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Corporate Debt Restructuring: Auctions Speak Louder Than Words

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In many countries, courts neglect to enforce bankruptcy laws and creditors' rights, even when they are adequate. Those countries' courts that can handle the ordinary failure of firms would still be overwhelmed by the sheer number of firms adversely affected by a general economic crisis of the magnitude of the recent East Asian crisis.

This chapter proposes a market-based scheme to swiftly reduce claims to levels creditors deem serviceable. The Auction-Based Creditor Ordering by Reducing Debts (ACCORD) involves creditors making noncash bids through debt forgiveness to vie for places in a line. Any existing hierarchy of claims is respected, and places within this hierarchy are auctioned. Creditors are serviced sequentially: the creditor at the head of the line gets paid from the operating cash flows as and when the firm chooses, and only when the creditor's (reduced) debts are fully discharged does the line move up to the next creditor in line. Owners remaining last in line continue to operate the firm. This chapter shows that this type of auction sufficiently reduces claims to give owners an incentive to operate the firms efficiently.

While such a scheme has general applicability, it serves particularly well the current East Asian situation in which ownership rarely separates from management, creditors are ill-suited to be owners, and existing owners balk at any dilution of ownership or loss of control. The recent attempts to improve bankruptcy laws failed to hasten the resolution of corporate indebtedness, and delay has eroded values when the owner-managers' overwhelming indebtedness saps incentives. Furthermore, by guaranteeing the deposits in domestic banks with a negative net worth, governments, either directly or through agencies they control, implicitly become unsatisfied creditors of private firms, which risks politicizing the resolution. Under these circumstances, market-based bankruptcy alternatives seem attractive.

The basic approach in bankruptcy involves creditors negotiating with debtors and with each other to reorganize a viable firm's liabilities or, if not viable, liquidating the firm in an orderly manner. Countries' laws differ in the specified pecking order of claims. For example, must secured creditors wait to give reorganization a chance? Do workers' claims come ahead of them in line? They all rely on negotiations to resolve bankruptcy. While all courts try to prevent individual creditors from seizing assets or garnering proceeds out of turn, only a few countries, such as the United States under Chapter 11, require courts to nudge negotiations directly. When courts only entertain liquidation petitions, ruling on them quickly and predictably, they encourage financial reorganizations through negotiations, without courts' direct involvement. This chapter argues that negotiations have become stymied in East Asia not because of the laws or courts, although these could doubtless be improved, but because of more fundamental incentives, making a market-based alternative more appropriate. The authors of this chapter propose a specific scheme using noncash auctions.

Firms in the crisis countries of East Asia find themselves heavily indebted (table 5.1). Despite weak creditor protection, they were highly leveraged before the crisis, partly because the even weaker protection accorded to outside equity holders (La Porta, Lopez-de-Silanes, and Shleifer 2000). These firms' leverage has since increased because debts were often denominated in foreign currency, even for nonexporters, and sharp rises in interest rates and falls in their currencies' values in the foreign exchange market accompanied the economic crisis. Their debts have now mushroomed to possibly unserviceable levels.

Despite heavy indebtedness, East Asian firms have been generally well run. While total factor productivity appears to have declined in recent years, making East Asia's growth less miraculous than earlier believed, few doubt that firms' managers are generally competent and able to adapt to the new situation. Despite vigorous attempts to restore the firms' profitability, unserviceable debts must be renegotiated, which has failed to occur rapidly. The status quo erodes the owner-managers' incentives to operate the firm efficiently, because any increase in firm value accrues almost entirely to the creditors.

Table 5.1. Salient Corporate Statistics, East Asian Crisis Countries

Statistic	Indonesia	Korea	Malaysia	Philippines	Thailand
Real GDP ratio (1988–96)	0.88	1.00	1.00	1.05	0.92
GDP (1998, US$ billions)	105	309	69.4	68	121
Nominal exchange rate ratio (mid-1999 to mid-1997)	2.75	1.31	1.5	1.43	1.44
Capacity utilization[a] (mid-1998), percent	58	71	65	68	60
Total corporate debt (US$ equivalent)	118.0	444.0	120.2	47.5	195.7
External debt	67.1	64.0	40.0	23.3	32.5
Domestic debt	50.9	380.0	80.2	24.2	163.2
Banking sector's external debt (US$ billions)	50.3	72.4	23.0	17.8	46.8
Debt to equity ratio (1996)	2.0	3.5	1.1	1.4	2.4

a. World Bank survey of firms (mid-1998).
Source: Hausch and Ramachandran (1999).

