Discussion of Franks-Sussman and Xu Bankruptcy Papers

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Aim of bankruptcy law

- Efficient firms should be reorganized and survive

- Inefficient firms should be liquidated

Problem in constructing bankruptcy law to do this:

- Conflicts of interest between different classes of claimants means this may not happen
  - Senior claimants have an incentive to shut down the firm prematurely so they receive the full value of their claims
  - Junior claimants want to keep the firm going because things may improve and they may receive their full claim

These conflicts mean

- Efficient firms are liquidated
- AND/OR
- Inefficient firms are kept in operation

US System:

- Chapter 7
  - Assets liquidated (as a whole or separately)
  - Liquidation proceeds distributed in accordance with absolute priority

US System (cont):

- Chapter 11
  - The automatic stay
  - Debtor in possession financing
  - Reorganization

US System (cont):

- Problems
  - Management can invoke Chapter 11
  - Absolute Priority is often violated in Chapter 11 and shareholders receive part of the reorganized firm
  - Chapter 11 can lead to inefficient firms surviving

US System (cont)

- Jensen (1989) and others have argued that a private system operating outside the judicial system is better because
  - It would limit violation of absolute priority
  - Inefficient firms would be closed more easily

Two papers here provide interesting evidence

- Franks and Sussman: Evidence from UK small and medium sized firms where bankruptcy process is contract-based

- Xu: Evidence from Japan where in the 1980’s the main bank system provided a form of private distress resolution without the involvement of courts

Franks and Sussman

- In contract-based system creditors may intervene and cause early liquidation
  - Concentration of debt may mean
    - Lenders liquidate at first sign of trouble (lazy banking)
    - Strategic default by borrowers
  - Dispersion of debt can lead to coordination problems
    - Asset grabs
    - Creditor runs

Franks and Sussman (cont)

Four main results:

1. Liquidation rights extremely concentrated in the hands of bank
2. Mixed evidence with regard to lazy banking:
   - Banks' likelihood of liquidating a firm depends on firm's own restructuring effort
   - But high recovery rates suggest banks don't wait long before liquidating

Franks and Sussman (cont)

3. Banks are successful in resisting any attempt to renegotiate

4. No evidence of asset grabbing or creditors' runs

Xu

- In 1980’s evidence by Hoshi, Kashyap and Scharfstein (1990), Aoki and Patrick (1994) and others indicated main bank system dealt with financially distressed firms outside court
- Main bank system was a form of private system and it worked well

Xu (cont)

- In 1990's more and more firms ended up in court-based bankruptcy as the economic situation in Japan worsened

- How well does Japanese bankruptcy law operate compared to US bankruptcy law?

Xu (cont)

- Questions addressed
  - What is bank lender intervention and senior management turnover around bankruptcy filings?
  - How well does the Corporate Reorganization Law (where management changes) work?
  - How does it compare to the recently introduced Civil Rehabilitation Law (where management can stay)?

Xu (cont)

Results

1. Bank lenders are less likely to intervene

2. Irrespective of law used senior management turnover is high around bankruptcy

Xu (cont)

3. Average time from filing to resolution under the Corporate Reorganization Law is less than in the US

4. Civil Rehabilitation Law works even faster.

5. There is less violation of absolute priority under both laws in Japan than in the US.

Comments

- UK and Japanese systems appear to work well

- Japanese evidence suggests private system works better in upturns than downturns. Is there any evidence in the UK that the effectiveness of the private system is better in the upturns?

Comments (cont)

- Focus of traditional theory on efficiency of liquidation and continuation is rather narrow

- Key issue for comparative financial systems is do bankruptcy laws encourage or discourage risk taking?

Comments (cont)

- How easily can entrepreneurs and management teams start again after bankruptcy and liquidation?

- Dynamic issues of effects of bankruptcy on risk taking and growth are extremely important compared to the static issue of inefficient liquidation