Rehabilitating distressed enterprises during recessions

A submission to the
Corporations and Markets Advisory Committee

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Summary

I submit that Australia needs a new form of bankruptcy protection which would be available only during a declared state of economic emergency, and which would enable any debtor enterprise to reschedule its

existing unsecured debts on a last-on-first-off (LOFO) basis. Creditors in the queue (''old'' creditors) should be able to raise their priority only by offering to settle at a discount; and while the state of emergency remains in force, only ''new'' creditors (owners of debts incurred after the rescheduling) should have recourse to conventional remedies for default. The availability of LOFO rescheduling would restore the confidence of potential suppliers and lenders in the credit-worthiness of customers and borrowers, at least in respect of *new* business, so that commerce would recover and economic growth would resume. While the rescheduling of one debtor's payments would force some low-priority creditors to invoke the same bankruptcy protection themselves, thereby forcing some of their creditors to do likewise, etc., the resulting chain reaction would not be a cascade of enterprise failures leading to general depression, but a cascade of debt restructures after which the remaining bad debts would be borne by parties who can bear them without becoming insolvent.

1. Motivation

1.1 Why recessions require special rules

In the rare event that a large and complex enterprise fails in a time of full employment and brisk business, the damage done to the victims is moderated by the plenitude of economic opportunities. Employees can readily find new jobs. Shareholders should be adequately protected by diversity of investment. Creditors should have sufficient margins to cover the resulting bad debts. Suppliers should have plenty of alternative customers. The necessary adjustments, although somewhat traumatic for the affected parties, are part of the process by which inefficient enterprises make way for more efficient ones. This is capitalism working as it should.

In the more likely event that the enterprise fails in a time of recession or impending recession, the situation is far more serious. Employees will be out of work for months or years. Shareholders will be caught by widespread asset depreciation. Creditors may be overexposed to non-performing debt. Suppliers may not survive the loss of business. The ensuing fall in consumption and tightening of credit will put pressure on other enterprises and contribute to a deepening of the recession. Under these conditions, enterprises fail not because they are inefficient but because others are failing; thus the number of enterprise failures greatly exceeds the reasonable requirements of economic Darwinism, while valuable knowledge and skills that will be needed by future enterprises are lost through prolonged lack of use. Moreover, the resulting breadth and depth of hardship could not be defended by any arguments about efficiency, because surely one purpose of efficiency is to avoid such hardship.

The rules governing the rehabilitation or liquidation of troubled enterprises during recessions should therefore be different from those that apply in better times. In normal times, the rules may be characterized by a stoic admission that some business failures are inevitable and necessary for the maintenance of efficiency. But in a recession, one must simply minimize the number of enterprise failures.

1.2 Why the next recession is imminent

Frank Gelber of BIS Schrapnel has predicted that the property bubble will burst in 2006, causing a recession in 2007/8. He reasons that the present economic growth phase will continue until it becomes inflationary, forcing the Reserve Bank to impose higher interest rates, which will pop the bubble; then the belt-tightening caused by the fall in asset values will bring on the recession.

I predict that the bubble-burst will come in 2004 and the recession in 2005/6. My reasons include the following:

- Residential property is now about 30 percent overpriced relative to rental yields. Such high prices can be sustained only by an expectation of continuing rapid capital gains; any stabilization of prices undermines that expectation and consequently removes the support for today’s prices. It follows that the bubble cannot end in a plateau; it can only end in a bust. As to the timing, the Melbourne-based Land Values Research Group, which has been charting real estate turnover since 1972, has established the empirical rule that turnover in excess of 19 percent of GDP portends a crash, then a recession. Current turnover is at least 25 percent. The record, set just before the last great property crash (1989-90) is about 27 percent, and on current trends will be exceed within six months if it has not been exceeded already.

