

Teaching Points:

Modern Bankruptcies as Tools for Teaching Valuable Lessons in Business

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Executive Summary

Every day the headlines are full of news of giant corporations that have fallen into bankruptcy or stand on the brink of the abyss. Business school educators can seize this opportunity and turn these calamities into valuable teaching tools, as bankruptcy is not just about insolvent companies and creditors scrambling to get paid, nor is it simply limited to legal issues. To the contrary, modern bankruptcy scenarios provide a wonderful teaching opportunity across a broad swath of disciplines and provide educators with the ability to explain and examine the vital interaction between finance, accounting and management, to name a few. This article highlights a few key points and posits a methodology for teaching them.

Introduction

Enron and WorldCom are infamous names familiar to most people. More recently and at a different "altitude," we have Delta, Northwest and United. And who in America today has not agonized over the bankruptcies of the once great Lehman Brothers, Chrysler and — possibly most astonishing of all — General Motors? Once again, "megabankruptcies" preoccupy the world of business. Banks, financial institutions, vendors and businesses of every size and shape must grapple with

grave issues when a customer, supplier or competitor files for bankruptcy (and even when one of these institutions joins the rolls of the insolvent).

Business educators must take careful note as well. Today's bankruptcy process offers a multitude of lessons, among them: how to avoid the abyss of insolvency; methods of restructuring the troubled concern; and shaping strategies to maximize creditor recovery. Yet there is so much more, for modern bankruptcy proceedings offer enlightening insights on the legal and business environment that our students will soon enter.

Bankruptcy can be a vital and interesting tool to inculcate students with a number of essential concepts of modern business critical to their future success. The purpose of this article is to highlight just a few of those points and suggest a methodology for teaching them.

Finance and Secured Lending

In business today, nearly everyone borrows money to finance its growth. We teach classes wherein we demonstrate to students the theory of corporate finance. Bankruptcy is the crucible where we test mere theory to the maximum and discover what works and what doesn't. It is easy to apply those real world lessons in the classroom.

Secured Creditor Status – A Worthwhile Goal

Creditors in bankruptcy cases can be divided into two fundamental classes: secured creditors and unsecured creditors.

Secured creditors loan money on the basis of a promise to repay (with interest, of course), joined to a pledge of collateral (“secured assets”). In the event of default, the collateral will be turned over to the lender in satisfaction of the unpaid debt. This is the very essence of secured lending and the entire asset-based lending (ABL) industries.

Immediately, we have two valuable business lessons. One, in secured financing, the borrowing business either repays in debt in real dollars (the nominal way) or, if it cannot, then it effects repayment by the surrender of the pledged asset, voluntarily or by court proceedings.¹ Oft times, bankruptcy cases powerfully illustrate the latter as the lender’s means to retake the pledged asset.

Second, businesses will many times borrow money to purchase an asset and then pledge that newly acquired asset as collateral. This is “purchase money financing,” and it amply demonstrates how one can grow a business by carefully managing debt to acquire productive assets. It also highlights sound business judgment that the newly acquired asset must “earn its keep,” and individually or jointly generate sufficient revenue to pay for itself.²

Secured creditors are basically the more intelligent among creditors; bankruptcy teaches that if the debtor can’t repay the debt in real money, it repays it by surrendering the asset.³ Thus, such creditors in a very real sense are “secured,” in that they are assured that, one way or another, they will be made whole on the loan. Tomorrow’s financial mavens are thus well taught to seek the exalted status of the secured lender.

By contrast, **unsecured creditors** take a less circumspect approach and certainly a great deal more risk. Unsecured creditors loan money, provide services or sell goods on a mere good faith promise to repay. They are “unsecured” because they lack security. The borrower has no asset, or collateral, that can be used to repay the lender. Thus unsecured creditors bear the highest risk of not being repaid.

Bankruptcy powerfully reinforces the notions of due diligence, conservative asset valuation and carefully measuring credit risk.

In blunt terms, secured creditors could be described as “smart” creditors, because the expectation of repayment is backed up by a very real asset. On the other hand, unsecured creditors are just not that smart; unsecured creditors extend credit and/or goods on faith alone. Such appellations may be unkind, but they are nonetheless true. It is imperative to cement knowledge of these distinctions into the minds of students.

