Bankruptcy Protection, Good or Bad?

Poll:

Does Chapter 11 protection make economic sense?
Is bankruptcy protection bad for the economy?
I don't know.

Surprise! I posted a poll on the NPI board over at the Fool asking about the merits of bankruptcy protection given to debt laden companies that can't pay their debt. I wrote a very biased intro to the poll that would have skewed the results towards: **Is bankruptcy protection bad for the economy?** The surprise is the huge number of votes for: **I don't know.** My conclusion is that bankruptcy has not received sufficient attention from investors.

I have to admit ignorance as to how Chapter 7 and Chapter 11 made it to the books and during the good times only a few, badly managed companies go broke so, who cares anyway? But during bad times Chapter 11 seems to set off a chain reaction. Weak companies go broke and, being protected by Chapter 11, they continue to function but with much lower cost structures. As they are able to lower prices, they put a lot more pressure on marginal companies. As these too go broke, the pressure on strong and well run companies mounts. In the end, two or three companies survive. The question is, would it be better to liquidate the bankrupt companies?

In bad old England, when someone could not pay his debts, he was put in the debtor's prison until he paid up. Of course, being in jail and out of work, he never did have a way to pay. In whatever field of endeavor he happened to be in, now there was one less competitor. Individuals tend to have a very small overall impact on society a whole so it makes sense to offer the individual debtor some protection in the name of human dignity. On the other hand, when large, public companies like Rolls Royce, Lockheed, Chrysler or Continental Illinois Bank go broke [all these would have gone broke had it not been for government assistance] then there are large constituencies affected: employees, investors, and customers come to mind. Chapter 11 offers little protection to investors: shareholders lose their stake and bondholders get pennies on the dollar, if they are lucky. The protection , then, is for the employees and for the customers.

An important distinction needs to be made between the individual who goes broke and the investor in a public company that goes broke. An individual is responsible for his debts with his entire fortune save for the clothes on his back. On the other hand, the investor in a public company only loses what he has invested, the rest of his fortune is not at stake. The corporate structure is such that the investor has his protections and, as far as I can see, he should not get any additional protections.

Do employees and customers merit any protection from bankruptcy? I don't believe their risk is all that great. In many cases, the bankrupt company can be taken over by a healthy one and continue operating. The new owners will pare some employees and maybe some products but the market should be able to deal with that. If operations are so bad that no one wants to take over the failed company, then I think they should be liquidated in a stated period of time, certainly no more than a year from bankruptcy.

Denny
"Demand creates queues. Supply gets rid of them."
Software Times