The East Asian crisis has raised firms’ debt to levels that some may never be able to fully service. Such high debt erodes the incentives of even competent owner-managers to operate firms efficiently, because any increase in firm value accrues almost entirely to creditors (ironically, to their detriment). Debt reduction for such firms is neither swift nor sure if corrupt or inept bankruptcy courts oversee negotiations. Moreover, owners and managers are not separate in most East Asian firms, and creditors realize that more value may be lost if they take over a firm they cannot run or put in a manager they cannot oversee. So the countries’ bankruptcy laws, many of them new or amended, languish unused. If debt negotiations did begin, they could take on a political color; as a result of heavy intervention in the banking system, governments are now major (direct or indirect) creditors of private firms. All this makes market-based alternatives to court proceedings very attractive.

A market-based proposal

Bankruptcy specialists have proposed market-based alternatives to negotiations even for advanced countries, to avoid delay and waste. Building on Black and Scholes’s (1973) insight that equity is a call option allowing owners to buy the firm from creditors, Bebchuk (1988) proposed making owners out of the class of claimants that fully pay off all claims more senior than their own. Aghion, Hart, and Moore (1995) proposed a variant allowing outsiders to also bid, and specified how competing bids could be compared. These proposals are ill suited to East Asia, however. The crisis has severely disrupted credit markets, and bidders may be cash constrained. Unconstrained bidders could outbid those more competent, reducing economic efficiency. And where these bidders were foreign, a populist backlash could result, especially in countries with recent and unpleasant colonial experiences. Even if these problems were surmountable, auctions may be an appropriate way to reorganize the liabilities of some overindebted East Asian firms—those that are generally well run, for which there is merit in keeping the existing owners in place, but for which conventional bankruptcy procedures are proving too slow. Delays in reducing debt can erode the value of firms, to the detriment of both creditors and taxpayers. This Note proposes an auction scheme dubbed Accord—for Auction-based Creditor Ordering by Reducing Debts. Firms pay creditors in sequence as their operating cash flows permit rather than on a promised schedule. Creditors bid for position in the queue by the proportion of debt they forgive, choosing between smaller or more deferred repayments. The outcome: a firm with serviceable debt, controlled by existing owners with an incentive to operate it efficiently.
outsiders (domestic or foreign) would be hampered by acute information asymmetry. Firms are coy about divulging their finances even to their creditors, and this tendency would worsen if their ownership and control were threatened.

A better scheme would acknowledge that existing owner-managers should continue to operate the firm, and have creditors lower their claims to serviceable levels (but remain creditors). Not all firms are worth more as going concerns or are best run by existing owner-managers. But if the scheme required the consent of owners and a majority of creditors, it would be used only for those firms that are.

**The proposed Accord**

The aim of the scheme proposed here is to overcome the free-rider problem that arises with multiple creditors, inducing them to reduce their claims just enough to restore the owner-managers’ incentives to operate the firm efficiently. The scheme arranges creditors in a queue, to be paid by the firm as its operating cash surplus permits rather than on a promised schedule. Only when the claimant at the head of the queue is fully paid do creditors move up in the queue, with the next payment going to the new head of the line.

The creditors form the queue through an auction. They bid the proportion of debt they are willing to forgive, and those that reduce their claims by the most go to the head of the queue, and those by the least (or not at all) to the end. Owners, as residual claimants, continue to control and operate the firm, but as last in line, they get no cash dividends or other payments until all the creditors’ deferred (reduced, or undiminished and delayed) claims are fully discharged. The firm is protected from liquidation for, say, five years. If any of the deferred debts remain unpaid then, the firm is automatically liquidated and the proceeds are shared among the remaining creditors.

Creditors bid the reduction they would accept knowing these rules. Those that think the firm is worth little and doubt they will be repaid would forgive a larger proportion (“to get at least something before the firm folds”) to be paid early. And those that think the firm’s difficulties are temporary would forgive little or nothing and wait patiently for their turn (with interest accruing but no payments).

The scheme essentially auctions places in the creditor queue being formed—thus the name Accord, for Auction-based Creditor Ordering by Reducing Debts. It maintains any existing hierarchy of claims by having creditors bid for places only within the relevant segment of the queue. Uncertainty about the firm’s value, and competition among creditors to preserve their wealth (rather than the face value of their claims), reduce debt to just under the expected present value of the firm (see Hausch and Ramachandran 1999). The owners get the difference—about 10 percent of the firm’s value, roughly what former owners get in conventional bankruptcy—giving them the incentive to operate the firm efficiently.

Having creditors reduce their claims and letting the debtor firm decide when to pay—central features of Accord—is not unfair to creditors, despite what some might think. Creditors have already been hurt, because they lent too much and (laws notwithstanding) they cannot take over the firm and operate it as well as existing owner-managers. Accord cannot hurt them further, especially if their consent is required. If all parties must agree to the scheme, it would be used only when all would benefit—because the auction reduces the transaction costs and other inefficiencies of multiparty negotiations (the inevitable but wasteful negotiating threats and bluffs) or because the firm is better run after the disincentive of excessive debt is removed.

Accord can deliver the desired results in the current East Asian situation: the owner-managers remain in control, the creditors remain creditors, and the debt is reduced. Unlike other market-based bankruptcy schemes, Accord does not require cash bids or well-functioning credit markets. It also differs from earlier proposals in other ways: while Bebchuk’s has classes of creditors
contest for ownership, Accord has creditors bid only for the right to be paid early.