In the recent crisis, all five East Asian countries promulgated new bankruptcy laws or amended old ones and began improving their courts' functioning. It nevertheless seems clear that the courts are—and should be—designed to deal with the normal failure rate of firms, not economywide financial distress, or systemic crisis. Furthermore, for most creditors to take over and attempt operation of the affected firms would be foolhardy, because they lack the skills and cannot oversee the managers who do. In the aggregate, a large-scale reshuffling of owner-managers, even if possible through widespread bankruptcies, only destroys firm-specific managerial human capital.

The debts must be quickly reduced to sustainable levels while existing owners remain in control. Bankruptcy negotiations remain slow partly because owners stall, fearing loss of control, and courts seem unable to prevent such delay. Moreover, the governments have intervened heavily in the banking system and, by guaranteeing the deposits, have become liable for banks' losses that far exceed bankers' equity. As a result, governments, either directly or through various agencies, have become major creditors of privately owned firms. Consequently, debt negotiations could become a political issue; but even if this were averted, bureaucrats would be unwilling to reduce the face value of the claims—even if their market value were the same or higher—lest they be accused of corruption or favoritism. Although owners are often blamed for the slow pace of negotiations to resolve the firms' excessive debts, the creditor agents' unwillingness to accept "haircuts" (practitioner parlance for partial forgiveness) would also be a hurdle. Market-based debt reduction provides an objective yardstick for creditor bureaucrats to defend their actions, and such alternatives to court proceedings therefore appear attractive.

Market-Based Bankruptcy

In recent years academics (Bebchuk 1988; Aghion, Hart, and Moore 1992) have proposed market-based alternatives to often seemingly protracted negotiations. Using Black and Scholes' (1972) original insight that equity is a call option on the firm's assets with an exercise price equal to the debt owed, Bebchuk proposes working up the hierarchy of claims. Starting with the most junior claimant, namely, equity, each claimant class is given a choice of either fully paying off all the more senior claimants or having its own claims extinguished. Whichever class pays off, all the more senior claimants become the firm's new owners. Bebchuk's proposal respects the absolute priority of claims and results in an all-equity firm.[1]

Bebchuk's proposal allows only existing claimants (shareholders and creditors) to bid for a settlement. However, outsiders may run the firm better, thereby raising its value, so Aghion, Hart, and Moore proposed allowing outsiders to bid also and to specify different means of paying the existing claims. Creditors may offer to restructure the existing debt, while an outside bidder, a firm in a similar business, for example, may offer to merge and replace debt with equity in the merged entity.

These proposals may be ill-suited to East Asia, where credit markets work poorly, especially in a financial crisis. Domestic banks are largely bankrupt (governments are restructuring them) and access to foreign credit has been disrupted.[2] With potential domestic bidders' cash constrained,

1. The firm could borrow through a separate transaction that may occur simultaneously if all the claimants in that class agree to accept *pro rata* fractions of each class of liabilities in the desired new financial structure.

2. Hart and others (1997) extend the Aghion, Hart, and Moore proposal to accommodate cash-constrained creditors, but the difficulties of cash constraints on the firms' bidders persist.

foreigners could outbid those better suited to maximize firm value. Furthermore, large-scale sales to foreigners could generate a backlash of public sentiment, especially in countries with recent and unpleasant colonial experiences. Even if surmountable, these problems present outsiders (whether domestic or foreign) with an acute information-asymmetry problem: firms have been remarkably coy about divulging their finances to their own creditors let alone to unrelated parties, even if they were potential bidders. Schemes relying on outside bidders (as in the Aghion, Hart, and Moore proposal), or having junior claimants raise additional cash (as in the Bebchuck proposal), are therefore unworkable.