The Detriment of Unsecured Creditor Status in a Bankruptcy Case

The difference between secured and unsecured creditors takes on significant proportions in bankruptcy cases. There we find unsecured creditors are at the very end of a long line of creditors.⁴ In all too many cases, they receive a minimal payout or even nothing at all. Truly, unsecured creditors fare the worst in modern business bankruptcies.

We can utilize this to impress upon students the significant risks associated with being an unsecured creditor. Clearly, the lesson to be emphasized across the entire spectrum of business learning is that it is far preferable to be a secured rather than an unsecured creditor. Emphasize this as a management decision

that has significant impact on a company's finances and accounting for reserves and you have taught some valuable lessons in the aforementioned three disciplines, aside from business law itself.

Secured Creditor Status Does Not Come Easily

But we must remember to impress upon our audience that even secured creditors are not unassailable. In truth, classification as a "secured" creditor is but a term unless the underlying collateral maintains its fair market value. If it does not, the creditor succumbs to "undersecured" status, a dangerous place to be.

Take a Lesson from the Airline Bankruptcies

Consider the fate suffered by all too many secured creditors in the Continental Airlines bankruptcy. They had loaned huge amounts of money to finance purchases of new aircraft at the peak of the pricing cycle for such acquisitions. Those aircraft had severely depreciated in market value when Continental filed for bankruptcy. Thus, secured creditors were left with collateral whose market value was tens of millions of dollars less than the outstanding loan.

Creditors in such a position can then be easily "squeezed" by a smart debtor. Undersecured creditors face an unsavory choice; take back the asset, whose value no longer covers the debt and write off a significant loss. The alternative is to "restructure" the debt; in simple fact let the debtor keep the asset, free of repossession and then have the debtor repay the loan that has been greatly reduced in principal, debt service or both. Too many creditors in Continental took the second path, simply to make some recovery and avoid being stuck with a low value asset and a high writeoff.

To be sure, this explains much of the malaise of the more recent airline bankruptcies. While

never stated outright, United and U.S. Airways, to name two, managed to stay airborne partly because ostensibly "secured" aircraft financiers knew that, in truth, their collateral had severely diminished in market value, given that hundreds of commercial jet airframes sit idle in desert "boneyards."⁵

These lenders knew that recapturing their collateral would not only be futile, but dangerous to their balance sheets, by saddling them with non-performing assets. After all, bankers are in the business of loaning money, not owning airplanes. Witness the subsequent reorganization cases of Delta and Northwest, who underwent surprisingly little pressure from their financiers, mainly because nobody wanted to take back the airplanes pledged as collateral. An interesting contemporary case study, most certainly.

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Teaching Diligence is Teaching Success

What's the lesson to tomorrow's bankers and financiers? Bankruptcy powerfully reinforces the notions of due diligence, conservative asset valuation and carefully measuring credit risk. Pay careful attention to the viability of potential assets, avoid overconfidence in the value of the asset serving as collateral and don't be generous with the amount of the loan secured by that asset. Seek to ensure an "equity cushion," that is, extending a loan in an amount safely below the current fair market value, thus establishing a "cushion" that the collateral's market value must descend to before you risk the debt declining into "undersecured" status.

Any doubt that these skills need to be taught in the classroom were ended forever by contemporary events. Witness (as if you had a choice!) the current debacle. Just as secured creditors in years past did not want to wind up owning devalued aircraft, today's banking institutions are racked with fear that they will wind up owning overpriced real estate and other assets that they once loaned money out on. This explains much of the credit paralysis in the financial sector and the resultant government bailout. Today we as a nation are paying the price for the past's utter disregard of fundamental lending principles. An introduction to secured lending, unsecured creditor status and bankruptcy law is a good start towards making sure future generations do not repeat these mistakes.

Credit, Collection and Bankruptcy "Preferences"

Consider the following scenario: You are a business owner and recently a troubled customer paid a long overdue bill. Soon you hear the customer filed for bankruptcy. Months later, the bankruptcy court demands you return the money. What? I have to give back money lawfully paid? How did I get into this mess and what can I do?

