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# Strategically Surviving Bankruptcy during a Global Financial Crisis: The Importance of Understanding Chapter 15 ☆

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A B S T R A C T

Chapter 15 of the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act allows foreign courts more power in cases that include foreign multinational firms. U.S. businesses unexpectedly have to file a claim in another country with bankruptcy rules that are sometimes drastically different from those in U.S. courts. This paper outlines the different bankruptcy laws in selected countries and exemplifies how some countries place U.S. creditors at a disadvantage relative to employees and stockholders. This knowledge should be incorporated into management's strategic contingency plans in the case of supplier or business customer default. During periods of global financial instability such as the 2008 financial crisis, an understanding of Chapter 15 is essential.



## 1. Introduction

The recent economic crisis is the first major Global Economic Management Disaster of the 21$^{st}$ century according to Ivashina and Sharfstein (2010). The Euro fund's European Restructuring Monitoring reports the number of bankruptcies peaked in many countries in 2008 and 2009 as the global recession spread. For example, in Denmark, commercial firms filed 85% more bankruptcies in 2008 and in Belgium 239% more firms filed for bankruptcy in 2009. The global crisis is a major reason for these filings.

Sachs (1995) calls for the formation of an international bankruptcy court to reduce global financial instability. Due to the global financial crisis of 2007–2009, numerous countries' economies plummeted into a severe recession, destabilizing firms within a cross-section of industries and, thus, increasing bankruptcy filings (Ivashina & Sharfstein, 2010; Schwartz, 2009). Therefore, management's contingency turnaround plans rest on a strategic knowledge of bankruptcy laws. In particular, bankruptcy outcomes and decisions affect corporations' resources and their ability to repay domestic and international creditors. Yet, to date, few studies evaluate how the design of an international bankruptcy law affects turnaround strategies or a firm's decision to participate in a business relationship with a foreign firm.

What is Chapter 15's effect on firms' strategic managerial decisions (Beckett-Camarata, Camarata, & Barker, 1998; Berkovitch, Israel, & Zender, 1998; Bruton, Keels, & Scifres, 2002; Chowdhury & Lang, 1996; Evans & Green, 2000; Hambrik & D'Aveni, 1988; Lewin, 2003; Moulton & Thomas, 1993)? We encourage management and marketing scholars, as well as corporate executives, to understand the unexplored effect of global recession from the 2005 change in the U.S. bankruptcy code (Porter & Millar, 1985; Vasconcelos & Ramirez, 2011).

The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) codes and ordinances are the first attempt in the U.S. to internationalize the bankruptcy process (Chapter 15). The Chapter 15 code, section 304, allows foreign firms with assets in the U.S. to file in U.S. bankruptcy courts, while simultaneously giving jurisdiction to their home courts. Chapter 15 attempts to achieve a uniform and coordinated legal regime for cross-border insolvency cases and reduce inefficiency in the process with respect to international trade. The outcome should ideally make bankruptcy decisions more predictable. The code, however, is flawed because bankruptcy law across different countries is heterogeneous. For example, Sweden requires acquirers of bankrupt firms to rehire employees prior to paying off creditors, whereas the U.S. bankruptcy court does not give employees as high a priority. Coughtrie, Morley, and Ward (2009) describe several countries' bankruptcy regulations and report that local cultures dictate legal variations across countries.

This study provides a conceptual understanding of Chapter 15's impact on management's strategic decisions with respect to international business-to-business partnerships. During volatile periods that are often characterized by firm financial distress, corporations

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need to reassess their international business partnerships to sustain viability and strategic positioning in the industry in light of the Chapter 15 code. A U.S. firm's ability to collect on a contractual claim depends on the court and country with primary jurisdiction.

## 2. Strategy and the bankruptcy law

Fitting internal resources to the external constraints imposed by bankruptcy is a critical strategic issue requiring innovative thinking and transformational leadership (Wernerfelt, 1984). In the past, provisions to the 1978 Bankruptcy Reform Act only allowed international firms to file for either Chapter 7 or Chapter 11 in the U.S. bankruptcy court. In Chapter 7, the judge allows a trustee to liquidate the firm's assets. Alternatively, Chapter 11 frequently allows publicly traded firms to survive based upon a plan of reorganization.

Now, international firms that have a substantial presence in a foreign country are required to file for Chapter 15. Chapter 15 of the bankruptcy code governs the process for transnational companies, for both American corporations with international operations and foreign corporations with operations within the United States. Essentially, Chapter 15 is a universalist approach to dealing with bankruptcy since the proceedings often take place in the debtor's home country as well as in other countries where they have business operations. Chapter 15 is unique because the debtor can request that U.S. courts make distribution decisions or choose the court in a foreign country where the company's operations exist. The Model Law on Cross-Border Solvency of the United Nations Commission on International Trade Law (UNCITRAL) reinforces the concepts behind the implementation of Chapter 15.