The Proposed ACCORD

This chapter proposes a scheme that assures existing owners' continued control of the firm and compels creditors to reveal their valuations in a noncash auction in which they accept a reduction of the face value of their claims. Concerns that this needlessly or unfairly favors existing owners would be assuaged in the scheme's offering of an additional alternative whose adoption requires creditor consent. Creditors in the noncash auction bid the reduction in the claims they are willing to accept, and their bids arrange them in a line to be serviced in sequence. Those willing to accept the greatest proportionate reduction would be placed ahead of the others in the line to be serviced sequentially from the firm's operating cash surplus, which owners continue to control and operate. The firm does not promise a schedule of cash payments, and pays creditors only as and when it feels able. Also, unlike conventional seniority in which junior and senior claimants get paid simultaneously and seniority only affects the distribution of liquidation proceeds, other creditors get nothing until full discharge of the (reduced) debts of the creditor at the head of the line. When this happens, the line moves up, and the next creditor in line awaits payment.

All creditors remain creditors, but those that forgive a greater proportion have their (reduced) debts fully discharged before others who forgave less, leaving them further behind in the creditor line. Creditors who attach a low value to the firm and doubt if they would be repaid would be willing to forgive a larger proportion of their claim to ensure obtaining at least something before the firm's operating cash flows are exhausted. Conversely, those perceiving the firm's difficulties as temporary would forgive little, waiting patiently in line for their turn. The original equity holders, that is, the most junior claimants, would not bid, but would continue to own and operate the firm, obtaining any leftover residual. So until all the creditors' reduced claims are fully discharged, the owners receive no cash flows, such as dividends.

This process may be thought of as auctioning places in a creditor line. Creditors essentially bid the fraction of debt they will forgive: the more they forgive, the sooner, and more likely, they will be repaid. The creditor trades off between a higher amount and a higher probability of being repaid, and by this means prices overcome the free-rider problem.

The free-rider problem makes negotiations difficult in a conventional financial reorganization in which creditors are asked to forgive some of their claims. The dominant strategy often entails not forgiving, because the creditor would be entitled to a larger fraction of the resulting claims when others forgive. Furthermore, creditors in all classes simultaneously receive the periodic payments made. Junior creditors thus have a greater incentive not to forgive. Experienced judges could prevent negotiations from stalling, although in the crisis-affected East Asian countries, that remains unlikely, especially on the required scale.

In contrast to such negotiations, ACCORD makes nonforgiving creditors wait longer for the payments, as they would remain behind others in the line. ACCORD deals with the free-rider problem through the noncash auction: creditors are motivated to forgive because, although their claims will be lower, they will receive payment sooner and, hence, with a higher probability.

Hausch and Ramachandran (1999) solved the equilibrium bidding strategy of the creditors. If the value of the firm is certain, in equilibrium creditors with the same initial seniority bid the same proportionate reduction in their claims to share the value among themselves and leave nothing for the owners. For example, if the firm is worth US$160 (unobservable, but known to the creditors), and only two creditors exist, each owed US$100, then each would offer to forgive 20 percent in equilibrium. As the creditors make identical offers, they are randomly chosen to be at the front or back of the line. In this certainty case, both creditors eventually obtain US$80, regardless of their place in the line. This is an equilibrium (the unique pure-strategy equilibrium), because—given that one creditor forgives 20 percent—the other would be worse off forgiving more than 20 percent (and being first in the line) and no better off by forgiving less (and being second in the line).

Uncertainty about the value of the firm provides each creditor an incentive to be near the front of the line, leading to greater forgiveness. For instance, consider the above example of two creditors, but now suppose that the value of the firm could be either US$120 or US$200 (a two-point distribution), both equally likely. As before, the expected value of the firm is US$160, but some uncertainty exists about the actual value. Both creditors forgiving 20 percent no longer creates an equilibrium, because if they did, they are equally likely to be at the front and the back of the line. The one at the front definitely receives US$80, but the one behind gets an expected value of US$60 (receiving US$80 if the firm value turns out to be worth US$200 and only US$40 if the firm value is US$120). As the two creditors are equally likely to be positioned at the front and the back of the line if both forgive 20 percent, each creditor's expected payoff is one-half (US$80) plus one-half (US$60), equaling US$70. Clearly, each creditor has an incentive to forgive a bit more (say, up to 21 percent), because that would put the creditor at the front of the line, thereby being assured of obtaining US$79.

