
CHAPTER 11: A TOOL OF STRATEGIC MANAGEMENT

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Since the current bankruptcy law was enacted in 1978, there has been a virtual avalanche of bankruptcy filings. The number of "straight" bankruptcies, under Chapter 7 of the U.S. Bankruptcy Code, more than doubled from 1979 to 1983; but the number of "reorganizations" under Chapter 11 almost quintupled, to more than 18,000 filings in the year ending July 31, 1983. Just as remarkable as the number of filings is the diversity of strategic purposes which have been served by those filings (1).

Because of the uses to which Chapter 11 has been put, many feel that the law should be repealed or its provisions modified (2). Repeal appeared to have been effectively accomplished in 1982 when the Supreme Court ruled Chapter 11 to be unconstitutional because of the extraordinary powers it confers upon bankruptcy judges, who lack the lifetime tenure and the salary maintenance protection which insulate other federal judges against political influence. However, the law continues in effect under a "Special Rule," which was established by the federal judiciary in December 1982. Under the Special Rule, bankruptcy judges operate with district court oversight and controversial matters are heard by district court judges if a party at interest in the bankruptcy court so moves.

The Supreme Court has refused to hear challenges to the Special Rule and several appeals courts have upheld its constitutionality. In addition, proposed bills in Congress would cure Chapter 11's unconstitutionality by essentially incorporating the provisions of the Special Rule (3). In light of this, it appears probable that the provisions of Chapter 11 will remain in effect for a long time and corporate managers will continue to take advantage of its provisions to serve themselves or one or more of their multiple constituencies. Let us consider how Chapter 11 can be turned to the benefit of different constituent groups, especially the managers themselves.

Managers May Extend Their Tenures or Obtain Favorable Severance

Most executives who file Chapter 11 petitions for their companies do so to their own benefit, if not for their own benefit. By the time a company seeks protection under the bankruptcy law it is usually doomed to failure without such protection and company executives are facing imminent loss of their

jobs. After a Chapter 11 filing managers typically continue in office and enjoy full pay, benefits and perquisites. They may even be able to enhance their compensation packages. Of course, a party at interest in the bankruptcy court may object to the executive pay and benefits, but this seldom occurs.

In a small percentage of Chapter 11 cases, professional “turn-around artists” are employed. Among the better known of such specialists are Sanford Sigoloff, the new leader of Wicke’s Corporation; Joe B. Freeman, of AM International; and Victor Palmieri, the chairman of Baldwin United Corporation. When these specialists take over, they typically replace senior managers and often fire managers far down in the organizations. Even then, however, top managers frequently leave on very favorable financial terms. The deposed chief executive of AM International, for example, received severance pay along with a lucrative consulting contract. When the senior vice-president of Manville Corporation left shortly before the Chapter 11 filing, he did so under a new and highly favorable early retirement plan. The two top executives of International Harvester, which threatened a Chapter 11 filing for more than a year, left with millions in severance pay and debt forgiveness. Such results are predictable because executive compensation typically accounts for a small proportion of total corporate expenses and there are much more pressing matters facing creditors and other parties at interest. In addition, any top management team which is deposed without gracious treatment can contest their removal in the cognizant district court.

Power and Cash Simplify the Management Job

Company management has increased power under Chapter 11 because it is typically able to pick the forum in which the Chapter 11 process will be conducted. There are districts which tend to be “pro-debtor” and others where creditors are favored. In the Western District of Louisiana, for example, top managers are often replaced with a trustee. In the Southern District of New York, where Cincinnati’s Baldwin United and Denver’s Manville Corporation filed, this does not happen. The bankruptcy code allows a bankruptcy petition to be filed wherever the company has had a “principal place of business” for the 180 days preceding the Chapter 11 filing. For most major corporations, this includes almost any bankruptcy district in the United States. Even smaller companies can establish a “principal place of business” in any district where they desire to file as long as they anticipate the filing, even potentially, as much as six months in advance. This allows management to “judge shop” and to select that district in which they feel that they are most likely to have their way.

Managers who stay in power after a Chapter 11 filing may find their jobs much easier to perform. The monthly struggle to pay maturing debt ceases and cash shortages are usually quickly eliminated. Receivables due at the time of the filing flow in and payables, leases, trade accounts, installment notes, etc. no longer have to be paid. This can produce from thousands to

hundreds of millions of dollars in added cash. (Post filing cash and near cash exceeded \$65 million at Continental Airlines and \$200 million at Manville.) Until a reorganization plan is confirmed — and to some extent thereafter — prefiling creditors have little control over what is done with inflowing cash. Management is relieved of the trying responsibility of dealing with dozens or hundreds of separate creditors and can confront them collectively through their duly appointed committees in the bankruptcy court. When Continental Airline's secured creditors tried to restrict the use of cash from prefiling accounts receivable, they were unsuccessful. Of Manville's more than \$230 million in cash and marketable securities as of June 30, 1983, only \$77 million was restricted as to use.