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What is a Bankruptcy "Preference"?

Welcome to the strange and expensive world of "preferences."⁶ Modern law presumes that a troubled company "prefers" some creditors over others in its final days before officially filing for bankruptcy. For example,

Acme Toys is in serious financial distress. The CEO has two invoices on her desk; one from Shocking Electric Company, which threatens an immediate termination of service and the other from Stretcho Plastics demanding payment for its last shipment. She quickly concludes that there is enough raw material on hand, so she can stall the vendor Stretcho, but failure to pay the utility will immediately shut down Acme. Madame CEO makes the obvious choice and a preference is born.

The Bankruptcy Code demands all such preferential payments be returned to the post bankruptcy debtor, which will then combine the money with all other funds and then money will be paid to all creditors equally. All other things being equal, in the case of Acme Toys the utility and the vendor will each get some (but not all) the money they are owed, in an equal percentage and avoid the obvious injustice of the electric company being repaid 100 percent and the supplier zero.

Now a preference is a preference and it must be repaid, *unless* you can demonstrate that the payment was received in the "ordinary course of business," i.e., that this payment, while made just before the debtor filed for bankruptcy, was nonetheless made as part of an overall, repetitive course of dealing between the parties, again in the "ordinary course" of business. This gives rise to the preference defense of the same name.⁷ And who finds these notorious preferences and provides the data for the "ordinary course" defense? Accountants, because the search for preferential payments and devising a defense to the allegation is largely an accounting exercise.

Preferences as a Learning Tool for Modern Business

Here's the lesson for business. Modern corporations have "C & C" functions: that is, "Credit and Collections" departments, or at

least one responsible person. Preferences can and should be prevented. We can train the C & C managers of tomorrow by inculcating them with the mandate to carefully and continually monitor customers, their payment status and their overall financial health (here is where Dun & Bradstreet and similar services provide an important function). A well educated credit and collections professional will keep tabs on customers, keep them up to date and thus minimize or even eliminate altogether payments that arrive too close to bankruptcy and thus become tainted as preferences.

Preferences Are About Management and Marketing, Too

Based on the foregoing, we can anticipate the inevitable clash between the C & C person, usually trained in finance and accounting and the sales force, more driven by marketing and management dicta. Every day in business brings about confrontations between aggressive sales personnel who push sales, sometimes without regard for the likelihood of repayment and more conservative credit managers, who want to pull back and curtail financial risk. Upper management, with years of experience and hopefully well trained with an advanced degree in business, will recognize the pros and cons of each side and resolve it in a way that maximizes sales while minimizing credit risk.

This topic provides a rich vein to be mined. Practical lessons can be taught in the proper role of Credit and Collections personnel safeguarding the financial health of an enterprise and the need for marketing and sales people to be cognizant that selling entails not only the risk of not making the sale, but of not being paid on a sale made. This is a stark reminder to management disciplines that their overall vantage point requires a delicate balancing of competing interests in order to assure that the business functions properly. Again, business lessons abound across a wide swath of disciplines when discussing bankruptcy preferences.

The Risks of Entrepreneurship

An essential component of modern business education is entrepreneurship. Aspiring business moguls need the skills necessary to conduct due diligence, make well reasoned decisions and then take sensible risks. It is also important to remind them of the price of failure.

Injuring the True Owners – The Shareholders

The end game of the bankruptcy process is a grim reminder of the consequences of mismanagement. It is axiomatic that creditors suffer in bankruptcy cases, but the ultimate pain is inflicted upon shareholders, whose interests are quite literally erased from existence.

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By law and by cold reality, the interests of shareholders are wiped out in bankruptcy cases. "Reorganization" means there is nothing left for equity holders and thus former ownership is eradicated. This exemplifies the established axiom that shareholders assume the ultimate risk of loss, as the entity's ultimate owners. We would do well to remind our audiences that "free market" includes the freedom to fail alongside the freedom to succeed. Having one's equity holdings wiped out in a Chapter 11 could indeed be the ultimate downside of entrepreneurship. Almost as an aside, we also see the efficacy of the corporate form of business ownership, since shareholders lose the totality of their investment in the defunct corporation, but their personal fortunes are unscathed.