Each creditor has this incentive to forgive a bit more than in the certainty case, and the resulting equilibrium results in greater forgiveness (than the 20 percent) and results in the owner obtaining some residual value. The result is driven by the fact that creditors near the back of the line get little when the firm's value turns out to be low. Thus, owners in equilibrium obtain a strictly positive residual return—an important feature of the equilibrium—if they are to have the incentive to operate the firm more efficiently.

Implementing ACCORD

ACCORD does not require a complex bureaucracy, and the auction could be conducted either outside of or by the bankruptcy courts. While the details should be tailored to the circumstances of each country, the outline given here shows how it could be implemented under the aegis of the bankruptcy court, however inadequate it may otherwise be in overseeing complex negotiations.

The judge's role is modest and, by splitting the oversight role among others, the scheme cannot be easily subverted through incompetence or corruption. The judge announces the rules for participation in the ACCORD scheme and the auction procedures (bidding forms, deadlines, and so forth). The court appoints (a) an ACCORDer and (b) a recorder, whose roles become far more modest than that of a conventional administrator or receiver under bankruptcy. Each could therefore handle a large number of firms. Only one of them, perhaps the ACCORDer, need be an official of the court. The recorder might be an accounting firm with an incentive to maintain an international reputation for honesty and trustworthiness.

As the ACCORD scheme requires the firm's consent, that is, managers/controlling owners and a significant majority of creditors, no coercion is involved. A refusal entails no adverse repercussions beyond the existing "threat" of conventional bankruptcy, which already exists. Also, the preparatory steps are nonbinding; the parties commit themselves irrevocably to the ACCORD rules only just before the auction is conducted.

Preparatory Steps

Any of the parties involved—a creditor (for instance, a bank restructuring agency that has inherited the claim), a shareholder, or the firm's managers—can approach the bankruptcy judge to suggest the firm for the ACCORD scheme. This does not constitute a filing for bankruptcy, and at this stage the court serves simply as a sort of post office.

The judge informs the firm's managers about the rules of the ACCORD scheme and asks if they are interested in submitting within 30 days (a) a list of creditors and the amounts they are owed, and (b) a business plan. Official notification is only made to the party who suggested the firm to inform that person that the request was heeded, but the publicity of a bankruptcy filing is avoided. The firm's owner-managers may prefer the ACCORD scheme to conventional financial reorganization under bankruptcy in which their ownership may be diluted and they may lose control. Thus they are likely to provide the court with the creditor list and business plan, perhaps even contacting the major creditors directly to canvass the requisite majority support for the plan to ensure the ACCORD can proceed. As in a conventional financial reorganization, the creditors may form a committee to discuss the plan with the firm's managers, but the court would not be involved. As creditors may not approve a skimpy plan, the firm's owners have an incentive to supply information to satisfy the creditors.

If the firm declines, or fails to respond by the specified deadline, the matter ends without prejudice. If, however, the firm submits a plan, the court conveys it to all the creditors involved without examining its viability or fairness and alerts any claimants not listed by publishing its intent to conduct an auction of the firm's claims under ACCORD rules. The court notes that it will do so within two weeks if no disputes arise about the creditor list and the amounts owed and the requisite supermajority of creditors approve the plan.[3]

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3. The requisite supermajority would be the same as that required for a cramdown under the bankruptcy law: generally, a simple majority within each class and two-thirds or three-quarters of the aggregate. This would also bind any new creditors who subsequently lend the firm money (suitable clauses could be inserted into the loan contract).

After the two weeks, the judge ascertains the above two steps in a hearing. If the judge is not satisfied, for example, because new claimants emerge, the matter ends with no prejudice against any party involved. In other words, the parties are free to either live with the status quo or file any suit under the bankruptcy or other laws, or to try to enter the ACCORD at a later date. If the judge is satisfied, the parties commit to ACCORD's binding rules.

The Binding ACCORD Rules

At this stage, just prior to conducting the auction, the judge binds the parties to the ACCORD rules. All creditors forfeit their right to file bankruptcy or liquidation petitions for, say, five years.[4] Owners agree to forgo any cash dividends or payouts during this period and, if the reduced debts are not fully discharged by the end of five years, to forgo automatic liquidation.[5] Box 5.1 outlines some of the auction's procedural details intended to make collusion among participants difficult.

