The Corporate Entity: From Failure Through Reorganization

An Honors Thesis (HONRS 499)

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Chapter I

Introduction

Business in America is a very prevalent phenomenon due to our capitalistic society. Whether it be big business or entrepreneurship, business is there. Due to many factors, success in business is hard to attain; therefore, failure is very common. The need to study this subject stems from the desire to succeed. The unfamiliarity with the factors or causes of failure is the most significant problem with failure. No one really cares about failure in itself, but they do care about what caused it—the steps that led to the downfall (Barrickman p. 4). If the businessman understands what caused problems in the firm, he would be better equipped to handle them. To use an analogy, the reason the disease Cancer is so detrimental to our society is because no one knows what causes it; therefore, no one can find a cure. The businessman needs to know what causes failure so that he will be able to cure it before the firm "dies."

Before continuing any further, it is necessary to define a few terms that will be used throughout this paper and that could get very confusing. There seems to be a need to distinguish between failure, insolvency, and bankruptcy so that the reader will know in which stage a firm is. Beginning at the first step and progressing forward, a firm goes from failure to insolvency to bankruptcy unless something is done to counteract the problem.
A economic failure is defined as a company that realized a rate of return on its invested capital that is significantly and continuously lower than the prevailing interest rates on similar investments (Altman p. 2). The significant point about failure is that the company can have this problem for years and still be able to pay its bills. As long as a firm can pay its current debts, it will be allowed to stay in business. Less than .4 percent of all companies that discontinue each year are due to economic failure (Argenti p. 49).

If the problem of low rate of return is not dealt with properly, the firm will digress into the next stage: insolvency. Insolvency is divided into two categories: technical insolvency and permanent insolvency. Insolvency is often referred to as legal failure because it has all of the characteristics of failure plus the inability to meet its current debts even though total assets still exceed total liabilities (Ramaswami p. 65). If the problem seems to be only temporary, it is termed technical insolvency or "insolvency in an equity sense" (Altman p. 3). "Insolvency in a bankruptcy sense" is more serious (Argenti p. 49) because it is a more permanent situation. It means that total liabilities exceed total assets or that the real net worth of the firm is negative (Ramaswami p. 66).

The next step is the final one and it deals with a formal declaration of the firm's bankruptcy. When the firm
realizes that the debts are just too much to handle and something needs to be done with the creditors, it will file a formal declaration with the bankruptcy court. If there is a problem but management does not notice, the creditors can file an involuntary bankruptcy petition against them. The formal definition of bankruptcy is an insolvent firm that has filed a petition for either liquidation or reorganization under the court's supervision (Altman p. 3). If a company is valued more alive then dead, it reorganizes rather than liquidates (Platt p. 6). Without the formality of filing, bankruptcy and insolvency are virtually synonymous (Argenti p. 49).

Business failure is not necessarily a bad thing. It is just a status that if not handled properly will digress into a very serious problem: bankruptcy, the ultimate business failure (Platt p. 6). The point to remember is that not all firms that fail are discontinued; if the manager can recognize the problem and correct it, the firm may recover (Platt p. 116). If the firm deteriorates from unrecognized problems, it will have to be discontinued (Weintraub p. 1). This is much like the cancer analogy made previously, if the body deteriorates because of the undiscovered causes of cancer, the body will inevitably die.

The need to study causes of corporate failure are obvious then. If an entrepreneur or manager of a large firm wants to succeed, he can choose to learn and understand the
causes of failure and then deal with them properly. Success ultimately balances failure (Platt p. 15) because if the symptoms are dealt with properly the possibility of success is increased. On the other hand, if the causes are ignored, the possibility of failure increases.

The need to know is the basis of this study. The writer will attempt to show the causes of corporate failure in an easy to understand manner. If the firm recognizes the problems too late, it will have to understand the formal procedures of Chapter 11 of the Bankruptcy Code entitled Reorganization so this paper will also summarize that procedure. Before the reader can fully appreciate Chapter 11, he must understand the evolution of the American bankruptcy laws. For this purpose, the writer will also include a brief history. To conclude this study, the writer will summarize case analysis that will show the corporate failure, the filing for Chapter 11 protection, and the succeeding of the firm through reorganization.
Chapter II
What Causes Corporate Failure

Just merely listing the causes of corporate failure is extremely hard to do because there are different ideas depending on who is asked, managers or creditors (Argenti p. 51). A corporation that fails could be a one man organization, a $100 million manufacturing firms, or any type in between (Stanley p. 107). Though it may be hard to do, this paper will attempt to summarize the major causes of corporate failure. The largest cause of failure seems to be being a young firm; the young firms seem to have a high propensity to fail, and the longer a firm exists, the smaller possibility of failure exists (Altman p. 21). The majority of small, new businesses that fail are between one and five years old; the reason for this is that a new firm has a competitive disadvantage to existing firms. The older, already existing firms have greater access to the money and capital markets so that they can withstand financial problems that the new firm has trouble controlling. The younger firms must rely on sources of capital that possess a small amount of capacity to finance the business.

Many small firms discontinue its operations on a regular basis so the economic impact on society is little if any at all. The larger the firm going bankrupt, the more profound is the impact on society (Altman p. 1). If the
large firm fails, suppliers will have a significant decrease in demand, customers are inconvenienced even if substitutes are available, and the public is hurt because of increased tax burdens. If a small firm fails, society will not be affected as badly as when a large firm fails because the smaller firm does not impact society in the same manner as the large firm when it is operating. Small firms usually do not have that many suppliers or customers, so not that many people will be affected by its failure. A small firm can fail in an industry and another small firm can replace it rather easily. If a larger firm fails in an industry, it cannot be instantly replaced by a firm of identical size. Therefore, the fact remains that a small firm's failure does not hurt society as much as a larger firm's failure. In this thesis, though, both a large failure and a small failure will be treated equally because both firms have similar causes of failure and they both reorganize under Chapter 11 in the same manner.