- According to the Reserve Bank [1], Australia's household mortgage servicing ratio (mortgage interest as a percentage of disposable income) is at an all-time record in spite of low interest rates. The total household debt servicing ratio is at the highest level since the late 1980s and, if present trends continue, will surpass that record within a year. Housing investment is about 8 percent of GDP, while borrowing against housing is more than 12 percent of GDP [1,p.21]; both figures exceed all previous peaks (at least since 1980). Clearly the expansion of debt must end soon. When it does, consumption will contract and GDP will fall.
- Much discussion is based on the assumption that the Reserve Bank determines the future of interest rates. But, while the interest paid by a central bank can raise market rates, it has very limited capacity to lower them; at most, the cut in official rates represents the withdrawal of one borrower, namely the central bank, from the market. If private lenders lose their nerve, market rates will rise regardless of official monetary policy.
- Warning signs of a residential property crash include falling rents in inner Melbourne, stagnant rents in inner Sydney, falling apartment prices, and the rent-free periods offered by landlords in order to attract tenants without reducing the rents quoted to prospective buyers.

Concerning the severity of the coming recession:

- The Reserve Bank's graph of housing equity withdrawal [1,p.21] shows that throughout the 1980s, borrowing against housing was consistently below housing investment, by a margin of about 3 percent of GDP. The margin narrowed during the early 1990s and was typically about 1 percent of GDP in the second half of the decade. But since the beginning of 2001, borrowing against dwellings has exceeded dwelling investment; the margin is now about 4 percent of GDP, or about 8 percent of household disposable income. Borrowing against housing (as a fraction of GDP) has risen about 8 percent of GDP since the late 1990s and about 10 percent of GDP since the 1980s. This gives an idea of how much household spending will contract when borrowing returns to sustainable levels. And that is only the first-round effect; the resulting unemployment will cause another fall in consumption, which will cause more unemployment, and so on.

Note that the blowout in borrowing relative to housing investment is unprecedented; the absence of this Damoclean sword before the recessions of the early 1980s and early 1990s indicates that, unless radical preventive measures are taken, the coming recession will be more severe than those.

- More than 40 percent of housing loans (by number and by value) are now taken out by investors, and the fraction is rising; whereas owner-occupiers' housing debt is rising at about 20 percent per year, investors' debt is rising at about 30 percent per year [1,pp.22,23,39]. Because of the prevalence of negative gearing, investors are more dependent on capital gains than owner-occupiers and are more likely to default in a market downturn.

  Note that negative gearing has now become the norm; Australia's 1.3 million property investors -- not just new investors -- collectively claim more in rental deductions than they declare in rental income.

- The APRA has calculated that Approved Deposit-taking Institutions (ADIs) can withstand a 30 percent fall in home prices and a 3.5 percent mortgage default rate. But the bursting of the housing bubble will also curtail the consumption that is now being financed by borrowing against home equity. Will the ADIs withstand the ensuing business loan defaults? or the second round of mortgage defaults caused by job losses? or the second round of business loan defaults caused by reduced sales caused by the first round of business failures and job losses, etc.?
- If a recession begins when interest rates are low or when market interest rates have decoupled from official interest rates, there is little scope for monetary stimulus.

Notice that the above comments on the timing and severity of the recession consider only the domestic situation. Let us now turn to the United States:

- The U.S. stock market, whether it is assessed by P/E ratios or replacement costs of assets, is about 30 percent overvalued [2] notwithstanding the bear run from late 2000 to early 2003. In other words, given the right trigger, the market is ripe for a crash.

- Notwithstanding recent positive news on employment, the U.S. economy has shed more than 2.5 million jobs in three years. Economic growth has been financed not by sustainable growth in spending power, but by expansion of debt -- notably including cash-out mortgage refinancing. Because the U.S. property bubble is more localized and less extreme than Australia's, this mortgage refinancing depends less on rising property values and more on the equally unsustainable circumstance of falling interest rates.
- Since 2000, the U.S. federal budget has blown out from a surplus of 2.4 percent of GDP to a deficit that is now more than 3 percent and rising. There is little political will to cut spending, and even less to raise taxes. The deficit must either raise market interest rates or drive inflation, prompting a rise in official interest rates.
- The U.S. current account deficit is about 5 percent of GDP. In spite of this, the U.S. dollar remains highly valued because it is the global *de facto* standard trading and reserve currency. But the high dollar drives employment and manufacturing offshore and thereby adds to the trade deficit. Eventually this must cause a loss of confidence in the U.S. dollar, which will stem the flow of imports into the world's biggest economy, forcing painful adjustments in the U.S. and abroad. And the longer this reckoning is delayed, the more traumatic it will be. Possible triggers include a crash of the U.S. stock market or property market, or a new corporate scandal, or a decision by one or more OPEC states to sell oil for euros instead of dollars, or the next attempt by the Fed to adjust monetary policy (which may reveal that market interest rates have decoupled from official interest rates).

