

Going Bankrupt in the World

By Sam Vaknin, Ph.D.

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It all starts by defaulting on an obligation: Money owed to creditors or to suppliers is not paid on time, interest payments due on bank loans or on corporate bonds issued to the public are withheld. It may be a temporary problem - or a permanent one.

As time goes by, the creditors gear up and litigate in a court of law or in a court of arbitration. This is a technical or equity insolvency status.

But this is not the only way that a company can be rendered insolvent. It could also run liabilities which will outweigh its assets. This is bankruptcy insolvency. True, there is a debate raging as to what is the best method to appraise the assets and the liabilities. Should these appraisals be based on market prices - or on book value?

There is not one decisive answer. In most cases, there is strong reliance on the figures in the balance sheet.

If the negotiations with the creditors of the company (as to how to settle the dispute arising from the company's default) fails, the company itself can file (=ask the court) for bankruptcy in a "voluntary bankruptcy filing".

Enter the court. It is only one player (albeit, the most important one) in this unfolding, complex drama. The court does not participate directly in the script. To say its lines - court officials are appointed. They work hand in hand with the representatives of the creditors (mostly lawyers) and with the management and the owners of the defunct company.

They face a tough decision: should they liquidate the company? In other words, should they terminate its business life by (among other things) selling its assets?

The proceeds of the sale of the assets is divided (as "bankruptcy dividend") among the creditors. It makes sense to choose this route only if the (money) value generated by liquidation exceeds the (money) the company as a going concern, as a living, functioning, entity.

The company can, thus, go into "straight bankruptcy". The secured creditors will receive the value of the property which was used to secure their debt (the "collateral", or the "mortgage, lien"). Sometimes, they will receive the property itself - if it not easy to

liquidate (=sell) it.

Once the assets of the company are sold, the first to be fully paid off will be the secured creditors. Only then will the priority creditors be paid (wholly or partially).

The priority creditors include administrative debts, unpaid wages (up to a given limit per worker), uninsured pension claims, taxes, rents, etc.

And only if there is any money left after all these payments, it will be proportionally doled out to the unsecured creditors.

The USA had many versions of its bankruptcy laws. There was the 1938 Bankruptcy Act, which was followed by amended versions in 1978, 1984 and, lately, in 1994.

Each state has modified the Federal Law to fit its special, local conditions.

Still, a few things - the spirit of the Law and its philosophy are common to all the versions. Arguably, the most famous procedure is named after the chapter in the law in which it is described, Chapter 11. Following is a small discussion of chapter 11 intended to demonstrate this spirit and this philosophy.

This chapter allows for a mechanism called "reorganization". It must be approved by two thirds of all classes of creditors and then, again, it could be voluntary (initiated by the company) or involuntary (initiated by one to three of its creditors).

The American legislator set the following goals, in writing the bankruptcy laws:

To provide a fair and equitable treatment to the holders of various classes of securities of the firm (shares of different kinds and bonds of different types)

To eliminate burdensome debt obligations, which obstruct the proper functioning of the firm and hinder its chances to recover and ever repay its debts to its creditors.

To make sure that new claims received by the creditors (instead of the old, discredited, ones) equal, at least, to what they would have received in liquidation.

Examples of such new claims: owners of debentures of the firm can receive, instead, new, long term bonds (known as reorganization bonds, whose interest is payable only from profits).

Owners of subordinated debentures will, probably, become stockholders and stockholders in the insolvent firm will receive no new claims.

The chapter dealing with reorganization (the famous "Chapter 11") allows for "Arrangements" to be made between debtor and creditors: an extension or reduction of the debts.

If the company is traded in a stock exchange, the Securities and Exchange Commission (SEC) of the USA advises the court as to the best procedure to adopt in case of

reorganization.

What chapter 11 teaches us is that:

The American Law leans in favour of maintaining the company as a going concern. A whole is larger than the sum of its parts - and a living business is worth more than the sum of its assets, sold separately.

A more in-depth study of the bankruptcy laws shows that they allow for three ways to tackle a state of malignant insolvency which threatens the well being and the continued functioning of the firm:

Chapter 7 (1978 Act) - liquidation

A District court appoints an "interim trustee" with broad powers. Such a trustee can also be appointed at the request of the creditors and by them.

The Interim Trustee is empowered to do the following:

liquidate property and make distribution of liquidating dividends to creditors

make management changes

arrange unsecured financing for the firm

operate the debtor business to prevent further losses

By filing a bond, the debtor (really, the owners of the debtor) is able to regain possession of the business from the trustee.

Chapter 11 - reorganization

Unless the court rules otherwise, the debtor remains in possession and in control of the business and the debtor and the creditors allowed to work together flexibly. They are encouraged to reach a settlement by compromise and agreement rather than by court adjudication.

Maybe the biggest legal revolution embedded in chapter 11 is the relaxation of the ages old ABSOLUTE PRIORITY rule, that says that the claims of creditors have categorical precedence over ownership claims. From now on, the interests of the creditors have to be balanced with the interests of the owners and even with the larger good of the community and society at large.

