Financial restructuring in fresh-start chapter 11 reorganizations

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The effectiveness of the existing bankruptcy code has long been a source of vigorous debate. More and more lately, high-profile firms like General Motors, Enron, and K-Mart are seeking protection from creditors through Chapter 11 filings. But are these firms really getting the "fresh start" they need? In a recent edition of *Financial Management*, researchers Randall Heron, Erik Lie, and Kimberly Rodgers argue that the Chapter 11 process is flawed and fails to offer the clean slate needed to establish new capital structure.

Their article, "Financial restructuring in fresh-start Chapter 11 reorganizations", looks at the debt ratio of 172 firms emerging from Chapter 11 "fresh start" accounting rules. Using a range of variables, they analyze how differing firm characteristics and the reorganization process affect capital structures.

Although a company's debt burden is substantially reduced by reorganizing, they found, the firm still winds up with higher debt ratios than industry norms. Debt is sticky -- in fact, a firm's long-term debt ratio is particularly high after Chapter 11. The median total at the end of the first year a firm emerges is 0.392 as compared to an industry norm of 0.283. In two years, the median debt ratio declined to 0.362, compared to an industry norm of 0.272.

Total debt is also substantially higher - due, in part, to inefficiencies in the Chapter 11 process which block firms from discarding old capital structures in favor of a fresh start. Even in organizations where at least

50 % of equity ownership is transferred to creditors, holdout problems plague emerging capital structure. Creditors are reluctant to trade senior claims for equity, seeing them as a way to force liquidation should the firm's profitability lag.

A key factor in the speed of emergence appears tied to the circumstances leading up to the bankruptcy. Those firms struggling with financial difficulty -- not economic distress -- spent less time in Chapter 11. "The data suggest that firms that fit this profile are able to emerge more quickly perhaps because they have fewer, more concentrated creditor classes, and/or because they were simply over-levered, but still clearly economically viable," the article states.

Finally, the data pokes holes in claims about so-called pro-debtor vs. pro-creditor bankruptcy courts by examining filings in the District of Delaware and the Southern District of New York. "There is no support for the notion that post-emergence debt ratios for firms that reorganize under the supervision of Delaware courts are abnormally high," the study concludes.

More information: To view the abstract for this article, please visit www3.interscience.wiley.com/jo … l/123191968/abstract .

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