When a line of hailstorms is racing towards your city, you don't necessarily know which cell is going to strike first or which suburbs are going to have their cars dented, their roofing tiles cracked and their drains overwhelmed. But you act preemptively to minimize the damage.

2. The proposal

The descent into depression is a domino process in which the collapse of some enterprises causes a loss of income for others, which also collapse, and so on. So the challenge is to devise an emergency regime whereby enterprises can keep trading indefinitely, even if they are, for the time being, technically insolvent.

The perceived moral turpitude of insolvent trading arises from the risk that parties who are induced to deal with the insolvent entity may lose their money. The same risk makes people reluctant to deal with any entity that they perceive to be under financial stress. But the moral objection and the practical impediment both disappear if those who deal with the entity go to the head of the creditor's queue in the event that the entity is liquidated. Of course a new moral objection is raised by those older creditors who find themselves demoted in the queue; for this reason, such a radical re-ordering of the queue should not be allowed under normal circumstances. But in a recession, when *all* creditors are nervous about their chances of being paid, and when those chances would obviously be enhanced by an end to the recession, a rational creditor should welcome any policy that would shorten the recession and keep debtor enterprises afloat until the end of the recession, even at the cost of some seniority among creditors. Any place in the queue is better than no queue. Rescheduling of debts in favour of new creditors would indeed end the recession, because it would break the chain of enterprise failures and remove impediments to new business.

I therefore suggest that the Federal Parliament, using its ‘‘bankruptcy and insolvency’’ power under s.51(xvii) of the Constitution, should legislate to the effect that the Governor-General in Council, if satisfied on reasonable grounds that the economy is falling into recession, may declare a state of economic emergency, during which enterprises may decide to reschedule their existing unsecured debts on a last-on-first-off (LOFO) basis. When an enterprise announces that it is exercising this option, debts incurred after the announcement (‘‘**new**’’ debts) take priority over debts incurred before the announcement (‘‘**old**’’ debts), and only new debts may give grounds for traditional remedies (e.g. liquidation proceedings) in the event of defaults. Old debts are placed in a queue, with more recently incurred debts having higher places. In practice, some creditors who are placed low in the queue will be prompted to reschedule their own debts, so that a chain reaction will ensue. Debts in a queue are legally subject to a moratorium as long as the enterprise is not liquidated and the state of emergency continues; but in practice the debtor will wish to show some progress in paying those debts, in order to keep faith with future suppliers and lenders and prepare for the end of the state of emergency. Creditors may legally jump the queue by offering to settle for less than the amount owing (a minimum discount, e.g. 20 percent, should be specified in the enabling legislation). In practice, the initial queue-jumping offers will come from creditors who can take losses without becoming insolvent themselves, but some debtors wishing to accept these offers will try to finance their acceptance by making similar offers to their own debtors, and so on up the chain; this is the mechanism by which the burden of bad debts is shifted onto those best able to bear it. If a *new* creditor decides to enforce liquidation, the special LOFO provisions cease to apply, so that new debts no longer have automatic priority over old debts; this ensures that new creditors are not too eager to enforce liquidation.

The advantages of LOFO debt rescheduling over the current voluntary administration (VA) procedure include the following:

- LOFO requires no court proceedings; this feature is essential during a recession, when the enterprises in difficulty are too numerous to be processed through the courts.
- Even before an entity announces a LOFO rescheduling, those who deal with the entity today know that they will be near the head of the queue if the entity makes a LOFO announcement tomorrow. VAs give no such assurance.
- If the economy is to recover from a debt-induced recession, a large number of debts must be settled for less than their face value and the burden of bad debt must be shifted onto those who can most easily bear it. The LOFO queue-jumping rule provides a fast, informal, market-based mechanism for settling debts and distributing the burden. VAs, like most provisions of current insolvency law, regard queue-jumping as cheating.
- LOFO rescheduling automatically avoids some of the most harrowing consequences of enterprise failures. Consider, for example, an insurance company making periodic payments to accident victims. Under current laws, those payments do not enjoy any special priority and are liable to be suspended pending an assessment of the funds available for that

category of creditors. Under LOFO rescheduling, those payments continue as usual because the liability for each instalment is deemed to be incurred when the instalment falls due -- i.e. after the LOFO announcement.