Managers of most companies feel obligated to provide creditors with timely financial information whenever they demand it. Under Chapter 11, however, such timeliness is not required. While bankruptcy law contemplates monthly financial reports, many courts allow substitution of Securities and Exchange Commission Forms 10-K and 10-Q. The 10-Q forms are filed within 45 days after the end of each calendar quarter and the 10-K reports are required three months after year end. So corporate managers typically have additional power because they have access to and control over financial facts and figures which creditors and others do not have — at least for a few months.

Top managers of a firm which has filed a Chapter 11 petition typically have the power to dismiss employees and other managers willy-nilly or to afford exceptional benefits to those whose allegiance they consider most useful. "Saving the company" justifies almost any kind of extreme action. The necessity to compensate valuable team players to get them to give their best to a company which may not have a long term future provides a rationale for high pay. There is really no need for company management to struggle with the question of whether a manager is really worth the amount paid or not because any savings achieved through compensation efficiencies typically must be allocated to provide additional payment to creditors and other claimants.

Managers operating under the shield of Chapter 11 may also have an easier time meeting competition in the marketplace. Not only have they avoided some of the usual expenses of doing business, like interest and some of the principal on unsecured debt, there is no real need to sell at above the cost of production if pricing below costs will make the sale. Besides, any profit made will usually just go to pay creditor claims.

Eliminating Problem Divisions

Chapter 11 also simplifies the management job by providing a rationale for disposing of difficult to manage and/or unprofitable segments of the company. The typical pattern in major company reorganizations is to sell off whole divisions, thereby obtaining cash while improving profitability and

simplifying management. Manville sold its Belgium operation — by the way, to the managers of that organization — and its U.S. pipe operation along with a large number of other assets and divisions. Wickes Corporation sold its House of Fabrics chain, a furniture manufacturing division, and a number of other units. If management sells any part of the company at all, this makes the job of managing easier. But it is possible to concentrate upon disposing of those elements that require most of management's time and energy while retaining decentralized and profitable parts of the company. The debtor in possession is required to report major asset disposals to the bankruptcy court and sometimes the proceeds from such sales are restricted as to use, but it is seldom that such sales are effectively opposed.

An Easy Assignment: Minimize Profits

Prior to the confirmation of a plan for reorganization, managers actually have an incentive to minimize profits, a condition which greatly simplifies the job of management. Executives need not worry that low profits may cost them their Chapter 11 shield. The provisions of the bankruptcy code which allow the conversion of a Chapter 11 proceeding to a Chapter 7 liquidation are seldom used. Even if such an effort is made by creditors it can be contested in the district court by management. Any attempt to vacate a Chapter 11 petition can be similarly resisted. In one Chapter 11 case in Shreveport, Louisiana the bankruptcy judge ruled that the debtor should be stripped of Chapter 11 protection. The Company appealed that ruling to the district court and immediately filed a new Chapter 11 petition, which the bankruptcy court honored. A similar motion has been filed by the Asbestos Claimants Committee in the Manville Case. That motion was not carried forward for more than a year. Such efforts in other cases are likely to meet with little success because of the heavy burden the bankruptcy code places on a party which desires to have a Chapter 11 case converted to a Chapter 7 case and because of the presumption that the "debtor in possession" that is, current management, will continue to operate the firm while in Chapter 11.

If prior to filing a reorganization plan, the bankrupt firm were to earn significant profits, this would surely result in creditor demands for a larger percentage payout to themselves and stockholder resistance to any effort to dilute their interest or diminish their returns under a reorganization plan. So, in the period between the filing of a Chapter 11 petition and the confirmation of a reorganization plan there are strong incentives for minimizing profitability as long as this can be done without risking conversion to a Chapter 7 liquidation, imposition of a liquidating plan under Chapter 11, or the replacement of company management by other managers or a trustee.

Even after a plan is confirmed there is often little reason for company management to put forth the effort required to earn profit. Amounts due unsecured creditors are often stated as a percentage of profits and more profits just means that more must be paid. Second, management can prob-

ably defer payment of planned amounts with relative impunity, standing ready to appeal any adverse bankruptcy court decisions to the district court.

A successful Chapter 11 might be defined as one in which the debtor in possession (1) files a reorganization plan providing for payment of all or a portion of the company's debts over an extended period of time, (2) pays those debts in accordance with the plan, and (3) emerges from reorganization a profitable company. Of the 200 or more cases which have been filed since 1978 in the Western District of Louisiana, not a single case meets this definition. This reflects the disincentives which managers have to fulfill the spirit of Chapter 11.

