Coalitions, the me-first rule, and the liquidation decision

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Conventional wisdom in economics recommends that a bankrupt firm with liquidation value greater than going-concern value be liquidated by the creditors and that a firm with going-concern value greater than liquidation value continue to operate. Recently, counterexamples to the traditional rule have been presented. This note argues that violation of the me-first rule is responsible for these counterexamples. Since violation of the me-first rule involves the absence of value-maximization on the part of some economic agents, economic theories concerned with rational behavior may justifiably still assume that the liquidation decision follows the traditional rule.

1. Introduction

■ Traditional wisdom in economics suggests that for value-maximizing creditors, liquidation of a firm in distress should take place when the firm's liquidation value is greater than its going-concern value; otherwise, the firm should remain in operation. This rule is simple and unambiguous. However, in a recent article in this *Journal*, Bulow and Shoven (B-S) (1978) introduced a coalition between the short-term creditors and the equityholders into their analysis and arrived at the conclusion that the liquidation decision is no longer unambiguous. Specifically, they demonstrated that a firm may liquidate (continue) its operation even when the going-concern value exceeds (is below) the liquidation value.

This note points out that it is the operation of the me-first rule rather than the formation of coalitions that affects the liquidation decision. When the me-first rule is observed, the traditional liquidation rule applies no matter what coalitions of the firm's claimants are formed.

2. The liquidation decision

■ The relationship among various classes of a firm's claimants is governed by contracts which normally have two components. The first component specifies the amounts and the priorities in distributing the firm's cashflows in

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future periods to the various claimants. The second protects against infringement on these amounts and the priority hierarchy. Fama and Miller (1972) termed the proper design of a contract to remove all possibilities of such infringement observance of the "me-first" rule. Therefore, a claimant protected by the me-first rule is one who has veto power over any change in the investment and financing policy of the firm that would make the value of his claim on the firm's cashflows after the change less than its value before the change. If all claimants are value maximizers, then the me-first rule should be assumed to hold in all transactions among claimants. By including the me-first rule in the analysis, the traditional liquidation rule may be properly qualified and restated as:

Proposition 1: When the me-first rule applies, the decision criterion for liquidation is whether or not liquidation value exceeds going-concern value.

Proof: Let the liquidation value, which is the sum of the values of all claims upon liquidation, be greater than the going-concern value, which is the sum of the values of all claims upon continuance. This implies that for at least one of the claimants, say A, liquidation value is greater than going-concern value. It also implies that even if liquidation implies a potential loss for the rest of the claimants, there is enough total incremental gain in liquidation for A to compensate the rest of the claimants so that they are as well off as in continuance and A is still better off in liquidation than in continuance. Under such circumstances, the me-first rule would dictate that A compensate the other claimants and the firm be liquidated. Otherwise, the me-first rule would be violated for A, since he would be subjected to a policy that reduces the value of his claims. Following the same line of reasoning for the case in which liquidation value is less than going-concern value, it is easy to show that the firm would continue to operate by compensating those who will potentially incur incremental losses under continuance.

Violation of the me-first rule means that a class of claimants or a coalition can legally enforce liquidation or continuation without the consent of all creditors. A class of claimants will do this only if it stands to gain incrementally from the decision. However, if the total value of the firm remains constant, such gains will have to be at the expense of the other claimants. When value can be shifted, it is not difficult to find situations in which a class of claimants or a coalition with the power at bankruptcy to take over all or more than its original share of the liquidation value of the firm finds that liquidation is preferable to continuation for the firm with going-concern value greater than liquidation value. Likewise, it is easy to construct situations in which a coalition that can at bankruptcy take over all or more than its original share of the firm's going-concern value finds that continuation of operation is preferable to liquidation, even if the total liquidation value of the firm is greater than its going-concern value. Thus, we have a proposition to explain the B-S counterexamples.

Proposition 2: When the me-first rule is not observed, the traditional liquidation rule does not apply.

It is easy to show that all the counterexamples to the traditional rule presented in B-S involve violations of the me-first rule. In their example A, the liquidation value was 480, while the going-concern value was 450. Thus, the traditional rule would dictate liquidation. B-S showed that if the bank increased its loan to the firm by 20, enabling the firm to pay 10 to the bondholders and keep the firm alive, the bank would gain. However, in the process, the value of the bondholders' claims will have decreased. Thus, counterexample *A* involves a violation of the me-first rule: any bail-out financing that would keep the firm alive would always decrease the value of the bondholders' claims.

B-S used counterexample *B* to show that if the bank forms a coalition with the equityholders, the coalition would choose to liquidate a firm with going-concern value greater than liquidation value. Since the bondholders' claims have been infringed upon, this should be possible as proposition 2 suggests. However, this particular example is unfortunate in that the rule is also violated as far as the bank is concerned, since the best alternative for the bank is to cooperate with the bondholders in extending the life of the firm (see Table 1). Then the me-first rule is not violated. Therefore, the example actually assumes that the bank is not a value-maximizer, since it allows a financial rearrangement that does not maximize the value of its own claims. The frequent postponement of debt servicing charges by long- and short-term creditors together shows that the coalition between bank and bondholders is possible. Thus, we have:

Corollary 2.1: Bail-out financing may affect the liquidation decision rule only if it violates the me-first rule.