By allowing bidders to hide their true identity, bidder collusion becomes more difficult and corruption less likely when the ACCORDer and the recorder divide this information between themselves. Limiting the judge's discretion, both before and after the auction, makes success less vulnerable to any shortcomings of the court. The judge only rules on disputes of fact, not questions of fairness. Once creditors approve the plan and bid in the auction, only fraud or egregious misconduct, not mundane business decisions, for instance, whether some asset should have been sold, would come up before the court.

One likely dispute may involve creditors' belief that the firm could pay out more cash faster. Cash is often needed to operate, or even expand, the business. While unlikely, some owners may accumulate a cash horde needlessly, but having the judge adjudicate this contingency would tie the courts and the parties involved into endless knots. Such fears are easily exaggerated: owners, eager to operate unfettered by the rules of the ACCORD, may discharge their debts sooner rather than later. Having interest at specified rates accrue on deferred debts, and automatically liquidating the firm

4. As the requisite supermajority needed for any cramdown under conventional bankruptcy has approved both the plan and the decision to enter the ACCORD scheme, this can be made binding on the dissenters.

5. Depending on the company law, a shareholder meeting may have to ratify the management decision to undertake ACCORD. This protects the board of directors and managers against subsequent shareholder suits (although few countries are as litigious as the United States).

Box 5.1. *Details of the Auction Procedure*

Bidding

Creditors submit bids in double envelopes to the recorder, who opens only the outer envelope. The envelope contains (a) a slip with only the bidder's name, address, and so on; and (b) another sealed envelope containing the bid, which the recorder does not open. The outside of this inner envelope and the accompanying slip contain the claim's priority and face value.

The recorder generates a unique identifying code and stamps it on the outside of the inner envelope (which does not otherwise identify the creditor) and on the accompanying slip. The recorder notes this code in his or her own records, with the bidder's name and face value of the claim and, knowing the list of original claims, also ensures that no bids are submitted in excess of what is owed. If the amount that has been (cumulatively) bid exceeds what the creditor is owned, the bid is rejected; if not, each bidder gets the slip back immediately as proof of the bid (it has each bidder's name and identifying code).

Creditors may submit multiple envelopes, perhaps bidding different reductions for different face values, or just splitting the bid to hide their identity (because the list of original claims is publicly known).

When the date for accepting bids ends, the recorder also submits envelopes on behalf of creditors who did not bid (an identifying code and amount outside with a zero reduction bid inside). There are therefore sealed envelopes totaling the aggregate claims outstanding (publicly known), and all these unopened inner envelopes are passed on to the ACCORDer on the date when bids are opened.

Opening the Bids

On the appointed day, the ACCORDer opens the sealed inner envelopes in public and reads out the identifying code, the face value of the claim, and the proportionate reduction bid. The aggregate reduction in the debt could be immediately calculated and announced. Each creditor can verify that his or her bid has not been tampered with, his or her position in the line, and (if the creditor keeps track of all bids) the (reduced) amount owed ahead of (and behind) the creditor. However, because of the identifying codes, the creditor does not know the true identity of those ahead or behind, nor how much any other creditor forgave, thereby making bid collusion difficult.

The ACCORDer knows those in line by their identifying codes, but not their true identities. The recorder (who is not present at the opening) knows the creditor identity of each code and the aggregate auction result (public information), but not what each creditor forgave. The firm (the owner) knows the original claims of each creditor and the aggregate reduction in debt, but does not know where any creditor is in line or the individual amounts of the deferred (or reduced) claims.

The ACCORDer sends a written confirmation of each bidder's result in a sealed envelope, with the identifying code outside, to the recorder by the end of the day, and the recorder forwards it to the creditor within another three days.

Periodic Payments

The firm places periodic payments into an escrow account (which the recorder administers) and informs the ACCORDer. When told the cash balance, the ACCORDer tells

(box continues on following page)

Box 5.1 continued

the recorder whom (identifying code) to pay and how much. (Only then does the recorder discover the bid amount.) In addition to paying the amounts promptly, the ACCORDer sends all creditors a quarterly statement of how much (face value) is still outstanding ahead of them, so they know how the line is moving.