It was mentioned previously that the list of causes of corporate failure was long, but really there are only two major factors that cause a corporation to fail: poor management and inadequate finances. All other causes stem directly from one of these two problems. Success of a business is virtually guaranteed if it has a good management team and adequate financing to complement the firm's capital (Barrickman p. 15). Poor management can mean a few
different things; it could mean management just does not possess the skills needed to be successful or it could mean that management is dishonest in some way. By dishonest, the writer means that the manager uses corporate funds for his own personal use. Though this happens some, not all bankruptcy is due to dishonesty. Only five to ten percent of all bankruptcies are due to a dishonest manager (Stanley p. 110-112). Dun and Bradstreet were quoted as saying that in "90 percent of the bankruptcy cases you will find a 'lack of experience' and 'incompetence' as the causes." The second cause of failure was stated as inadequate financing and by this the writer means that the small businesses were inefficient at current market condition (Stanley 117). The inefficiencies stem from the lack of opportunity to receive loans in order to pay debts; or on the other hand, if the young firm can receive the loan, the interest rates are much too high to afford. "Most failures are unjustifiable entries into business aided in most cases by the indiscriminate and careless granting of credit" (Stanley p. 107). The credit companies are part of the problem, if they were more cautious of who they lent money to, the inability to make payments would happen less frequently.

Management incompetence causes the majority of corporate failures; but to narrow those causes, two classifications are made: external causes, and internal causes (Barrickman p. 12). The external causes are listed
under management incompetence because it is the manager's inability to adapt to or the lack of skill to handle the external forces. The internal forces are directly related to the manager's incompetence.

The external section contains many problems that could be more easily handled if the management of the firm was better prepared. Extensive competition can cause a major problem for the firm. Normal competition is usually beneficial because it keeps the company "on its toes" (Barrickman p. 13). If the competition gets too strong and the price wars get too substantial, the larger, stronger firms will inevitably destroy the smaller, weaker firms. A strategy that could be used, that may be beneficial or not, is to merge with a major competitor.

The biggest external factor that causes corporate failure is change--the company's inability to adequately respond to change. The company is not acting in isolation so it must be ready to change (Argenti p. 128). The factor of change can be broken up into many subsections so that it can be easily understood.

Bad economic activity or a change in the business cycle is a possible external cause of corporate failure. A recession or depression are bad for a firm because they cause lower prices, drops in sales, or slower collection of debts. All of these things make the revenues gained much lower and it in turn creates a lower cash account. The most
potent economic activity upon corporate failure is the "credit squeeze" (Argenti p. 51). A credit squeeze is a period of "tight money" where credit is rationed to those firms who are believed to be the best risks. These best risks and not small firms or firms that are already in danger, but those firms who are larger and stronger (Argenti p. 52). This fact will solidify the point that the majority of failures seem to be small firms. If a firm cannot receive credit when it needs it, it will not be able to operate in our competitive society. Even if the small firm could receive the credit it needed, it would not be able to afford it anyway. When money is tight, the interest rates rise to a point where only the larger, richer firms can afford to take loans which causes an anti-small, anti-marginal market (Argenti p. 52). With a management that is prepared for anything, this really would not be a problem because they would have anticipated the problem and controlled for it.

Change in public demand may also cause a firm to fail. If the firm sells an item that is an anachronism, it can never be successful because it will not have a demand for its product. A very good example of this is the "buggy whip maker"; when new forms of transportation were created, if the buggy whip maker did not adapt with the change, his business would soon fail due to the lack of demand for buggy whips. To be successful, a firm must sell what the public
wants and can afford (Barrickman p. 13). If management was competent, they would be ready to adapt to change. In these times of change, management must be prepared to adapt and to diversify. With a prepared Research and Development team, the firm would always be ready to strive onward despite the change in society.

Other changes in society also have a negative effect on the firm's success. If society's attitude toward work changes, the management will have to be ready to change. If the attitude changes from the want of more money to participation and job satisfaction, the management needs to have programs ready to keep employees happy (Argenti p. 129). If there is anything management does not want, it would be an adverse act of labor (Barrickman p. 14). Labor unions were created to keep the workers happy; they are skilled at bargaining so the management of the firm must be skilled also because a prolonged strike could devastatingly hurt production and be detrimental to the firm's existence (Barrickman p. 14). The last societal change that affects the firm is a change in technology (Argenti p. 130). If there is a new cheaper way to produce, but the management is too incompetent to notice or too cheap to care, the firm's profit margin per unit may decrease because other firm's prices are lower because they are using the new technology. A well managed company will be able to adapt to any type of change no matter how great it is.
Normal everyday occurrences or just plain "bad luck" can be detrimental to the firm's success if not handled properly. Failure due to this cause should never happen because all firms are subjected to the same daily occurrences (Argenti p. 137). Managers should be able to foresee possible strokes of bad luck and prepare for them. Examples of the natural occurrences are fires, earthquakes, explosions and floods. The only way a manager can really prepare for any of these is to take a preventive approach by being watchful and choosing a good location for the firm (Barrickman p. 15). The possibility of financial failure is greatly reduced by having insurance policies covering natural phenomena. Though even with insurance, if one of these phenomena happen, there will be down time due to rebuilding which will cause lost profits and increase the possibility of failure. If the correct insurance policy is purchased, even the lost profits can be insured. This external cause is a very serious one and can be controlled adequately if the management acquires the right insurance.

The last external cause of corporate failure to be discussed here is due to governmental acts whether it be local, state or federal (Argenti p. 129). The government may decide to pass some legislation in your area of production that will hurt your business. Examples of these governmental acts would be legislation concerning new tax structures or legislation concerning trade practices.
(Barrickman p. 14). Other governmental acts that may indirectly hurt business may be expiration of a patent for production or the initiation of tariffs. Management must be able to adapt or these governmental acts may cause its firm to fail.