This study describes how Chapter 15 affects U.S. and foreign domestic creditors for a sample of countries and how implementation of different bankruptcy codes directly affects a multinational corporation's strategic and risk policy decisions. For example, Chapter 15 allows the judge to dismiss a U.S filing to allow a foreign court to make the rulings, an option relevant to many stakeholders, such as unpaid employees and suppliers, as well as creditors, since country-specific regimes differ considerably in influencing behavioral-related incentives related to strategic decisions.

### *2.1. Bankruptcy codes*

In the following paragraphs, a synopsis of different regional bankruptcy codes from different countries exemplifies the importance of incorporating a country's bankruptcy code into a firm's strategic vision with respect to its international business-to-business relationships. This paper extends Coughtrie et al. 's (2009) study to include important emerging countries, such as China and India.

#### *2.1.1. Argentina*

Argentina has three insolvency proceedings: (1) formal reorganization, (2) out-of-court reorganization, and (3) liquidation. Similar to the U.S., the debtor must obtain majority approval for its reorganization plan or request the court to implement the plan despite creditor opposition. When a bankruptcy court does not approve a reorganization plan, the court opens a registry for five business days. During this time, any interested party can offer to purchase the equity of the debtor firm. This five-day registry period differs from the United States in the sense that piecemeal liquidation is not an option, even though from a creditor's perspective piecemeal liquidation may create a higher liquidation value than a distress sale to one buyer. Under these conditions, commercial relationship with distressed suppliers, buyers or distributors from Argentina during a global crisis will be limited.

#### *2.1.2. Brazil*

In Brazil, bankruptcy law is only applicable to private firms with notable exception related to financial institutions, credit cooperatives, consortia, supplementary entities, and society's operating health care plans. The bankruptcy code encompasses three legal proceedings, including a bankruptcy filing, a judicial recuperation that focuses on preserving the company, and an extrajudicial recuperation that promotes private negotiation between creditors and debtors. The third option (mediation) is not available in U.S. courts. The Brazilian code is optimal for U.S. creditors because it gives jurisdiction for publicly traded corporation bankruptcies to the U.S. courts.

#### *2.1.3. Canada*

The Canadian Companies' Creditors Arrangement Act (CCAA) is more flexible than the U.S. code. For example, a judge under CCAA may permit a sale of assets before the court gives a plan to creditors for approval. Amendments to the CCAA on September 18, 2009 codify this practice into law. The court can also give the Canadian business permission to borrow from a U.S. debtor-in-possession financier through a grid note secured by a court-ordered lien on Canadian assets. The law restricts the financier, often the parent company, from securing the entire value of Canadian assets to the detriment of unsecured Canadian creditors. From a U.S. business perspective, management would likely not want a partnership with a Canadian firm that goes bankrupt.

#### *2.1.4. China*

China's bankruptcy code applies to all legal entities, including foreign investment enterprises, but not individuals. The newest law gives secured claims priority over employee, tax, and general claims, in contrast to the previous code that gives workers the highest priority claim. This preference to secured claims over taxes is in contrast to the U.S. law. Since the new law applies to both Chinese multinationals and foreign firms operating in China, secured U.S. creditors benefit from Chapter 15. This change encourages firms to make China a strategic location for global commerce by allowing foreign creditors to pursue claims in an orderly fashion. Firms feel comfortable operating in legal jurisdictions where creditors' contractual rights are protected and domestic foreign firms do not have an advantage over U.S. firms with respect to the recovery of their claim or negotiation within the proceeding.

#### *2.1.5. India*

In India, the bankruptcy process can take a decade, even after a court declares a corporation insolvent. India does not have a clear law on corporate bankruptcy (1920 Provincial Insolvency Act). Consequently, an important strategic contingency within a business plan could be to sever relationships with financially weak Indian corporations.

#### *2.1.6. Ireland*

In Ireland, preliminary hearings take place before a main filing (pre-insolvency). An appointed administrator must file for bankruptcy.

#### *2.1.7. Estonia*

Instead of management, a court-appointed independent counselor devises a reorganization plan for the debtor firm instead of management. No exclusivity period where only management can file a plan of reorganization exists. Thus, the choice between liquidation and reorganization is the independent counselor's decision. This practice allows substantial discretion and uncertainty in strategic decision-making.

#### *2.1.8. Spain*

The incumbent management team remains in position if the firm files for bankruptcy and works with a court-appointed insolvency administration. An insolvency administration consists of a lawyer, auditor, and single creditor that represent the class of all creditors. Alternatively, if the creditor class makes an involuntary filing, the court transfers the management team to the insolvency administration, and a trustee operates the firm.