Extending the Grace Period

If managers desire to delay the confirmation of a reorganization plan under Chapter 11, it is usually easy to do so. For the first 120 days after a Chapter 11 petition is filed, management alone has the right to propose a plan of reorganization. This 120 day period can only be extended or allowed to expire. If it expires, any party at interest, including a stockholder, a creditor, the bankruptcy court, or perhaps others, can propose a plan. If this were to occur in a major case, pandemonium might result, with many plans being filed and probably with no plan likely to receive the required committee approvals for confirmation. Because of this spectre, bankruptcy judges are hesitant to terminate the 120 day exclusionary period and the period is often extended for a year or more. Even if management believes that the current extension at a particular time is "the final one" it is only necessary to propose a reorganization plan, however unlikely that plan is to be confirmed. As long as the plan is submitted "in good faith," the debtor in possession is automatically granted another 60 days to win approval of the plan by various committees. This period, too, can be extended for as long as the judge feels that there is some likelihood of achieving a confirmable plan.

Potential Benefits to Stockholders

It is possible for a Chapter 11 proceeding to result in a great improvement in shareholder interest, either collectively or as separate groups. It is even possible that Chapter 11 might benefit particular shareholders at the expense of others of the same class.

Stockholders in General

To begin with, Chapter 11 can hardly damage shareholder interest for a company which is truly insolvent. When companies are liquidated under Chapter 7 unsecured creditors seldom get significant payment on their claims. Rare indeed would be any return at all to shareholders, preferred or common. Just as rare would be a Chapter 11 reorganization plan which eliminates all shareholder equity. Such a plan would hardly receive the required two-thirds approval of shareholders.

If, as is usual, the Chapter 11 proceedings result in the elimination of some corporate debt, the payment of such debt over extended terms without interest, or the substitution of equity for debt, the company's equity securities have some potential value. In addition, the favorable tax treatment of debt discharges under bankruptcy law accrues to the benefit of shareholders (4). This is reflected in the fact that Manville Corporation common stock, after having sold for less than \$8 per share shortly before the Chapter 11 filing, increased to the range of \$12 to \$16 per share during 1983. In November 1983 Revere Copper's common stock was selling around \$13 per share and Baldwin United's was priced at over \$3 a share.

Shareholders may benefit in a major way if management is able to gain confirmation of a reorganization plan which provides for a reasonably quick payout of a small percentage of corporate debt and then if management tries to maximize company profitability. Of course, the amount and terms of payment for which creditors will settle is largely dependent upon their perception of the alternatives. If managers convince creditors that company profitability will be low, creditors are likely to accept either a low percentage of payment or very extended payment terms.

Until recently, the payment terms under Chapter 11 plans typically extended for less than five years after confirmation. Recent plans have tended to provide full payment of claims but over a period of up to ten years. In fact, a plan suggested by District Judge Edelstein in the Manville Corporation case contemplates payment over at least a 20 year period and perhaps longer. Judge Edelstein suggested that the entire profit of the company be allocated to pay claims. If management were forced to follow a plan which contemplates such extensive payouts over such a long period of time, it is unlikely that shareholders in the aggregate would benefit. It is possible though, that after profits fail to meet expectations and payments are correspondingly low, management might be able to negotiate a revised plan less favorable to claimants and more favorable to shareholders. After that, management might be encouraged to put forth the effort required to increase profitability.

If a company is solvent when its managers lead it into the Chapter 11 process, the shareholders stand a very good chance of losing, even though debt may be reduced and certain expenses may be avoided. The perverse incentives to management discussed above may lead managers to sub-optimize shareholder interest.

In some cases (Continental Airlines, Braniff, Wilson Packing Company, among others) Chapter 11 filings allowed the renegotiation or outright avoidance of labor contracts. In others (Rath Packing Company, Food Fair, Inc., among others) pension costs were reduced by termination of retirement plans, renegotiation of contribution rates, or withdrawal from multiemployer plans (5) Any contract, executory or not, may be avoided or renegotiated under the threat of cancellation by the debtor corporation. This

includes leases, supply contracts, debt indentures, and many more which may involve continuing costs for the obligor. Shareholders in solvent companies which file under Chapter 11 may benefit when any of these contract modifications or cancellations decrease costs.

Preferred vs. Common

If a single committee represents preferred and common shareholders, as is typically the case, common shareholders should usually gain in relation to the preferred shareholders because of a Chapter 11 reorganization. In case of liquidation, preferred shareholders would receive the par value of their shares before anything went to common shareholders. Since the bankruptcy code requires a two-thirds vote in amount of each class of interests before a reorganization plan can be confirmed, the common shareholders will normally block confirmation of any plan which fails to provide them significant benefits. Preferred shareholders, on the other hand, usually benefit vis a vis creditors because these shareholders would normally receive nothing in a Chapter 7 liquidation and are able to insist upon some benefits to gain their acceptance of a plan.