The preceding external causes were detrimental to the firm due to the management's inability to adapt to them. The following causes are internal in nature and are directly caused by management's incompetence. The trouble with the preceding statement is that no one really agrees what management incompetence means (Argenti p. 3). Some people agree that if the management team is well trained, the only way a firm can fail is sheer bad luck. It is agreed that management incompetence includes a lack of experience in the field, having a familiarity with the product market but unbalanced experience in one or more of the management functions, a lack of ability to anticipate unfavorable industry developments, and/or hubris which leads to the underestimation of the competition (Ramaswami p. 66). A common belief exists that a good manager will rarely make the same fatal mistake as a bad manager, but if he does he has the good management skills to help him protect the company (Argenti p. 123). Throughout history, studies have shown that there are six areas of internal management incompetence that will cause failure. Those six will be summarized in the following paragraphs.
The first four have to do with the CEO and the Board of Directors. First of all, CEO's that dominate their colleagues, called the "one man rule", rather than lead them is harmful to the firm. The CEO will hear no advice or allow any discussion so that every decision is one man's opinion (Argenti p. 123). An example of this is Apple, Inc. and its CEO John Sculley. Sculley made all of the decisions for Apple by himself, he never consulted his other managers. Apple's sturdiness in the industry started to fall until Sculley figured out his mistake and delegated much of the responsibility to the newly elected Executive Vice-President Michael Spindler (Buell p. 86). The second defective area is having the same individual fill both the CEO and the Chairman of the Board positions. This defect may be the most serious because if you draw a management tree you will find that managers are responsible to the manager directly above them (Argenti p. 126). To whom is the CEO responsible to? If he is also the Chairman of the Board, he is responsible to himself so there is no one to keep him honest. Apple Inc. and Sculley also had this problem but have yet to correct it (Buell p. 56).

A non-participating Board of Directors supplements the previously mentioned areas of management defects. If the inside directors do not know what is going on, they will not help the CEO even if he asked for their help. Outside directors are able to notice problems because they are
unbiased towards the firm's inside operations. If those outside directors are competent, they will be able to supply possible actions to fix them; but if they are incompetent, they will be as unable to help the CEO as the inside directors. The functional directors from within as well as the CEO need to pay closer attention to the surroundings of their company (Argenti p. 124). For the board to be effective, both the inside directors as well as the outside directors must be competent but more importantly they have to participate in operations by giving the CEO feedback.

The fourth defective area of management is having an unbalanced top team. Members of the top team include directors, senior executives, and advisors below the director level (Argenti p. 124). The whole point of having a "team" is so there will be discussions and debates about things within the company. The definition of unbalanced in this context concerns the amount of education and skill. No one with the same skill as the CEO will question his authority. The best top team will have a make up of many different areas of expertise, e.g. accounting, marketing, law, human resources. That way every manager will have a different opinion about things.

The last two defective areas have to do with the management in a general sense. The fifth defect is a lack of depth in the management. This runs hand in hand with the others but would be rather weak if studied independently
(Argenti p. 125). This would be hard to detect and if you detected it, it would be because the other areas were evident. The last area of defect causing management incompetence is having a weak financial function. Inadequate control of financial information and accounting figures would cause the management to be very ineffective (Argenti p. 125). Even if the finances were strong, if there was no financial director on the board, there would be no financial input during decision-making.

The internal non-financial causes of corporate failure can be due to unwise decisions by the management that do not deal with the handling of money. An example of this would be a promotion of an individual into a key position not because of his qualifications but because he is the CEO's son (Barrickman p. 16). Adequate consideration needs to be given to each promotion decision and the promotion should go to the individual that would make the firm better. Another example of an unwise decision that could possibly cause corporate failure is the decision to expand the firm when it is not possible. Many firms are very successful as long as they are content with being small (Barrickman p. 16). Two prime examples of trying to expand unsuccessfully are overtrading and "the big project." Overtrading means the management underestimated the amount they need to borrow for the expansion or the time it may take to arrange the loan (Argenti p. 132). If the manager overtrades, he may
increase turnover at the expense of the profit margin per unit. "The big project" causes a problem when the management incorrectly forecasts the costs and revenues so that the whole project is estimated incorrectly (Argenti p. 134). Examples of a "big project" are a merger, a diversification, and an expansion. If any of the decisions regarding these projects are based on incorrect information, it could be detrimental to the firm.

Another internal cause of corporate failure is the decision to have operating amounts that are inefficient. Examples of these are purchasing, production, sales and inventories. Inefficient purchasing means that the firm does not buy its inputs in bulk and therefore cannot receive the discount (Barrickman p. 16). If the firm's competitors buy in bulk, they get to take advantage of the discount and can afford to sell their products at a lower price. If the firm lowers its price to compete without receiving the discount, it will lose profit margin every time it sells a good. Inefficient production is merely not producing that quantity of goods that would be in an economic equilibrium. If a firm does this, it will raise the price of the good and it will be harder to compete in the industry (Barrickman p. 16). Having inefficient sales will have the same effect as inefficient production. If the firm produces the equilibrium quantity but cannot sell it due to bad or no advertising, the prices of the goods will eventually rise.
Bad advertising means inefficient salespeople, poor supervision, or inadequate advertising in terms of improper use of the distribution channel (Barrickman p. 17). The product, no matter how good it really is, will stay on the shelf due to this. Inefficient inventory levels merely means that when the firm wants to sell a good but there is nothing in stock. This can be due to many factors e.g. underproduction, inefficient delivery or a bad decision to keep a low level of inventory.

Now that the nonfinancial internal causes have been explained, it is time to discuss the financial internal causes. All of these financial causes are direct results of a poor financial management team. Incorrectly estimating the capital needs of the firm could be detrimental; if the team decides to put too much money in bonds and too little in stock, the firm could be put into a bind (Barrickman p. 17).

A major financial decision is whether to use debt (bonds) or equity (stocks) when financing operations. When checking this the financial manager will study a calculated figure called financial average which is a ratio of debt or equity to net income (Platt p. 14). The decision of which to use, debt or equity, is very important because it affects future earnings and it increases the possibility of bankruptcy. The decision is a difficult one because though bonds are cheaper than stock, stock is much safer
The managers must decide what is best for them cheaper or safer and in what amounts. If they decide to issue bonds, they have to decide whether to use short term or long term bonds. This is a major decision because they are gambling with the interest rates so they have to carefully study the current market before making the decision (Platt p. 15). Bond issues should only be sold if the firm foresees the ability to meet future obligations because even if they can meet current fixed charges if they cannot meet future maturities it may fail (Barrickman p. 18).