**Implementing Accord**

Although conceptually simple and with no need for complex bureaucracy, an auction must have detailed, well-designed procedures (bidding documents, secure storage of bids) to protect against collusion and corruption. When an auction is conducted under the aegis of the court, splitting the oversight role (so that no one has all the valuable information) would make it less vulnerable to corruption. This role could be shared by an accorder (a court official) and a recorder (perhaps an accounting firm with an incentive to maintain an international reputation for honesty and trustworthiness), each of which could handle a large number of firms (see Hausch and Ramachandran 1999). Since participants choose Accord voluntarily, binding rules apply only after the preparatory steps.

**Preparatory steps**

Any creditor can propose a firm for the Accord scheme to the (bankruptcy) court. The court then sends details on the scheme to the firm’s managers and gives them thirty days to accept the proposal, to list all creditors and the amounts owed, and to provide a business plan. With the possibility of conventional bankruptcy hanging over the firm, owner-managers have good reason to opt for Accord, because it preserves their ownership and control. So they not only are likely to provide the court with the information sought, they may even canvass the major creditors for support for the business plan so that the auction can proceed once the required majority approves the plan. There is no publicity or requirement for commitments at this stage.

If the firm declines or fails to respond by the deadline, the matter ends. But if the firm accepts, the court conveys the business plan and other information to the creditors without examining the plan’s viability or fairness. To alert any claimant not listed by the firm, the court publicizes the firm’s interest in using Accord and sets the date—say, two weeks hence—for the auction. As in a conventional financial reorganization, creditors might form a committee to discuss the plan with the firm’s managers, but the court would not be involved in this. Because creditors would probably reject a skimpy plan, the firm’s owners have an incentive to supply information to the creditors’ satisfaction.

After the two weeks the judge verifies that there are no disputes over the creditor list, that the amounts owed are correct, and that the requisite majority of creditors have approved the plan. Any disputes (such as the emergence of new claimants) would end the matter with no prejudice, leaving the parties free to keep the status quo, to file suit under the bankruptcy or other laws, or to try again later to enter the Accord scheme. When satisfied that the conditions are met, the judge binds the parties to the Accord rules before conducting the auction.

**The binding rules**

Under the binding rules all creditors agree to forfeit their right to file bankruptcy or liquidation petitions for, say, five years. Owners agree to forgo any cash dividends or other payouts until the deferred debts have been fully discharged and the court has freed the firm of Accord’s fetters. If debts remain outstanding after the five years, the firm would be automatically liquidated (this too could be by auction, with the owners and creditors free to bid for the assets).

Automatic liquidation (along with accrual of interest on the deferred debts in the queue) protects creditors against a situation in which a firm accumulates a cash surplus (which could have a genuine business purpose) rather than paying them, and reduces judges’ involvement in disputes over such firms. Creditors get the cash when the firm is liquidated. Furthermore, creditors can trade their claims at any time (though perhaps at a price different from their reduced claim), regardless of their position in the queue.
While firms may pay only the creditor at the head of the queue, they can raise additional funds by selling assets, issuing new equity, or borrowing anew. New equity would join the old equity at the end of the queue. But unlike postfiling loans under conventional bankruptcy, new borrowings would end up behind the deferred creditors in the queue (and interest could accrue but could not be paid). This ranking is only fair because the old creditors have already reduced or deferred their claims, and “queue jumping” should not be allowed once the line is formed. Some may argue that this makes new loans unattractive for lenders. But since there is no fixed debt service schedule, the firm could easily finance its operations and may not need new borrowings. And if the Accord rules seem onerous, the firm can free itself of them if new lenders or investors put in enough funds to discharge all its deferred debts.

The binding rules of Accord preserve the courts’ integrity by limiting judges’ discretion and restricting their role to disputes of fact, not questions of fairness. Once creditors approve the plan and bid in the auction, judges check only for egregious misconduct. There is no second-guessing of business decisions (Should a product line have been discontinued? Is the firm holding too much undistributed cash?).

Conclusion

Proposals for auction-based schemes such as Accord are new and have not yet been applied in any country. But not only are they conceptually attractive, they also can insulate debt restructuring from the venality of governments and courts. In East Asia the banking system problems and the public guarantee of deposits have made governments major indirect creditors of private firms. If government agents negotiate as creditors, the well connected might gain unfair advantage in having their debt reduced. But accusations of favoritism or corruption, even if false, would lead bureaucrats to choose inaction, for they would not be blamed for the greater losses that would stem from inefficiently run debtor firms or the theft of assets. An auction protects honest civil servants by producing an observable, firm-specific value—the weighted average of bids—to use in reducing government-controlled claims.

Auctions have long been used for complex and important transactions, and recently there has been a tremendous advance in the theoretical understanding of bidders’ incentives and of likely outcomes. Yet in bankruptcy, auctions have been used only to sell assets, not as a substitute for negotiations. The reason may be that in advanced countries experienced courts nudge the process along reasonably well when coping with the normal (modest) mortality rate of firms. In East Asia, where as many as a quarter of firms cannot service their debt and courts are decades away from functioning well, conventional bankruptcy solutions are woefully inadequate.

1 The majority would be the same as that required for a cram-down under the bankruptcy law: generally a simple majority within each class and two-thirds or three-quarters of the aggregate. The decision of this majority would also bind any new creditors (suitable clauses could be inserted into the loan contracts).

2 Since the majority needed for any cram-down under conventional bankruptcy would have approved both the plan and the decision to enter the Accord scheme, this forfeiture of rights can be made binding on dissenters.

3 Depending on the company law, a management agreement to suspend dividends and the contingent automatic liquidation might require approval at a shareholder meeting. Shareholders might also have to approve a curtailed role for the board of directors and managers to protect them against lawsuits from dissenting shareholders.

References


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