And so, chapter 11 allows the debtor and creditors to be in direct touch, to negotiate payment schedules, the restructuring of old debts, even the granting of new loans by the same disaffected creditors to the same irresponsible debtor.

Chapter 10

Is sort of a legal hybrid, the offspring of chapters 7 and 11:

It allows for reorganization under court appointed independent manager (trustee) who is responsible mainly for the filing of reorganization plans with the court - and for verifying strict adherence to them by both debtor and creditors.

Despite its clarity and business orientation, many countries found it difficult to adopt to the pragmatic, no sentiments approach which led to the virtual elimination of the absolute priority rule.

In England, for instance, the court appoints an official "receiver" to manage the business and to realize the debtor's assets on behalf of the creditors (and also of the owners). His main task is to maximize the proceeds of the liquidation and he continues to function until a court settlement is decreed (or a creditor settlement is reached, prior to adjudication). When this happens, the receivership ends and the receiver loses his status.

The receiver takes possession (but not title) of the assets and the affairs of a business in receivership. He collects rents and other income on behalf of the firm.

So, British Law is much more in favour of the creditors. It recognizes the supremacy of their claims over the property claims of the owners. Honouring obligations - in the eyes of the British legislator and their courts - is the cornerstone of efficient, thriving markets. The courts are entrusted with the protection of this moral pillar of the economy.

Economies in transition were in transition not only economically - but also legally. Thus, each one adopted its own version of the bankruptcy laws.

In Hungary - Bankruptcy is automatically triggered. It is not allowed to swap debt for equity. Moreover, the law provides for a very short time to reach agreement with creditors about reorganization of the debtor. These features led to 4000 bankruptcies in the wake of the new law - a number which mushroomed to 30,000 by 5/97.

In the Czech Republic- the insolvency law comprises special cases (over indebtedness, for instance ...). It delineates two rescue programs:

A Debt to Equity Swap (an alternative to bankruptcy) supervised by the Ministry of Privatization.

The Consolidation Bank (founded by the State) can buy a firm's obligations if it went bankrupt at 60% of par.

But the law itself is toothless and lackadaisically applied by the incestuous web of institutions in the country. Between 3/93 - 9/93 there were 1000 filings for insolvency, which resulted in only 30 commenced bankruptcy procedures. There hasn't been a single major bankruptcy in the Czech Republic since then - and not for lack of candidates.

Poland is a special case, always pitting horses against tanks, always losing the war, as

a result. The pre-war (1934) law declares bankruptcy when confronted with a state of lasting illiquidity and excessive indebtedness. Each creditor can apply to declare a company bankrupt. An insolvent company is obliged to file a maximum of 2 weeks following cessation of debt payment. There is, indeed, a separate liquidation law which Allows for voluntary procedures.

Bad debts are transferred to base portfolios and have one of three fates:

Reorganization, debt-consolidation (a reduction of the debts, new terms, debt for equity swaps) and a program of rehabilitation.

Sale of the corporate liabilities in auctions

Classic bankruptcy (happens in 23% of the cases of insolvency).

No one is certain what is the best model. The reason is that someone has yet to come with answers to the questions: are the rights of the creditors superior to the rights of the owners? Is it better to rehabilitate than to liquidate?

Until such time as these questions are answered and as long as the microeconomic debt crisis deepens -we will witness a flowering of versions of bankruptcy laws all over the world.

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Is America Bankrupt?

By Liron Rose

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The US Dollar has been falling continuously in last year. The Euro, not so long ago worth 82 cents, is now at \$1.27 - this is a gain of more than 40 percent in a very short time. The same goes for the Aussie Dollar: from 50 US cents to 77 US cents (that's almost 50 percent up). Gold, which was trading at less than \$300 per ounce for years, is now long past the \$400 mark. What is happening to the greenback?

I had this interesting conversation with a gourmet coffee vendor at the Sydney Airport. Originally from Afghanistan, he arrived in Australia some 20 years ago. He is very aware to what is not been told by the mainstream media. He argues that the US is practically bankrupt - too much debt owed to foreign nations, and no means (but greenbacks) to pay back. American industry? Well - the orders are not pouring in and unemployment is on a steep rise, the jobs are just not there. Ask any unemployed person how tough it is to get a job, any job in America these days.

So - he argues - US does what empires always did - go for conquest. This hasn't changed since the Spanish and the English did the same centuries ago. Seek out and conquer far lands for their precious treasures / assets. So now the US is control of the Iraqi oil - Oil is a real commodity - with intrinsic value, supply limited by nature (unlike paper money which can be printed) and can be sold on the open market at the going price.

Furthermore, Iraq's infrastructure was destroyed by the war. Someone is going to rebuild it - you guessed right - corporate America , all paid for by the Iraqi Oil.

Conquest, or treasure hunt, so it seems, is a good medicine to America's disease. Unfortunately there's not enough of it yet under control to overcome the illness, hence the patient is still sick, dollar falls.

Last weekend they finally captured Saddam Hussein.

The question is - can they repeat the trick again? Where can they find more of the medicine ? Who is next in line?

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