If the firm decides to use equity and issue stock, it also has many other decisions to make. If too many shares of stock are sold, it will be hard to report a sizeable earnings per share and an increase in the price of that stock will result (Platt p. 14). If the company issues equity beyond a prudent level, it may find itself vulnerable to errors, bad luck, but most importantly to normal business hazards (Argenti p. 136). If the firm is vulnerable to normal business hazards, they have an increased chance of failing.

The firm's financial team must also decide about the amount of current liabilities, loans with banks or other creditors (Barrickman p. 18). A wrong or misinformed decision increases the probability for the failure of the firm. Most small firms have an excessive floating debt, too
many current liability, and often times it is not beneficial. If an entrepreneur tries to finance the entire firm through bank loans, he may get himself into trouble if everything does not go smoothly.

Another internal financial problem stems from the over-extension of credit. Making a sale is very important so many firms allow credit sales. The problem is that if the firm offered too much credit to any one customer and the debtor fails, it may very well fail also (Barrickman p. 19). If the firm finds itself in a bind and needs cash but cannot collect from its debtors, it cannot pay its creditors and again may fail. Another problem that complements the inability to collect needed funds is the cash flow cycle. When purchasing and selling, the firm's management must anticipate the cycle and ensure its effectiveness. If the expenses come due prior to the revenues being collected, the firm is in trouble (Platt p. 14). The firm must strive to keep a specific and adequate amount of current assets just in case the cycle gets messed up or is incorrectly anticipated.

Having an unwise dividend policy could prove to be costly to a firm. If a firm is constantly expanding due to the sale of securities, management needs to realize that it is better to maintain a regular, liberal dividend rather than constantly increasing it (Barrickman p. 19). The management should also decide that if the profits begin to
decline, they should cut dividends opposed to keeping it the same. If the firm keeps the same dividend and profits decline, it will begin to lose capital with which to work.
Chapter III

The History of Bankruptcy Law

The previous section covered many causes of corporate failure that if considered by management would greatly reduce the chances of failing. If management decides not to consider them, they may be forced to file formally for bankruptcy. Before filing, management should understand what the bankruptcy laws are. One way of understanding today's laws is to study how the old laws evolved throughout the years. This section of the text will attempt to briefly explain the old bankruptcy law.

The Bankruptcy Act of 1898, the earliest bankruptcy law, contained no provision for discharging debts; if after liquidation and distribution the debts were not paid in full, the estate remained in debt until they were paid. This caused a problem because it continued to punish the debtor after bankruptcy. The newer laws try to be more understanding and to set up a system of discharge that would make both parties happy. The original law also did not provide any other remedy besides liquidation (Altman p. 5). Under the old law when a business filed bankruptcy, it was forced to discontinue. A system of reorganization did exist through equity receiverships, but it was very ineffective. Equity receiverships were developed to prevent disruptive seizures of property by dissatisfied creditors. In this
system, "receivers" were appointed by the bankruptcy court to manage the corporate property during the reorganization process (Altman p. 5).

The Bankruptcy Act of 1898 was replaced by the Bankruptcy Acts of 1933 and 1934 which were then revised by the Chandler Act of 1938. The new act of 1938 consisted of fourteen chapters. The first seven chapters dealt with the structure of the bankruptcy system. They established the federal district courts as the bankruptcy courts and they also defined the rights and duties of both the debtor and the creditors (Stanley p. 10). Chapters VIII through XIII authorized special proceedings for certain circumstances. This act permitted debtors to seek reorganization in a more efficient manner than the equity receiverships (Barrickman p. 166). The two most important chapters in this act were Chapters X and XI. Chapter X contained a lengthy, elaborate set of rules for reorganization while Chapter XI covered unsecured debts in corporate bankruptcy cases. Chapters X and XI will be further discussed in the following paragraphs.

Chapter X required that large public firms file under this chapter and it provided relief from secured creditors (Ramaswami p. 85). A voluntary petition could be filed by the debtor or an involuntary petition could be filed by the creditors provided there are three or more of them and the claim amounted to $5,000 or more. The petition was required
to state why relief could not be obtained under Chapter XI (Altman p. 7). This chapter automatically provided for the appointment of an disinterested, independent trustee to assume control of operations for the firm during the proceedings rather than leaving the existing management in control. The trustee had a number of duties including developing a reorganization plan that is fair and feasible to all parties involved, and running the day-to-day operations of the business. The trustee could delegate the latter to a new management team if so desired (Altman p. 7). The delegation normally went to new management because the old management's incompetence was the cause of the failure.

Chapter XI provided relief for debtors who had unsecured creditors. It was designed to be used by small non-public firms needing protection from creditors, time to evaluate their unsecured debts and time to develop a repayment plan (Ramaswami p. 85). This proceeding was strictly voluntary and also provided for the appointment of a trustee. Chapter XI did permit existing management to stay in control if they wanted (Altman p. 6). The distressed firm's petition for reorganization usually contained a preliminary plan for financial relief. The prospect of continued management control and reduced financial obligations made this more attractive that Chapter X. Many firms required to file under Chapter X tried to file under Chapter XI because it was much more beneficial.
The problem was that it caused three more problems for the creditors: 1) secured debt and equity shareholder rights were not protected very well; 2) the SEC was empowered by the courts to determine the value of the bankrupt firm and to protect shareholders, but it tended to overestimate the value hurting creditors; and 3) existing management was allowed to stay in control even though they may have been the cause of the bankruptcy (Ramaswami p. 85).
Chapter IV

An Introduction to the Federal Bankruptcy Act

Many times when a firm fails, it is forced to file for bankruptcy, but there really are other options. Business failures can end in a multitude of different ways. The firm can continue under the same name in two ways: an out of court settlement or through a Chapter 11 reorganization (Ramaswami p. 80). If the creditors decide to settle out of court, they have two possible offers for the debtor. The creditor can offer an extension which is a mere postponement of the payment date or a composition which is an acceptance of a smaller amount of money than what is due as payment in full. Extension and composition are designed to keep distressed firms in business and alleviate court costs; the only problem with them is that the offers for the two must be voluntary acts by the creditors (Ramaswami p. 81). Studies have shown that extension is favored because it consists of an agreement for payment in full. The second alternative that a firm has so that it can remain in business using the same name is reorganization which is covered by Chapter 11 of the Bankruptcy Reform Act of 1978 which will be covered in greater detail later in the thesis.

