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The Social Cost of Fraud and Bankruptcy

by Joseph Bower and Stuart Gilson

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Following one of the most complicated and closely watched corporate reorganizations in the history of U.S. bankruptcy law, WorldCom is now poised to emerge from Chapter 11 with a confirmed reorganization plan. A beneficiary of laws meant to preserve sound companies in temporary distress, WorldCom stands to gain undeserved advantage from its misdeeds. The firm—once greatly admired as the low-cost price setter in the hypercompetitive telecommunications industry—was in reality an elaborate work of fiction. Through fraudulent underreporting of operating expenses, the company concealed losses of more than \$12 billion from public view.

The costs of the deception and of cleaning up the mess have also been staggeringly high to the industry as a whole. Unable to match WorldCom's low cost structure and aggressive pricing, competitors were forced to drastically cut expenditures by sacking thousands of employees. Top managers are reported to have suffered the same fate because they couldn't match WorldCom's high reported profit margins. A crude estimate suggests that if WorldCom had priced so as to earn what it reported, the industry could have yielded an extra \$40 billion in revenue and commensurate profit. And the bankruptcy itself has been litigious and costly. Professionals' fees and other administrative expenses incurred in Chapter 11 will probably be in the hundreds of millions of dollars. Additional losses—just as real but unrecorded—have resulted from the distraction and dislocation of the company's business.

Ironically—some might say, perversely—the new WorldCom (to be known as MCI) will come out of Chapter 11 as a formidable competitor, this time for real. Under U.S. law, the goal of bankruptcy is to protect the underlying business and give the company every reasonable chance to succeed once it achieves a financial settlement with its creditors. While a company is in Chapter 11, it does not have to pay (or, in most cases, even accrue) interest on its debt. It can abrogate its lease contracts or use the threat of such abrogation to obtain fi-

ancial concessions from lessors. (United Airlines is said to have reduced its aircraft lease payments by 50% in this way.) Chapter 11 also gives the company access to new financing by giving new lenders priority over existing debt. WorldCom has written down \$74 billion in assets and \$42 billion in debt, leaving it with little interest, negligible depreciation, and a claimed operating loss carryforward of \$7 billion to deduct from any future income tax bills. Its earnings will not be burdened by heavy interest or depreciation. Nor, if its claim is upheld, will it pay taxes in the near future.

The merits of this long-standing approach are clear. In principle, it provides greater value for all the firm's stakeholders—not only creditors but also vendors, employees, and shareholders. Keeping a business on track, when it is fundamentally sound but suffering a temporary financial setback, ultimately improves economic resource allocation and provides more value for all of society. The system also implicitly encourages businesses to take more informed and legitimate risks—compared, say, with a system in which failed firms are automatically shut down. Indeed, for these reasons, a growing number of countries have modeled their bankruptcy laws after Chapter 11 in recent years.

WorldCom's bankruptcy, however, highlights an important, potentially very large social cost of the U.S. bankruptcy system. Competing telecom firms, which have played by the accounting rules and have used more prudent financing, now find themselves—once again—at a competitive disadvantage relative to the company. Unlike WorldCom, these firms had to stay current on their debt and service their lease obligations. They did not get to write down their assets and debt, nor have they been able to reduce taxes by claiming that their profits never existed.


Is this fair? Do the benefits of the system outweigh its costs? The system works well to protect assets and employees, to be sure. But are WorldCom's assets and employees really the ones that should be protected? What about

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those of more efficient firms? In capital-intensive industries like petrochemicals, steel, telecoms, and airlines, doesn't bankruptcy law make it harder for efficient *companies* to drive inefficient *assets* out of business? In the majority of bankruptcy cases in these industries, the top managers are gone, but old capacity returns to the market with an improved balance sheet. This can easily prolong a period of industrywide overcapacity as well as unfairly disadvantage competitors. In steel, for example, LTV returned from its first bankruptcy in 1993 stronger but inefficient, adding to the hyper-competitive conditions in the U.S. steel business and weakening Bethlehem, National, and others. Emerging from its second bankruptcy, LTV shed its legacy costs and is now one of the two lowest-cost integrated producers in the United States. Renamed ISG, it purchased Bethlehem in 2003. Maybe such outcomes make good economic sense. But when bankruptcy results from corporate fraud, the message is troubling: If your company gains competitive advantage by deliberately misrepresenting its financial condition, it will effectively go unpunished in the capital markets.

And what about the fraud? Six different investigations of tax and pricing fraud are ongoing; the cases are far from trial. Key managers

who profited mightily haven't yet been brought to account. Is it fair that the managers and the company that tormented competitors with illegal accounting are brought back to compete with legal but artificial economics before their accounting statements and their legal problems are settled?

Bankruptcy laws are designed to deal with a single firm's isolated problems. But giant firms like WorldCom affect the prosperity of giant competitors like AT&T and Sprint, as well as vendors, customers, and communities. It is far from obvious that a rapid emergence from bankruptcy for WorldCom represents good economic or social policy. And it is even less obvious that laws designed in simpler times, when fraud was not rampant, make good sense in every case today. 

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