Secondary Market

The deferred claims are transferable, but as they are not uniform, trading will only be sporadic with negotiated rather than quoted prices. The latest quarterly update forms the basis for the price, but a trade requires the seller to register the change in the claim ownership with the recorder. The secondary trade does not concern the ACCORDer or the firm.

if the (reduced) debts have not been fully discharged by the end of the specified five years, may provide sufficient incentives.[6] (Liquidation, too, could be accomplished by auction, with the owners and creditors free to bid.) Regardless of their position in the line, however, creditors may trade their claims at any time, as well as cash in their claims, albeit at a price different from their reduced claim.[7]

While firms may not distribute cash (except to the head of the creditor line as specified under ACCORD), they are free to raise additional funds through asset sales, new equity, or borrowings. These new claims cannot come ahead of existing claims and may not be serviced before full discharge of all the deferred claims outstanding. Any new equity would be in the same class as the old equity (at the very end of the line), but a new loan would come after all other loans (although ahead of the equity). This differs from conventional bankruptcy filing, in which new loans come before prefiling loans, because the old creditors have already reduced their claims.

Putting new borrowings at the back of the creditor line would not be detrimental to the continued operations of the firm or disadvantageous to

6. Interest accrual does not benefit creditors per se, as the bids compensate for this, but if interest did not accrue, firms would have an incentive to accumulate cash and only pay just before the five-year deadline to avoid liquidation. It is not onerous for the ACCORDer to calculate interest, which must be near market rates, permitting loans in foreign currency to accrue interest at a different rate. The automatic liquidation clause protects creditors against the firm accumulating cash surpluses (which may have genuine business reasons) instead of discharging the (reduced) debts.

7. When they do trade, they must inform the auditor so the check can be sent to the correct claimant, but neither the firm nor the court need be informed.

the new creditor, because the firm is not obligated to make any cash payment. Thus, its ability to finance its continued operations is considerably greater. The firm may also discharge all its outstanding debts at any time, so if the new lenders or investors find the restrictions onerous, the firm could use the proceeds to discharge the outstanding debts to the deferred creditors and operate unfettered by the ACCORD rules.

Additional Considerations

It appears initially that ACCORD hurts creditors by reducing their debts without giving them an equity stake or curtailing the owners' control. Despite laws, however, creditors are already hurt because they have little legal protection, and in most countries seem unable to seize control of the firm if they wanted to (though not all creditors seek this alternative). Offering ACCORD as an additional alternative to the status quo could therefore only benefit creditors, whose consent is still needed. ACCORD would only be used in the case of a Pareto improvement. That remains possible if the transaction costs, with the inevitable but wasteful threats, bluffs, and other inefficiencies of multiparty negotiations are reduced, or if increased efficiency results from eliminating the corporate debt overhang. The following section anticipates and answers some questions about the ACCORD scheme.

Preexisting Seniority of Claims

While ACCORD is best explained by beginning with creditors of equal initial seniority jockeying through their bids to become more senior, that is, to get ahead of other creditors in the line, the scheme can easily handle a preexisting hierarchy of claims by having an auction for each class.

A hierarchy of existing claims simply means that a creditor line already exists—albeit one that only applies to the distribution of liquidation proceeds. The scheme could nevertheless respect this priority of creditor classes when the new line gets formed: claimants could only bid for their relative positions within their class or segment of the creditor line. Thus, no matter how much a junior creditor forgives, that creditor could never get ahead of a senior creditor. As before, payments go only to the head of the line—that senior creditor who forgave the greatest proportion—and the line moves up. All the senior creditors are paid before any of the original junior creditors receive anything; however, within the class of senior creditors, the one who forgives the greatest proportion is paid before the others.

ACCORD begins with the most senior class of creditors, asking each of them to bid a level of forgiveness. The new aggregate debt level of this senior class is then publicly announced, after which the next most senior class bids, and so on until the lowest creditor class bids, knowing the new (reduced) aggregate debt senior to them. The analysis follows closely the discussion under the above heading "The Proposed ACCORD." Specifically, if the more senior classes are certain to be paid, that is, the range of possible firm values is such that they incur no uncertainty, they will forgive no part of their claims. Only when payment is uncertain for any creditor class will they offer to forgive, but as each will try to move ahead in that segment of the creditor line, they would forgive enough to leave a residual value to the class below them. This residual diminishes for every subsequent creditor class, but continues down to the owners, producing the desired outcome.

What if Forgiveness Were Insufficient?