Other possible results of business failures are a merger with or acquisition of a competing firm or the firm can merely cease to exist (Ramaswami p. 80). If a firm
chooses to merge, it usually takes the name of the other firm. If it decides to acquire a competing firm rather than merge with it, it will usually keep its original name. Sometimes under both choices a neutral new name may be decided.

A firm can cease to exist in two separate ways: an out of court settlement or through a Chapter 7 liquidation (Ramaswami p. 80). In an out of court settlement, there can either be a common law assignment where the assets of the distressed firm are assigned to an independent trustee who sells them and then distributes the money to the creditors or there is a statutory legal assignment. Chapter 7 is also a method and it is covered by the Bankruptcy Reform Act of 1978. Since this thesis is concerned with failure, filing, and success after filing, Chapter 7 will not be covered.

Before describing Chapter 11 in any detail, it must be noted that not every failing firm ends up in Federal bankruptcy court; the firm may simply shut down with or without the agreement of creditors (Stanley p. 107). If the causes of corporate failure mentioned previously in this paper are taken seriously, the firm can be turned around and possibly become successful again. Though, if the causes go unrecognized or are ignored, bankruptcy is inevitably the next step. Bankruptcy is the formal process that deals with the informal problem of failure. In the United States, it is taken very seriously and is controlled statutorily by the
Bankruptcy Reform Act of 1978.

The bankruptcy process was established to resolve in a fair and orderly manner the conflicts in interest that arise among the creditors of a businessman who cannot pay his debts (Stanley p. 9). Our bankruptcy law tries to protect the creditors from being cheated by controlling which claims receive payment first. Without the law, the creditors would race to the debtor and some of them would be paid in full while others received nothing at all. The legalized procedure tries to alleviate this problem by ensuring that creditors are treated fairly (Stanley p. 9).

The Bankruptcy Reform Act also protects the debtor firm be setting up a process where it can still exist after filing for bankruptcy. This process could give new life to a dying company because it will help set up a plan for paying debts (Platt p. 116). Without the law, the firm would most likely be forced to liquidate and then there is no chance for continued operations. So the law has become an opportunity for relief for the honest but unfortunate debtor (Stanley p. 10).

The problem with this legislation is that it has set up a process that could be used by an unscrupulous firm to "get out of" paying its debts. The debtor firm could easily conceal its assets and then file for protection from antagonizing creditors. It would then be discharged from its debts but still retain its property (Barrickman p. 141).
One must remember, though, that the act is a federal law so violation of it by concealing assets is a federal offense punishable by a fine up to $5,000.

Despite the previously mentioned drawback, the federal bankruptcy act is a good piece of legislation because it formalizes a process that could otherwise get out of hand. A business may be more beneficial if it is given some time to earn the money to pay its creditors rather than liquidating its assets. On the other hand, it may not be more beneficial— that is the decision to be made before filing. If the firm decides it would probably be more beneficial staying in business, Chapter 11 covering reorganization is the chapter under which it needs to file. This process is important to understand because if it is done correctly, the firm can possibly survive after filing.
Chapter V

Reorganization Under Chapter 11

Chapter 11 is the part of the Federal Bankruptcy Code, that is entitled Reorganization. Chapter 11 permits a person or business to obtain protection from creditors while it attempts to reorganize, or rehabilitate itself. When creating Chapter 11, the revisers basically combined Chapter X and Chapter XI of the old law (Ramaswami p. 87). To be eligible, the petitioner must be a legal "person" and cannot be a stockbroker, a commodity broker, an insurance company, a bank, or a savings and loan institution. If filed by a debtor, it must be in good faith and not for the intention of providing relief to an ineligible entity (Williamson p. 15). A petitioner could not have received relief or been a party to a dismissed bankruptcy case within 180 days prior to the filing. The only financial restriction is that the benefit received from filing must outweigh the costs and no size restriction is placed on the petitioner. It can be a small firm, a large firm or anywhere in between (Williamson p. 1).

The primary purpose of Chapter 11 is to facilitate reorganization and it may also be used to carry out an orderly debtor controlled liquidation (Williamson p. 13). The Reform Act of 1978 made it less stringent to file under Chapter 11 because legislators made it unnecessary to prove
insolvency prior to filing (Ramaswami p. 20). Today, a poor actual or expected cash flow or a mere inability to pay creditors is an adequate reason to file; the new law also allows the existing management, if competent, to stay in control of operations during the proceedings. Sometimes, a firm files for the purposes of voiding leases, contracts or lawsuits that threaten its existence. An example of attempting to void a lawsuit through filing is Texaco's filing for reorganization trying to void Pennzoil's $10.3 billion lawsuit.

This chapter offers debtors with one or more of those previously mentioned causes an opportunity to "freeze" their debts while they work on a plan of reorganization with their suppliers, institutional lenders, equity security holders, and employees (Weintraub p. 1). Virtually all firms who file have three similar characteristics: 1) the firm's existing or future claims exceed its assets, 2) new funds need to be raised and 3) problems causing the failure need to be found and corrected (Ramaswami p. 82). If these things cannot be done, reorganization will not be successful. Many people do not think it is possible to be a successful firm after going through bankruptcy proceedings, but if reorganization is taken seriously, it can have very high returns.

