a graduate seminar for PhD candidates. And there began a friendship that lives on forty years later.

debate between liquidation and reorganization of the bankrupt firm. Advocates of reorganization present it as a socially efficient procedure that reduces the high social costs of liquidation. Principles like "social welfare" or "public interest" are often used to advocate for a greater use of rehabilitation procedures. And in the present crisis higher rates of unemployment may be used as a strong argument to try to avoid liquidations. Critics argue, however, that rehabilitation is a procedure that breaks down the basic principles of bankruptcy and may be, in the long run, more expensive than liquidation.

Debates about this topic have been common in the last few years due to the pandemic, since governments have to make decisions on granting aid to some companies to keep them alive and, at the same time, on refusing such aid to many other companies that are considered not strong enough to stay in the market. But the reform of bankruptcy law has been widely discussed in Europe and the United States for many years, and one of the outcomes of these debates has been the substantial development of the reorganization procedures for bankrupt companies.

Reorganization basically consists of the implementation of a rehabilitation plan in order to allow a firm to stay in business. Although the best-known bankruptcy provisions for reorganization are those contained in the chapter "History and Economic Theorizing" of the American Bankruptcy Code, similar provisions can be found in many other countries. Each reorganization procedure has its own peculiarities. Some bankruptcy codes (the American Bankruptcy Code, for instance) allow the original management to stay in charge of the firm in most cases. Others, for example, the British Insolvency Act of 1986, appoint an administrator to lead the company during the bankruptcy proceedings. The role of creditors in the proceedings may also differ. Some procedures require the conversion of debt into stock, while others offer diverse alternatives to the creditors. Credit priorities do not always receive the same treatment. Differences also exist between the voting systems on asset sales or postponement grants to the debtor. Employees play a relevant role in some reorganization proceedings, and almost none in others. But in every case, the main objective of the procedure is to put the company on a solid base and to try to guarantee its survival.

Should liquidation or reorganization be the main concern of courts and judges in bankruptcy cases? Some codes consider liquidation and reorganization of the firm as alternatives, without showing any special preference

for one or the other. Other codes, however, favor the rehabilitation of the firm.

In any bankruptcy procedure it is essential to evaluate the firm's assets and liabilities in the most accurate possible way since the decision between liquidation and reorganization usually depends on this valuation. Most bankruptcy codes are, however, very vague when dealing with the value of a company. Judges have therefore significant discretionary powers in a subject they usually know little about. For instance, there is substantial evidence to suggest that, in the United States, the valuation of bankrupt firms by judges in order to consider its possibilities for rehabilitation is systematically overstated (Jackson, 1986, p. 220). This concern has led a number of scholars to seek alternative procedures that provide market-based estimates of a firm's value.

There are two main methods to evaluate an insolvent firm: the balance method and the feasibility method. The balance method is static. It uses the market value of assets and liabilities in order to determine whether the company has a positive or negative net worth. A negative net worth would imply liquidation, while a positive net worth would pave the way for reorganization. This method has two inherent problems: first, there is the usual problem with the valuation of equipment and inventories when they may have to be sold in the short run. This possibility requires that these evaluations should be made as cautiously as possible. For instance, if inventories can be valued at the original cost or at the present market value, the lowest one should be used. Second, the fact that there is a net worth does not guarantee the future survival of the firm in the market. A company whose net worth is positive because it owns expensive equipment or valuable buildings should be liquidated if there is no demand for its product in the market.

The feasibility method is dynamic. It does not focus on the static value of the firm's assets and liabilities but rather on the probability of survival that a reorganized company would have in a specific market. According to this method a firm should be rehabilitated if the discounted value of its future cash flows is expected to be positive. This is a strong argument from an economic perspective. But this method poses a major problem: the subjective judgements, unavoidable in these evaluations, permit different interest groups to seek rents and try to get a court decision convenient to their own interests, as will be discussed in the following section of this chapter.