While ACCORD reduces debts, no guarantee exists that subsequent cash flows will prove sufficient. This commonly occurs in conventional bankruptcy. Gilson (1997) reports that one-quarter to one-third of financially distressed firms that reorganize experience financial distress again within a few years. The expectation of another opportunity to reorganize could alter bidding strategies: creditors would bid a smaller forgiveness, thereby increasing the likelihood of subsequent bankruptcy. However, creditors realize that such uncertainty is detrimental to the firm and to the value of their claim, so they may bid more aggressive forgiveness.

Owner/Manager Effort

The ACCORD scheme results in creditors giving owners some residual value (they forgive more than seems absolutely necessary), but conventional financial reorganization under Chapter 11 also has this feature. Such seemingly "excessive" forgiveness provides the owner/managers with the incentive to operate the firm efficiently, especially when creditors are unable to closely oversee them.

If, as seems reasonable, owner/managers' effort is an increasing function of their residual return, more forgiveness does not just mean a smaller slice of the pie for creditors, but a smaller slice of a larger pie. The pie gets larger because, with the restoration of managerial incentives, managers operate the firm better. The assumption decrees that because creditors forgive less with Chapter 11, the owner/managers' effort remains lower, reducing the likelihood of creditors being repaid.

Government-Creditor and Noncompetitive Bids

Many East Asian governments now hold, directly or indirectly, substantial claims against financially distressed private firms. The governments have either taken over or substantially control the domestic banks whose nonperforming loans far exceed their capital. Banks' claims on private, financially distressed firms, whether residing in the intervened banks, bank restructuring agencies, or asset management companies, are substantial, but they may be influenced by the governments, or by various regulatory rules on capital and/or provisioning. While such government agents could bid like other creditors, given their size and vulnerability to making politically motivated bids, this chapter argues that they not be allowed to; instead, these claims should be reduced by the weighted average of the other bids.[8] Such noncompetitive bids (to use the misleading term derived from the auction for U.S. Treasury bills) would avoid politicizing the auction, and may also be permitted for other small creditors who may be at an informational disadvantage.

Nonparticipating Creditors

If a creditor fails to bid, one response would interpret this as a refusal to forgive and place the creditor at the end of the relevant segment of the line. Knowing this, other creditors would be emboldened to forgive less, because they would be certain to be ahead of the inactive creditor. Depending on the number of nonbidders, the result might be insufficient reduction in the aggregate debts of the firm. Of course, this imposes a penalty on those who did not participate and now find themselves at the back of the line with the firm's debt level difficult to sustain, possibly motivating their participation.

An alternative would treat nonbidders like the noncompetitive bidders, and reduce their claims by the weighted average forgiveness. While this

8. It could also be that the government's claims and positions in line are assigned to match perfectly the proportionate reductions and positions in line of the other creditors. Thus, rather than the government's claims appearing as a bulge in the middle of the queue, its claims could be uniformly spread over the queue.

may be reasonable, it might increase the incentive to corrupt the auction process by providing an incentive for bids "to go missing."

Conclusion

A common question posed in response to an unusual solution is "Has it been done before?" Some may find the absence of a precedent disconcerting. Systemic bankruptcy on the East Asian scale is unprecedented, and tailor-made solutions obviously cannot have been tried elsewhere. While the proposed ACCORD now only exists as an idea, auctions of analogous importance and complexity are increasingly widespread. In 1996 the U.S. Federal Communications Commission auctioned part of the spectrum suitable for cellular telephone use.

Besides its theoretical attraction, auction-based schemes such as ACCORD prevent politics and venal courts from distorting the renegotiations of debt. East Asian governments and courts already have a reputation for being susceptible to the influence of powerful and wealthy business interests. With taxpayers bearing much of the losses through the government guarantee of banking deposits, some of the well-connected debtors may enjoy an unwarranted reduction in debts in negotiations with government agents; for example, the asset management companies or bank restructuring agencies that hold the claims. Even if this does not prove to be the case, the fear of such an accusation would stymie any bureaucrat negotiating unpaid claims. An auction protects the honest civil servant, because the government-controlled claims could be reduced by the weighted average of other bids. The ACCORD dispenses with a complex bureaucracy, and the auction could be conducted either by or outside the bankruptcy courts.

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