The Globe and Mail (Canada)
January 19, 1993 Tuesday

FIFTH COLUMN
LAW AND SOCIETY

Bryan Schwartz looks at different approaches to firms that have gone down the tubes

---

LAST year, a large number of Canadian companies went bankrupt. Around the world, economies remain sluggish and some major enterprises have been going under. Governments are being forced to re evaluate their legal policies toward corporate failure.

In the United States, the 1979 Bankruptcy Act remains controversial. The critics say that under the famous "Chapter 11," bankruptcy courts have become cozy havens for big companies that want to shuck their obligations. Bankruptcy judges do not want to take responsibility for overseeing the liquidation of corporate giants. Instead, they define success as rehabilitating them. That means encouraging a "reorganization." Creditors accept a fraction of what they are owed, and the company arises from the debt.

A typical Chapter 11 scenario, the critics say, goes like this. A big company faces some debt problems, although it is not insolvent. It files for court protection. The judge lets the managers stay in place and take their time about developing a proposal for reorganization.

In the meantime, the company cancels some of its contracts – including the collective agreements with its workers. Proceedings drag on. Claimants against the company grow desperate. They can't collect their money, and the fees of the lawyers and accountants are mounting. At long last, the company makes its proposal. Business creditors are offered a pittance. The claimants are worn out; most accept the proposal. Dissenters are outvoted by fellow claimants or overruled by the judge.

It does seem that to keep a company alive artificially can cause more harm than good. Sustaining the Chapter 11 company can mean short-changing its lenders and suppliers. As The Economist magazine has pointed out, a Chapter 11 company can also inflict undue harm on its competitors. Freed from many of the usual corporate obligations, it can offer unreasonably low prices. Chapter 11 habitues such as Continental Airlines are contributing to the price war that is disrupting the airline industry.

Sometimes, it is better to liquidate the company and sell off its parts. The creditors may get more. The most efficient operations - and the jobs attached to them - may be acquired and continued by a healthier enterprise.

THE Canadian Bankruptcy Act has just been amended. The aim seems reasonable: to adopt some of the positive aspects of Chapter 11 but to avoid the abuses. The new law gives companies a greater chance to rehabilitate themselves but there are safeguards against stalling tactics.

Some companies might still prefer to use the Companies' Creditors Arrangements Act. It was enacted during the Depression, largely forgotten, and then revived as an alternative to bankruptcy. It allows a

company to reorganize under court supervision. The act provides little detail. Many things are left to judicial discretion. The uncertainty has its advantages; it encourages everyone to arrive at a negotiated settlement.

So far, Canadian judges have not been charged with bias in favour of troubled companies and against their creditors. Perhaps our system benefits in not having specialized bankruptcy judges. A judge who has heard a wide variety of cases may be better equipped to appreciate the competing interests tied to a troubled company.

While judges should have considerable respect for the judgment of the market place, they do have a necessary role. There must be fair and orderly ground rules for making business decisions. For example, if most creditors want to keep a debtor company going, it may be unfair for a single creditor to force it into liquidation.

Occasionally, a government bail-out may be warranted. But these tend to be ad hoc decisions and heavily influenced by self-serving political considerations. Governments should instead establish clear and strict guidelines for interventions, and stick to them.

We definitely need rational and universal programs to help individuals recover from the impact of corporate failure. For example, we should maintain a decent unemployment insurance program. It could be expanded to cover wages that are earned but left unpaid by a bankrupt employer.

As part of Unemployment Insurance, or as a new program, perhaps every displaced worker would receive a retraining voucher. It would be used to pay for the training program the individual chooses. A consistent policy on business failure would also respect the marketplace judgment of workers.

Bryan Schwartz is a professor of law at the University of Manitoba.