Individual Shareholders

Even though stockholders in general may not gain from a Chapter 11 reorganization, it is possible that certain individual shareholders will. This is especially true for those holding large blocks of stock or those who have reliable sources of information about how the Chapter 11 is going. As the fortunes of the company ebb and flow with each new filing by a party at interest and with each new ruling by the cognizant bankruptcy judge or district judge or by other judges in related cases, stockholders who are able to predict the impact on share prices are able to buy and sell profitably. In the Manville Corporation case, both common and preferred stock prices have gyrated widely as various developments have occurred in the case. For example, Manville common shares which sold for less than \$5 the day after the Chapter 11 filing sold for a high of \$16 in 1983 with several variations in the 30 percent range during the intervening months. Revere Copper's common stock ranged from $4\frac{3}{4}$ to $14\frac{7}{8}$ in the year after that company's filing. In general these variations did not follow changes in the productivity or earning capabilities of the corporations but rather accompanied the various pleadings and rulings in the cases. The opportunity that these kinds of variations provide for persons with special contacts need not be explained.

How Creditors Fare

The bankruptcy code appears to provide adequate safeguards to protect creditors from losing from a Chapter 11 reorganization as compared to a Chapter 7 liquidation. The code requires that the reorganization plan provide a settlement for all claimants at least as favorable as that they would

receive under a Chapter 7 liquidation. It would also at first appear that creditors can make sure they gain from Chapter 11 by withholding their approval of any proposed reorganization plan which provides less than what they would receive under Chapter 7. However, any real losses which occur after the Chapter 11 filing may reduce the amounts which creditors eventually receive. Because of the flexibilities allowed under accounting convention, managers have little trouble hiding moderate real losses. In addition, no matter how much has been lost up to any point in the Chapter 11 process, creditors are likely to find it difficult to terminate the process as long as management is able to show a prospect for improvement. So, reorganization often proceeds along until creditors are much worse off than they might have been at the start with a liquidation. For example, Sambo's Restaurant, Inc. lost more than \$30 million after filing for Chapter 11, provoking the assistant trustee in the case to conclude that there would be nothing at all left for the unsecured creditors and not enough to even pay the claims of secured creditors.

Even when the company's assets are not depleted through losses, unsecured creditors may lose because they are often not paid interest on their claims. In fact, it is not even necessary to accrue such interest in the debtor's books. Secured creditors may lose because the value of the assets on which they hold liens may be diminished through use and lack of maintenance. At the same time, as in the Sambo's case, the company's other assets may be depleted to the extent that nothing is available to make up the deficiency in the lien property. Continental Airline's secured creditors tried to protect themselves against this eventuality by asking the bankruptcy court to restrict certain cash balances. The judge refused to do so. Of course, secured creditors have access to their collateral to the extent that it is not required for the continuation of the business, but managers seldom have any problem showing that a particular asset is required. Consequently, secured creditors, at a minimum, often must accept delay in payment (6).

Creditors of all kinds may come out ahead, as compared to how they would fare upon liquidation. This would be the case if current corporate managers, notwithstanding the disincentives to do so, have both the ability and inclination to operate the company more profitably than potential purchasers. Of course, this should rarely be true.

Conclusion

Chapter 11 provides a procedure which may produce major and continuing benefits to corporate managers and almost certainly improves the situation for stockholders, but which is exceedingly unlikely to benefit creditors. Company managers are the primary referees as well as the main beneficiaries.

REFERENCES

1. For an interesting overview of some of these purposes, see Anna Cifelli, "Management by Bankruptcy," *Fortune* (31 October 1983), pp. 69-72.
2. James E. Stacy, "Innovation Through Bankruptcy?" *Business Horizons* (March/April 1983), pp. 41-45. While Stacy reports the clamor for tightening the bankruptcy law, he feels that such sentiment is misguided, that the law as it stands benefits the public by encouraging innovation.
3. For a readable discussion of the "Special Rule," see David Ranii, "Bankruptcy's Twilight Zone," *The National Law Journal*, Vol. 6 (7 November 1983), pp. 1, 9-11.
4. Richard A. Noffke, "Discharge of Indebtedness Under the Bankruptcy Tax Act of 1980," *Taxes*, Vol. 60 (September 1982), pp. 635-649.
5. Richard S. Soble, "Bankruptcy claims of Multiemployer Pension Plans," *Labor Law Journal* (January 1982), pp. 57-63. Soble discusses the difficulties of collecting pension liabilities from bankrupt companies which withdraw from mulitemployer plans.
6. See, for example, "Continental's Feisty Chairman Defends Deregulation — and Himself," *Business Week* (7 November 1983), pp. 111-115.