Chapter 11 proceedings may be broken into two different phases: 1) prior to confirmation of the plan which is six
to eight months long depending on severity of failure, and
2) after the plan which is normally three to five years
(Williamson p. 3). The first step in the first phase of the
proceedings is the filing of a petition with the federal
Bankruptcy Clerk that normally costs $500. A voluntary
proceeding is when the debtor files and subjects himself to
the law where he has no legal duty to or cannot be forced
to. In an involuntary proceeding, the debtor is subjected
to the law by its creditors. For the creditors to file,
there must be more than three different named creditors
unless the debtor only has twelve or less creditors, then
only one creditor is needed (Williamson p. 13). In the
involuntary proceeding, the debtor is issued a subpoena and
petition and the hearing date is set. Upon filing, the
court can either dismiss the case due to lack of evidence
that the debtor is indeed insolvent or it can adjudicate the
debtor bankrupt (Barrickman p. 129).

When the debtor files voluntarily, it must file a
schedule of assets, a schedule of liabilities, and a
statement of financial affairs. Upon filing the debtor
becomes a "debtor in possession" of the same business with
the same board of directors. From that point forward, the
debtor in possession runs the business in the same way as
before but with new books and a new bank account as all old
secured debts are frozen (Weintraub p. 2). The debtor is
authorized to operate itself in normal everyday business
worry about paying all of the debts that come due, it will never regain its stature so that it can participate in this competitive society. The primary responsibility of reorganization is to relieve the burden of the debtor's immediate liabilities and to realign the capital structure so that the same problem will not happen again (Altman p. 3). The automatic stay feature helps the debtor meet this major goal.

The automatic stay provides the debtor with a few months to make its bill payments. The long term relief comes in the form of reorganization, where the firm continues to function in the present or revised form of the firm (Williamson p. 3). The reorganization may be done by the extension of time to pay creditors or the total restructuring of the business. Which ever choice the debtor makes, it is spelled out in the reorganization plan. When creating the plan, the debtor must do it in a manner that will so adjust the debts in order to reach the primary objective of reorganization--to reestablish itself as a successful firm (Weintraub p. 2).

In most cases, the existing management remains in possession and in control of operations and assets; the only exceptions to this rule are in the instance of fraud, dishonesty or incompetence, in which a United States trustee is appointed to take control. In normal circumstances, when a trustee is not appointed, an examiner is appointed to
investigate the debtor's affairs (Williamson p. 14). A committee of unsecured creditors, made up usually of the largest ones, is created to help in the devising of the reorganization plan. The creditors are divided into classes of importance and committees are formed for each class; after the plan is proposed, the committees vote on its ratification (Altman p. 8).

The major portion of the reorganization process is the plan proposal made by the debtor within the first 120 days after the commencement of the case. If the debtor has not issued a plan within those 120 days or the plan has not been accepted by the class committees within 180 days, the classes can propose a counter plan. The plan must classify all claims and interests by the classes as the plan is accepted or rejected by the classes (Williamson p. 14). If a class is not impaired, its interests or claims are not diminished or substantially changed (Williamson p. 15), by the plan, it accepts it. A claim is a right to payment and an interest is an equity security right of a shareholder. If a class receives nothing from the plan, it usually rejects it. To accept the plan, two thirds of the class committee must ratify it; if less than that number accepts, the plan is rejected (Altman p. 8). Not all classes need to accept the plan for it to be implemented; as long as one class accepts the plan it may still be used as will be discussed later in more detail.
In order to be able to vote, a creditor's claim or a shareholder's interest must be allowed, which means that it must be filed with the bankruptcy court within the time specified (Williamson p. 15). Even if all the classes vote to accept the plan, it does not become official until it is confirmed by the court. There is always a court hearing in every reorganization case for the purpose of the class vote and the court confirmation (Barrickman p. 153). Prior to confirmation, the court must decide three things: 1) does the plan conform to the Bankruptcy Act? 2) is it fair and equitable to all classes of creditors? and 3) is the plan feasible? (Barrickman p. 154).

Deciding the answer to the first question is quite simple because the Bankruptcy Act is written down for everyone to see. The other two questions may not be as easy to answer due to the vagueness in the definition of fair and feasible. By "fairness" the courts mean that the claims must be recognized in the order of their legal and contractual priority. The plan must meet the absolute priority rule which constitutes the rigid following of a list of priority rules including the rule that states that junior claimants cannot be paid until after all of the senior classes have been paid (Williamson p. 15). The primary test for fairness requires four steps: 1) estimate future sales, 2) analyze operating conditions in order to estimate future earnings, 3) determine the capitalization
rate to be applied to earnings in order to estimate the property value, and 4) determine the amounts of money to be distributed per claimant (Ramaswami p. 82). The fairness is considered from the standpoint of the creditor; if the previously mentioned four steps are feasible, the plan will be adjudicated fair to the creditors.

By feasible, the courts merely mean capable of being accomplished. If the plan is impossible to be completed, the court will not confirm it. The primary test for feasibility contains two steps: 1) are fixed charges in income after reorganization amply covered by earnings?, and 2) will some action need to be taken to ensure improvement of earning power? (Ramaswami p. 83). If the court decides that the issued plan is fair, feasible, complies with the law, and has been accepted by the classes of creditors, it will confirm the plan.

In a specific situation, the plan can be confirmed without being accepted by the classes of creditors. That situation is called a "cramdown confirmation"; if one or more classes rejects the plan it can still be confirmed provided that at least one class accepts it (Williamson p. 15). During a cramdown confirmation, the court must find that statutory requirements have been met and that the plan is not discriminatory to any of the classes. If every class rejects the plan, not even the cramdown provision can confirm the plan.
Upon confirmation, phase two of the Chapter 11 proceedings begin. This phase is less formal because it is where the actual reorganization, according to the plan, begins. The major occurrence during phase two is the discharge of the debtor's debts which happens upon the court's confirmation. The ironic part is that the discharge remains valid even if the debtor fails to meet the plan; the only way a discharge becomes invalid is if it is revoked by the court. The only debts not discharged are those payments that are necessary for a creditor's survival.