Property Rights in a Bankruptcy Procedure

American data show that as many as nine out of ten small- and middle-sized firms fail after going into a Chapter 11 (American Bankruptcy Code) reorganization procedure. In this context, Franks and Torous (1989) present historical data on firms under reorganization. In Italy and France, rehabilitation procedures have been criticized as a useless and expensive prologue to liquidation or even as procedures that anaesthetize creditors. And in Britain, where the reorganization procedure has been considered a possible improvement of the old bankruptcy law, its relative success has been due to a most efficient system of liquidation that allows the new managers to sell the profitable divisions of the bankrupt firm for good prices. And many bankruptcy scholars claim that reorganization is time-consuming, that it involves high administrative costs and often reduces the company's value. For instance, Bradley (1992) and Baird (1986) are good examples of this literature quite skeptical with the rehabilitation procedures.

Efficiency arguments fail to explain why so many firms with such low probabilities of survival are reorganized. The existence of interest groups and rent-seeking behavior, often disguised as public interest efforts, provide one possible explanation. A firm may be conceived as a framework of interests and property rights. Property implies three different rights over the firm: the right to control it; ownership of the firm's assets; and the right to take possession of the firm's profits. According to a complex web of legal provisions and contracts, owners share these rights with creditors, employees, and the government.

Discussions over priorities in the use of these rights are a characteristic feature of bankruptcy procedure. Business experience reveals that the preference for reorganization or liquidation is often determined by the property right framework, as defined by law. The interests of secured creditors may be very different from those of unsecured creditors when faced with a choice between liquidation or reorganization. Employees and unions may think that reorganization is the most beneficial outcome for their interests. The incumbent managers may prefer reorganization if the procedure allows them to stay in charge of the reorganized firm (Gilson, 1990) but have reasons to be against reorganization if it seems likely that an external administrator will be appointed to lead the firm. Another argument for current managers to oppose liquidation could be that they may try to avoid being considered responsible for the failure of the company.

All these property rights and interests collide in bankruptcy procedures and each group follows its own strategies. Their relative success will depend on the value of their credit, the specific regulations of bankruptcy law, and the public support they can secure for their demands. Suppose that employees believe, as they usually do, that reorganization is the most convenient outcome for them. They will follow a strategy that puts pressure on decision makers, local politicians, and the media, in order to keep the firm in business. Some laws go even one step further and assign an active role to employees in the negotiations between debtors and the creditors (the French Bankruptcy Code being a good example). Public choice and rent-seeking models offer plausible explanations for the possible success of this strategy and account for the public subsidies that some companies receive in case of reorganization (Buchanan et al., 1980).

It is usual to present the liquidation-reorganization dilemma as a private vs. public interest problem. It is argued that the already complex framework of property rights and interests should be enlarged to include some kind of public interest in the survival of the bankrupt company. Unemployment or deindustrialization in a depressed area are the arguments more often used to justify the public interest in avoiding the liquidation of insolvent private firms. From an efficiency perspective it may be hard to justify these arguments. Bankruptcy law is not the best instrument to deal with problems such as unemployment or deindustrialization. There is no reason to consider the interests of unemployed employees or local interest groups more "public" or "social" than the welfare of the creditors, the taxpayers, or the whole society, which will eventually pay for the misallocation of factors of productions. The costs of liquidation and rehabilitation are often misperceived. It is easy to overestimate the short-run social costs of the liquidation of a firm, especially in cases of high rates of unemployment. It is, however, more difficult to assert the long-run costs of an inefficient allocation of resources. These long-run costs are usually downgraded by the public opinion, and public interest arguments often prevail over the efficiency aspects of the decision. It is true that a rehabilitation procedure may allow some efficient firms with short-term illiquidity problems to stay in the market; but it should be emphasized that more often it creates incentives to save inefficient firms that should be liquidated.

Firms Without Entrepreneurs?