Example *C* was used by B-S to show that cash balance could influence the liquidation decision, even though the balance is less than the total current debt charges. This time the me-first rule was not violated as far as the bondholders were concerned. They obtain more than what they would receive at liquidation. However, the bank's me-first rule would be violated because its claim would be less than it would receive if the cash balance (the cashflow from partial liquidation) were not disbursed. (See Table 1). Again, this would require that the bank not be a value-maximizer. Thus we have:

TABLE 1

A COMPARISON OF CLAIMANTS' RETURNS

<table>
<tr><th rowspan="2">EXAMPLE B</th><th colspan="2">VALUE OF CLAIMS</th><th rowspan="2">EXAMPLE C</th><th colspan="2">VALUE OF CLAIMS</th></tr>
<tr><th>BANK</th><th>BOND-HOLDERS</th><th>BANK</th><th>BOND-HOLDERS</th></tr>
<tr><td>(1) NO COALITION: LIQUIDATION</td><td>90</td><td>360</td><td>(1) NO COALITION: LIQUIDATION</td><td>90</td><td>360</td></tr>
<tr><td>(2) BANK AND EQUITYHOLDER COALITION: LIQUIDATION (VIOLATION OF ME-FIRST RULE)</td><td>90</td><td>360</td><td rowspan="2">(2) BANK AND EQUITYHOLDER COALITION: CONTINUANCE WITH BANK SUPPLYING BAILOUT FINANCING (VIOLATION OF ME-FIRST RULE)</td><td rowspan="2">104</td><td rowspan="2">436</td></tr>
<tr><td rowspan="2">(3) BANK AND BONDHOLDER COALITION: CONTINUANCE BY CARRY-FORWARD OF ALL CURRENT DEBT* (NO VIOLATION OF ME-FIRST RULE)
BANK LOAN: 135 + 27 = 162
BONDS: 54 + 108 + 432 = 594</td><td rowspan="2">119.7</td><td rowspan="2">412.5</td></tr>
<tr><td>(3) BANK AND BONDHOLDER COALITION: CONTINUANCE BY CARRY-FORWARD OF ALL CURRENT DEBT CHARGES AND NO DISBURSEMENT OF CASH* (NO VIOLATION OF ME-FIRST RULE)</td><td colspan="2">SAME AS (3) IN EXAMPLE B</td></tr>
<tr><td colspan="6">*NOTE THAT EQUITYHOLDERS ALSO RETAIN POSITIVE RESIDUAL VALUE OF 7.8 WITH CONTINUANCE.</td></tr>
</table>

Corollary 2.2: Cash balance at bankruptcy may affect the liquidation decision rule only if it is used to violate the me-first rule.

3. Taxes and mergers

■ If firms pay no taxes, then the impossibility of a merger that would affect the liquidation rule is easily shown. New partners will have to assume payment of all outstanding debts. Since, by definition of the bankrupt firm, the total value of the firm is less than the total debt outstanding, even if the new partners inherit the firm without compensating the old equityholders, the net value of the cashflows is still negative. Therefore, mergers that would affect the liquidation decision rule are possible only in the presence of taxes.

If there were no legal barriers to the assumption of all tax shields when mergers take place, then it would be possible to find cases where merger could keep alive a firm with liquidation value greater than going-concern value. These are instances when the accumulated tax deductions are large enough to offset the difference between the going-concern value of the firm and the total value of debt.

In our present tax system access to tax shields faces formidable legal barriers. (See Sections 269, 371, 382 of the U.S. Internal Revenue Code of 1954). First, the new partners have to prove to the tax courts that the merger has taken place for reasons other than the advantage generated by the tax shields. This is difficult to show when the bankrupt firm has large losses. However, large losses are necessary to produce the tax shields sufficiently sizable to offset the full payment of debt. Next, to carry all the tax losses forward, the equityholders of the bankrupt firm must own 40 percent of the resulting merged firm. Thus, even if the tax courts are persuaded, the old equityholders will have to find another firm that is willing to give up more than 40 percent of its equity value in exchange for the tax shields. The value given up in exchange is greater than 40 percent because the new partners will also have to pay the difference between the going-concern value of the bankrupt firm and the total value of its outstanding debt. Hence, we may conclude that it is not very often that merger and tax shields can be used to violate the traditional liquidation rule.

4. Conclusion

■ The results here support the traditional decision rule that creditors would liquidate a firm if and only if the going-concern value is less than the liquidation value. Contradiction of this rule could happen only if some of the firm's claimants were not value-maximizers. Under such circumstances, the me-first rule may be violated and the traditional liquidation rule may not hold. Coalition formation, bail-out financing, and firm liquidity are all shown to affect the liquidation decision only if they are used to violate the me-first rule. Last, we showed that the combined effect of taxes and merger on the liquidation decision is less than previously thought and may be insignificant.

If the me-first rule does not hold, we can obtain far more important results than the altering of the liquidation decision. For example, relaxation of the me-first rule could be used to repudiate the long-standing irrelevance theories of debt and dividend decisions (Modigliani and Miller, 1958; Miller and Modigliani, 1961). Since violation of the me-first rule assumes the absence of value maximization on the part of some claimants, rational theories of economic behavior may still be developed by assuming that the traditional liquidation rule holds.

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