I envisage that the LOFO rescheduling would apply only to the lowest-priority category of creditors, loosely described as unsecured creditors. For example, it would not apply to a loan secured against an asset and requiring periodic repayments; those repayments would continue regardless of any LOFO announcement. But an unsecured loan would be placed in the queue according to the date of the loan contract, while a bond would be queued according to the date of issue and credit-card transactions would be individually queued.

3. Questions raised by the Advisory Committee

The discussion paper [3] raises some issues which I shall address in the context of LOFO debt rescheduling.

Q. *''Will the directors, or some external appointee, control the company during the rehabilitation period?''*

A. Usually the directors, because the workout of debts is meant to be informal and market-driven. Moreover, in a recession, the number of enterprises in trouble would cause a shortage of administrators if every such enterprise required an administrator. In the case of an exceptionally large and complex enterprise, it might be argued that there is an unusual degree of public interest justifying the appointment of an independent administrator; but it would be impractical to extend this requirement to all enterprises.

Q. *''Do directors obtain any immunity from possible liability for any debts incurred by the company during the rehabilitation period?''*

A. The interests of ''new'' creditors are adequately protected by the priority of new debts over debts incurred before the LOFO announcement. Hence there is no special reason for directors to fear lawsuits from new creditors. Concerning old creditors, the interests of directors are adequately protected by the right to make a LOFO announcement with all that it implies; in particular, the newest ''old creditors'' -- i.e. those who gave credit closest to the announcement and are most resentful of its timing -- are placated by being at the head of the queue. Hence there is no need for any special provisions regarding directors' liability; the usual laws regarding negligence, malfeasance and dishonesty should continue to apply.

Q. *Under what conditions should an enterprise be allowed to invoke LOFO debt rescheduling?*

A. In normal economic times, not at all; only during a declared state of economic emergency would LOFO rescheduling be allowed. But, given that such an emergency has been declared, further legal restrictions on LOFO rescheduling are unnecessary and undesirable -- unnecessary because any enterprise making a LOFO announcement would suffer some loss of reputation, which loss it would rather avoid; and undesirable because:

- the courts do not have the capacity to process the number of legal disputes that could arise from such restrictions;
- in an emergency there is no time for arguments;
- if some entities make LOFO announcements, other entities may be compelled to make similar announcements in order to remain competitive, even if they have been viable and competitive up to that time;
- while the old creditors of the nation would have a collective interest in supporting LOFO rescheduling, which would end the recession and restore debtors' capacity to pay, the old creditors of a particular debtor might think they stand to gain by preserving their priority with that debtor, and might therefore oppose that debtor's LOFO application if given the chance; this is a conflict between the collective and individual interests of creditors, and the object of the LOFO proposal is unashamedly to protect collective interests.

Q. *Could an enterprise invoke LOFO rescheduling merely in order to brush off creditors or, worse, to obtain a debt holiday and the concomitant competitive advantage?*

A. Yes, and these are some of the reasons why LOFO rescheduling should not be allowed in normal economic times. But in a recession, when the overwhelming necessity is to shake out bad debts and make a fresh start, such objections miss the point. Concerning the competitive advantage conferred by LOFO rescheduling, the remedy is to allow the competitors to follow suit; this, as stated above, is a reason for the lack of restriction on

LOFO announcements during a declared state of economic emergency.

Q. *Should a LOFO announcement override ipso facto clauses, reservation-of-title clauses and set-off rights?*

A. Clearly it should override ipso facto clauses; otherwise an old creditor with a small debt could potentially force liquidation on the basis of some trivial contractual condition, thereby defeating a key feature of the LOFO system. The other parts of the question are less important. Reservation-of-title clauses allow repossession only of those goods which are subject to the clauses and for which the debtor has not paid in full. Set-off rights apply only to creditors who are also reciprocal debtors, and allow such creditors to withhold payments only up to the value of the debts owed to them. A LOFO announcement further reduces the consequences of such clauses by making it easy for the enterprise to raise new credit.