Keep in mind that in numerous "megabankruptcies" the existing shareholders are erased and are replaced by creditors who take on new ownership stakes in the

“reorganized” company in lieu of an actual cash distribution on their claims.⁸ Quite naturally, students are often perplexed when they discover that the shares of reorganizing corporations are still being publicly traded. Part of our job is to ensure that they are not taken in by these mere appearances. First, such trading is usually done by ultra-sophisticated “vulture” investors on a less prestigious trading platform (i.e., over-the-counter or via the “bulletin board”). Second, such “investors” have a much different agenda and are concurrently buying up debt (which gives them a legitimate position as a creditor) as part of a concerted plan to buy out the distressed corporation lock, stock and barrel. Third, some people do stupid things, such as buying and selling Enron even after it filed for Chapter 11. Pragmatic advice goes hand in hand with academic theory on these points.

Creditors often find themselves to be the new equity stakeholders in the aftermath of major reorganization cases. For example, KMart recently paid its creditors with stock in the “new” KMart, because it did not have enough cash to pay out their claims. In the recent past, the bulk of creditors in Continental Airlines were issued shares in the restructured company that emerged from bankruptcy, while former shareholders, including many company pensioners with all their retirement assets tied up in the airline’s old stock, were wiped out. And finally, we have the yet to be resolved bankruptcy of Lehman Brothers. Even today, long before we have a final outcome, the horrific erasure of the accumulated wealth of employees and shareholders invested in Lehman stock is a painful and indelible stain upon the history of entrepreneurship.

A High Price to Be Paid

Indeed, the Lehman case is a most telling lesson in the human cost and tragedy that comes from making poor business judgments. It could very well be that such lessons are worthwhile not

only from an orthodox business perspective, but from a business ethics standpoint as well, with regard to corporate responsibility.

Yet there is one further lesson. Not long ago, we witnessed firsthand the criminal convictions of the late Kenneth Lay and Jeffrey Skilling, former CEOs of Enron. We saw firsthand the harsh penalties to be paid by those who cheat, those who lie, those who by corrupt means drive a company into bankruptcy. With respect, we must observe that Mr. Lay left this mortal coil very shortly after his conviction was handed down. His death may have been caused by the strain and embarrassment of his trial. Certainly his condemnation inside and outside of the courtroom must have been overwhelming. There is a moral price to be paid for corporate malfeasance, a lesson we should remember when discussing the ethical constraints that should guide the conduct of modern business. Let the catastrophe of that bankrupt entity be the final lesson, not so much in the risks of entrepreneurship, but the calamities that are likely to ensue if someone violates the law when in business.

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In Conclusion

It is not an understatement to say that the foregoing only represents the mere tip of the iceberg of business education lessons that can be culled from modern bankruptcy cases. For this brief overview, the author selected only a few of the more pertinent ones that are multidisciplinary and thus would resonate across many fields of study. Many more abound, with valuable lessons in management, accounting, finance and of course business law.

But the point is well made. We as educators are obligated to view the corporate bankruptcies of today as more than simply examples of businesses gone wrong. Rather, we have a profound duty to take this one domain of modern business and extract countless lessons that will prove of great value to our constituency and enhance its success in the real world.

Endnotes

- ¹ See Uniform Commercial Code, Article 9 (secured transactions).
- ² Uniform Commercial Code Section 9-201 (definition of “purchase money security interest”).
- ³ Bankruptcy Code Section 362, the “automatic stay,” whereby a secured creditor can petition the court for permission to seize the secured asset upon the debtor’s nonpayment.
- ⁴ Bankruptcy Code Section 507 (in priority of repayment to creditors, unsecured creditors are last).
- ⁵ Robson, “Desert Airlines,” (Motorbooks International 1994), a pictorial history of the hundreds of aircraft, almost all from defunct commercial airlines, mothballed in the Mojave Desert of California.
- ⁶ Bankruptcy Code Section 547.
- ⁷ *Id.* at subsection (b), setting forth the statutory preference defenses.
- ⁸ Bankruptcy Code section 1101, et seq., commonly known as “Chapter 11.”