The trustee that was appointed at the beginning of the case now has a particular job to do. After court approval, the trustee is required to send two things to every party affected by the plan: a summary of the plan or plans approved by the court and the opinion of the judge (Barrickman p. 154). The only thing left is the carrying out of the plan. The debtor needs to implement and complete every provision in the plan. Finally, the plan must be consummated, a final accounting made, a final order entered, and the case is closed (Williamson p. 15). If the plan is implemented but the firm finds that it cannot complete it effectively, it can switch to the Chapter 7 proceedings of liquidation.
Chapter VI

Effect of Reorganization on a Firm

The key to a successful reorganization is the firm's ability to start over with a new capital structure (Ramaswami p. 70). The firm will need financing just as it did before an studies show that despite the stigma of bankruptcy, debtors have no real difficulty receiving credit after reorganizing (Stanley p. 3). It is a matter of management just going out and securing finances from bankers or general creditors. During the year 1987, 17,142 firms filed for protection under Chapter 11 and as of 1988, 6722 of them were still in business under the same ownership (Ramaswami p. 70). Successful reorganization is very possible, the management just needs to work hard. Entrepreneurs may need to work harder than the managers of the larger firms because statistics show that if revenues exceed $100 million, 69 percent of the firms stay in business but if the revenues are less than $25 million only 30 percent survive reorganization (Ramaswami p. 70).

The resources available on this topic are very scarce. Most of the extant literature on the performance of bankrupt firms deals with the effect on the firm under the old Chapter X law or with the performance prior to the bankruptcy (Ramaswami p. 92). For this reason, this topic will be viewed in a different manner. In the following
section, a case analysis showing the progression from corporate failure through reorganization of an actual firm will be given.
Chapter VII

Eastern Airlines: A Case Study

Eastern was established in 1928 by an old World War I hero named Eddie Rickenbacker (Ziemba p. 1d). The firm was instantly plagued by labor turmoil; Rickenbacker was not fond of spending money for employees, customers, or new planes. Early in its existence, Eastern had some problems, but nonetheless it prospered as air travel grew (Bernstein p. 22).

Upon Rickenbacker's retirement in the 1960's, his replacements as President of Eastern wanted to purchase the new technologically better planes. Eastern's debt grew and in 1975 when Frank Borman, former astronaut, took the helm, the bills began to come due (Ziemba p. 1d). When he took the helm it was $1 million in debt and in 1978, Borman ordered an entire new fleet of planes priced at $1.4 billion (Bernstein p. 22). At about this same time, the United States Congress deregulated the airline industry and the problems grew (Ziemba p. 1d).

Borman kept purchasing planes but did nothing to address any of Eastern's major problems. Eastern was at the brink of bankruptcy in 1983 when Borman persuaded the employees to take a cut in pay in return for 25 percent of the company and a few seats on the Board of Directors (Ziemba p. 1d). Borman was only willing to offer the deal
when the union threatened to strike due to the pay cuts. Borman tried other ways of survival but they all failed; he was forced to bargain with the employees.

In the summer of 1985, Eastern's profits hit a record level and everything seemed fine. The management reopened negotiations with employees and raised their wages to the original levels (Bernstein p. 31). No one in the management noticed that the market for travel was sort of in a slump and Eastern may again be in financial trouble. In 1986 its debt hit $2.5 billion and bankruptcy again loomed overhead. Borman offered an ultimatum to the union leaders to get them to agree to new concessionary cuts. If they did not accept the wage decrease, he would declare bankruptcy (Bernstein p. 33). When the leaders refused the wage cut, he consulted the banks with no avail. On February 23, 1986, Frank Lorenzo with the help of Texas Air Corporation, purchased Eastern Airlines for $676 million. Borman was asked to resign and was replaced by Lorenzo.

Lorenzo felt that he had the financial capabilities to take Eastern where Borman could not. Also, he felt the union problems were not as substantial for him; if Eastern's unions did not buckle, he could merely paint Eastern's planes in Continental Airlines, another subsidiary of Texas Air, colors and hire new, nonunion workers (Bernstein p. 55). Lorenzo, upon taking over the helm at Eastern, had no intention of keeping pace with the rising industry wages.
For a few years, Lorenzo fought with the unions trying to play one against the other. Financial problems began to grown along with the union problems. On March 9, 1989, the unions struck and Eastern was forced to do something it had been threatened with for decades: file for Chapter 11 protection (Ziemba p. 1d).

Chapter 2 of this thesis listed causes of corporate failure; this Eastern Airlines example is ideal because it incorporated more than one of those causes. Chapter 2 stated that management incompetence is the major cause of corporate failure because it causes other internal and external causes to occur. Eastern Airlines failed because of Lorenzo's, as well as Eastern's past presidents', incompetence when dealing with unions. It was also stated in that chapter that an adverse act of labor was another cause. At Eastern the unions were skilled in labor negotiations and management was not as skilled so something had to be done. Management should be able to recognize a problem and fix it; in this case, Eastern's management should have hired a skilled negotiator and/or possibly given in to the union's demands. The union's demands were not ludicrous as they rose as the industry's wages rose. Possibly Lorenzo was incompetent because he did not notice When the union was right. He refused to deal with the unions and ignored their demands. In result, Eastern failed.
Borman's incompetence went farther than unskilled labor negotiations; he took on a ridiculous amount of debt in order to "better" the company. If it was not for Lorenzo's buyout, Eastern would have folded in 1986. The problem of when to use and not to use debt was also listed as an internal, financial cause of corporate failure.

Lorenzo noticed that the debt was too high, and that Eastern needed funds. He sold some of Eastern's assets to gain some cash, e.g. the Northeast Shuttle and Eastern's Latin American routes in 1989 (Ziemba p. 1d). An investor group tried to purchase Eastern in 1989 in the same manner as Lorenzo but was unsuccessful. Several different options were listed earlier as choices for a firm after filing for bankruptcy: reorganization, merger/acquisitions, or liquidation. If the investment group had been successful Eastern would have chosen the second option. Since the buyout failed, Lorenzo decided to use the first option.