4. Assessment against guiding principles

The discussion paper [3] proposes five guiding principles for the rehabilitation of large and complex enterprises.

Principle 1: *''The earlier a company responds to its financial difficulties, the better may be its prospects of successful rehabilitation.''*

Hence I have proposed that when a state of economic emergency is in force, there should be no legal hurdles in the way of LOFO rescheduling.

Principle 2: *''The prospect of a financially distressed company being rehabilitated may be improved if it can be encouraged to enter into discussions with its major creditors as early as possible on how best to rectify its financial position.''*

The queue-jumping provision of LOFO rescheduling encourages creditors to settle at a discount if they are able to do so. Such offers from creditors may induce the debtors to make similar offers to their own debtors.

Principle 3: *''A company may have a better prospect of successful recovery if it can obtain new loan or equity finance* *during the rehabilitation period.''*

LOFO rescheduling encourages ''new'' creditors by giving them priority over ''old'' creditors.

Principle 4: *''The procedural timetable needs to be sufficiently flexible to adjust to the needs of particular companies.''*

LOFO rescheduling gives maximum flexibility; the only ''timetable'' constraints are the end of the state of economic emergency and the ability of ''new'' creditors to invoke conventional remedies in the event of default.

Principle 5: *''The process of rehabilitating a corporate group may be assisted if that group can be dealt with collectively, rather than on a company-by-company basis.''*

This question applies to judicial and quasi-judicial proceedings. LOFO rescheduling avoids such cumbersome formality.

5. For the future

Bursting asset bubbles figure prominently in recession forecasts. The recessions of 1974/5, 1982/3 and 1991/2 were triggered by crashes in the property market (although, very conveniently for the property lobby, the first two crashes coincided with oil shocks). The Great Depression was triggered by a stock market crash whose consequences were magnified by the debt burden left behind by the property crash of the mid 1920s.

If assets in a particular class can be produced by free enterprise, any rise in values will trigger more production and moderate the rise. Therefore price bubbles tend to be confined to asset classes involving some element of monopoly. In the property market, the monopoly consists in the strictly limited supply of *land* (as distinct from buildings) and the uniqueness and irreplaceability of each parcel of land. In the asset backing of corporate shares, there are monopolies in intellectual property (patents, designs, trademarks and copyrights) and special privileges (e.g. mineral rights, electromagnetic spectrum assignments, rights of way).

Bubbles are pumped up by speculators, i.e. buyers who are chiefly interested in capital gains. Bubbles can therefore be prevented by tax reforms that make it uneconomic to hold non-replicable assets for capital gains alone, forcing the owners of such assets to use them in ways that generate income. The simplest and most obvious of these reforms is to reduce taxes on income and impose or increase holding taxes proportional to the values (or changes in values) of non-replicable assets and payable by the owners of those assets.

While such tax reforms can prevent bubbles from inflating in the first place, they unfortunately cannot prevent pre-existing bubbles from bursting and leaving a crippling burden of debt. So the issue of tax reform is raised with a view to preventing the recession *after* the next. The next one can only be alleviated by insolvency reform.

References

[1] Reserve Bank of Australia, *Statement on Monetary Policy*, November 2003, available at http://www.rba.gov.au/MonetaryPolicy/ (under ‘‘Statements on Monetary Policy’’).

[2] Alan Wood, ‘‘Let the good times roll, unless Q’s the answer’’, *Weekend Australian*, August 23-24, 2003, p.36.

[3] Corporations and Markets Advisory Committee, *Rehabilitating large and complex enterprises in financial difficulties* (Discussion Paper), September 2003, available at http://www.camac.gov.au/ (under ‘‘Current Discussion Papers’’).

Acknowledgments

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The Mission of Prosper Australia is:

To create prosperity and full employment by collecting the rental from land and natural resources instead of taxation.

In general the views expressed herein should be taken as those of the author. However, the submission reflects the mission of Prosper Australia in that it emphases the connection between land speculation and recessions and advocates tax reforms for the prevention of such speculation.

This submission quotes figures on real estate turnover compiled by Bryan L. Kavanagh *AAPI(Val)*, who at the time of writing is the Honorary Director of the Land Values Research Group, of which the author is also a member.

The submission is *not* confidential.