As we have seen in the previous section, reorganization of a bankrupt firm often implies a change of management. It is true that the appointment of a new management does not always take place; for instance, under the chapter "History and Economic Theorizing" of the American Bankruptcy Law, management is usually allowed to continue operating the corporation. But other reorganization procedures insist on the removal of the incumbent management and the appointment of new managers under the supervision of the creditor's representatives. But are these managers real entrepreneurs?

Many economists think that the basic characteristic of firms in a competitive market is the existence of entrepreneurs that take risks and organize production, being both profit maximizers and discoverers of opportunities for gain. Some well-known models can be mentioned. In Schumpeter's theory of economic development entrepreneurs play a fundamental role when introducing to the market new goods or new methods of production or design new ways of organizing a company. Inventions per se are not relevant for economic progress. Only when they are put into practice do they become important. The role of entrepreneurs is to put together these "new combinations." Their effects are revolutionary changes that promote economic development. No one is an entrepreneur forever and there is not such a thing as a social class of entrepreneurs. Personal characteristics are required to be an entrepreneur. So, in his own words, one can inherit the entrepreneur's money, but not the claws of the lion. This first version of the theory was presented in Schumpeter's early book on the theory of economic development (Schumpeter, [1912] 1934). But some years later, in *Capitalism, Socialism and Democracy*, Schumpeter changed his theory at least in two relevant aspects: first, he put much greater emphasis on innovation than on entrepreneurship; and second, he said that the entrepreneur does not have to be a person. In this new approach to the study of economic development he accepted that a big corporation, a state company, or even a country itself might be the entrepreneur of the future. This idea explains his gloomy predictions about the future of capitalism: if the businessman entrepreneur is no longer necessary for economic progress, capitalism, as we know it, could cease to exist (Schumpeter, [1942] 1975).

A second approach to the role of the entrepreneur was presented by Frank Knight in his analysis of the role that risk and uncertainty play in

business economics. Knight made a clear distinction between risk—that may be treated as an insurable cost—and uncertainty which cannot be. Workers are more risk averse than entrepreneurs. So the “essence of enterprise” is the specialization of the function of “responsible direction” of economic life. The role of businessmen in a market economy is to organize production in an uncertain world, in which they are forced to speculate on the price of their final products. So, according to Knight, uncertainty about the future allows entrepreneurs to earn profits even in cases of competitive equilibrium (Knight, [1921] 1971, esp. ch. 9 on “Enterprise and profit”).

The third model I should mention is Prof. Kirzner’s theory of entrepreneurship. Kirzner (1973) draws a sharp distinction between the means of production ordinarily conceived and entrepreneurship, in the sense that entrepreneurship implies the existence of a project and taking initiatives. If the project exists and the entrepreneur thinks that it is worth undertaking it, he will try to obtain the necessary factors of production. In principle, engineers have the knowledge to do it. But, according to this model, only the entrepreneur takes initiatives. Knowledge and factors of production may be bought in the market. But entrepreneurship cannot be purchased or hired and cannot be taught. Entrepreneurs detect market imperfections, caused by information asymmetries, and exploit them being their role to discover opportunities that other people in the market cannot see.

These three models are quite different from each other. But they share an important characteristic: all of them assert that it is difficult to explain the role of a firm in the marketplace without someone playing the role of entrepreneur. From this perspective, bankruptcy should be conceived as an entrepreneur’s failure. And the point to be emphasized is that rehabilitation does not imply that a new entrepreneur takes over the firm—as it would happen if the company or part of it were sold to another efficient company with a sound business plan—and only means that creditors or workers appoint new managers. A manager usually is not an entrepreneur. So, according to the models that emphasize the role of the entrepreneur, it will be very difficult for a bankrupt firm to be saved by a group of managers, a trustee, or the representatives of workers or creditors. This is probably the best explanation of why so many failures occur in the rehabilitation procedures of companies in bankruptcy.

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