Eastern's creditors were divided into classes and the committees were appointed. The committees supported Lorenzo for thirteen months but were finally convinced that he would not create a viable plan. Alan Boyd, a chairman for one of the committees, said that even after the thirteen months of support, "Eastern's present management was incompetent" (McKenna p. 78). Since the March 9 filing, the present management had lost nearly $1.2 billion that the creditors blamed on Lorenzo.
Lorenzo, along with other managers, blamed the $1.2 billion loss on the increase in fuel prices, the decrease in air travel, and the requirement forcing Eastern to keep its South American routes operating (McKenna p. 79). In April of 1990, Bankruptcy Judge Burton Lifland, with the help of the creditor committees, concluded that Lorenzo was indeed incompetent in dealing with Eastern's reorganization (Ziemba p. 1d). On April 18, Lifland appointed former Texas Air Corp. executive Martin R. Shugrue, Jr. as the United States trustee (McKenna p. 78). Shugrue's duties would include operating Eastern on a day-to-day basis and also to come up with a reorganization plan. In defense of this appointment, Lorenzo came up with still another plan but was again unsuccessful. Lorenzo's new plan offered creditors thirty cents on every dollar (McKenna p. 79).

When a judge appoints a trustee, he is aiming for a successful reorganization. Eastern's case was not like that; Shugrue's promotional campaigns failed in luring back customers so that Eastern's business did not increase. Shugrue's reorganization plan was also unsuccessful due to another economic downturn and rising fuel costs. Finally, Eastern accepted defeat and on January 19, 1991, it announced its shutting down and the cancelling of all flights as of midnight (Ziemba p. 1d).

Eastern Airlines was a good example in that it exemplified numerous causes of corporate failure, and it
patterned the normal procedures for Chapter 11 bankruptcy. But on the other hand, it was a bad example because phase 2 of the proceedings were not the same as those mentioned in Chapter V. Eastern failed when the major point of phase 2 is to succeed in reorganization. To show examples of a successful phase 2, the next section will cover in less detail bankruptcy cases that were successful in reorganizing.
Chapter VIII

Successful Reorganizations

This section is meant to show success through reorganization. The writer takes no credit for the originality of the material. All information from this section comes from Ramaswami's and Moeller's book.

The largest bankruptcy in history was filed by Texaco, Inc. on April 12, 1987. Texaco was healthy prior to a jury verdict in December of 1985 that caused it to pay Pennzoil $10.3 million for interfering with its attempt to acquire Getty Oil Company. Texaco had acquired Getty in 1984. The actual reasons for Texaco's failure is really unknown; it merely could not meet a mandatory payment that was outside normal business practices. If the writer had to make a guess, he would charge this failure to "bad luck." Some say that the failure could be due to a lack of vigilance due to the permissive environment toward mergers and acquisitions during the 1980's.

Texaco emerged from the bankruptcy proceedings on April 7, 1988, after the court had approved its plan. As a part of the reorganization, Texaco was to pay Pennzoil $3 billion in settlement of the $10.3 billion. This was successful because Pennzoil voluntarily offered Texaco a composition which was defined earlier as taking less than is actually owed. This is usually not a favored choice, but
Pennzoil must have seen it as beneficial. Texaco survived its reorganization; a statistic to prove its success was its stock price on April 12 of 1987 was only $31 but on that same day in 1989 it was $53.60.

Two other recent reorganizations came from the bankruptcies of A. H. Robin and Manville Corporation. Both failures were caused by inadequate product testing and the lack of management appreciation. A. H. Robin was forced to file for Chapter 11 protection to freeze thousands of lawsuits by women hurt by the Dalkon Shield Interuterine Device that it produced. Manville’s failure was also caused by a defective product; many people sued the firm due to asbestos poisoning from one of its products. Both firms reorganized successfully after setting up trust funds for all of the claimants. A. H. Robin chose a different route as it was acquired by American Home Products, who set up a trust for the claimants and perfected its products. Manville’s success was due to its decision to quit producing asbestos based products.
Chapter IX

Conclusion

As anyone can see, a successful reorganization is hard to achieve. Eastern's management was unable to adapt to its recognized problems so that it was unsuccessful. Other companies have had the same problems that Eastern did, but their managements were competent enough to accept the causes and fix them through an acceptable plan. If the firms could have noticed the causes earlier, they could have alluded the Chapter 11 process, but some firms need the formal bankruptcy proceedings so that they can effectively restructure themselves so that they can be more successful and flexible towards change.

In the rest of this chapter, I want to give an evaluation of what I think of the Bankruptcy Code and Chapter 11 using the knowledge I have gained through writing this thesis. As a relief from debts, I feel that the Bankruptcy code is needed in our society because it provides a way for a debtor firm to "pay off" its debts. Chapter 11, in my opinion, may be too lenient because on many occasions it allows incompetent management to recover when it really should not be able to. In our competitive free enterprise system, if a manager is not competent to survive, maybe he should find another career. Chapter 11 is good if the cause of failure was due to something beyond the control of
management; it may also be an adequate remedy if the incompetence of the management was only a minor contributor to the failure. I honestly feel that the court hearing the initial bankruptcy case should be more strict in allowing for reorganization. The decision to reorganize or to liquidate should not be made by anyone but the judge. If the judge feels that the firm would be worth more as a reorganized firm, then and only then should Chapter 11 be used. If the judge finds that the creditors would benefit equally from a liquidation or from a reorganization, I feel that liquidation should be used. My reasoning for the previous statement is that if management caused the failure, why should it be given a second chance under reorganization. The judge should also decide whether the management is competent enough to continue control in all cases just as the judge did in the Eastern Airlines case.

As a process, the bankruptcy code is good because it brings a very confusing process into one piece of legislation. I feel that as a process Chapter 11 is good because it shows all of the steps needed for a successful reorganization. It begins at the failure and outlines the entire procedure. If management is confused about what to do next, it can go to Chapter 11 and the next step will be provided.

As a whole, I feel Chapter 11 is needed in our society today because it provides an effective way to handle a
bankruptcy case. The only change I would propose would be in the bankruptcy code as a whole. I would add an initial court hearing so that a judge can decide whether the bankrupt firm should go through Chapter 7 or Chapter 11 and if the management is competent enough to continue the control of the firm. Once the court decided that the management was indeed competent and that Chapter 11 would be the best route, I feel that Chapter 11 needs no changes to be an effective way of handling the problem of corporate bankruptcy.
Works Cited


