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Information problems, conflicts of interest, and asset stripping: Chapter 11's failure in the case of Eastern Airlines[1]

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Abstract

Eastern Airlines' bankruptcy illustrates the devastating effect on firm value of court-sponsored asset stripping, i.e., the use of creditors' collateral to invest in high-variance negative net present value projects. During its bankruptcy, Eastern's value dropped over 50%. A substantial portion of this value decline occurred because an overprotective court insulated Eastern from market forces and allowed value-destroying operations to continue long after it was clear that Eastern should have been shut down. The failure of Eastern's Chapter 11 demonstrates the importance of having a bankruptcy process that protects a distressed firm's assets, not simply from a run by creditors, but also from overly optimistic managers and misguided judges. © 1998 Elsevier Science S.A. All rights reserved.

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1. Introduction

When Eastern filed Chapter 11, its value was over $4 billion. During the Chapter 11 process, financial claimants lost an estimated $2 billion, or half of Eastern's pre-bankruptcy value. This paper examines the sources of this decline in value. Weak industry conditions prevailed during the period Eastern was in Chapter 11 and diminished the firm's performance. Our analysis, however, indicates that most of the $2 billion value decline cannot be attributed to industry conditions. Using clinical evidence obtained directly from parties involved in the bankruptcy, we show that information problems and conflicts of interest associated with the Chapter 11 process destroyed value (see Jensen and Meckling, 1976 and Wruck, 1990). We also show how these problems and conflicts make the outcome of Chapter 11 sensitive to a bankruptcy court judge's normative assessment of what should happen – in Eastern's case, Judge Burton Lifland's opinion that Eastern should keep flying for the sake of its customers and employees.

Following its Chapter 11 filing, information problems led to uncertainty about whether Eastern should be reorganized or shut down. Later, when it became apparent that the company was not economically viable, conflicts of interest between financial claimants and other stakeholders dominated the process. In an attempt to revive the airline, Lifland granted managers the right to use the proceeds of asset sales (technically held in escrow for creditors) to fund continued operations. In doing so, he undermined the claims of creditors through what amounted to court-sponsored asset stripping, that is, using creditors' collateral to invest in high-variance negative net present value projects (see Baldwin, 1993). Over a 22-month period, Eastern generated $1.3 billion in operating losses. We show that these losses represent the primary source of value decline.

Eastern Airlines' bankruptcy illustrates the counterproductive aspects of insulating a distressed firm from the realities of its economic situation. Rather than safeguarding assets against seizure by creditors, an overprotective court shielded Eastern from the reality of its weak route structure, high labor costs,

(footnote 1 continued)

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