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AMERICAN COMPASS

Pro-Worker Bankruptcy Reform

PUT WORKERS AHEAD OF WALL STREET WHEN FIRMS GO BANKRUPT

WHAT'S THE PROBLEM?

Financial markets push firms to assume excessive risk in pursuit of higher rewards.

While investors can spread their risk across hundreds of firms, **employees and communities face catastrophic failure** if their particular firms go bust.

Corporate debt loads now stand **at all-time highs** and private equity firms are sitting on record levels of deal-making cash, which they are using for **ever-riskier transactions**.

Bankruptcies expose workers and local communities to severe economic harms by destroying jobs, reducing wages, and devastating local tax bases.

DIVORCING RISK AND REWARD

Capitalism presumes that shareholders, managers, and workers have a shared interest in the solvency of their businesses. But as institutional investors and private equity firms have assumed ownership, investor risk has diffused.

The U.S. financial sector now tolerates the collapse of some firms in exchange for greater returns from others—making risky, highly leveraged investment strategies more attractive. Private equity represents an extreme case, routinely saddling acquired businesses with enormous debts that increase potential returns but also dramatically increase the likelihood of bankruptcy.

This strategy is rational for investors, who spread their bets across many firms, but it imposes high risks on workers and communities, who suffer only the downside. Yet when a bankruptcy does occur, the law places the creditors who enabled the reckless behavior first in line to recover what they can.

WHAT'S THE SOLUTION?

Policymakers should reform the bankruptcy code to establish primary financial obligations to workers, local communities, and suppliers that are paid first in the event of a bankruptcy:

1. **Six months' salary for all workers laid off in advance of or during a Chapter 11 reorganization** *(corporate officers excluded)*
2. **Six months' salary for all workers in the event of a Chapter 7 liquidation** *(corporate officers excluded)*
3. **One year's tax liability in each domestic locality where a business operates**
4. **Claims of suppliers and customers concerning goods and services already contracted**

RESTORING A HEALTHY MARKET

These reforms will better align the risks facing investors with the rewards they pursue. Making investor recovery in bankruptcy more difficult will increase the potential costs of bankruptcy and of financing risky strategies, promoting more responsible investor behavior.

When bankruptcy does occur, **these reforms will also reduce the hardships faced by workers and communities and compensate them for the risks imposed upon them.**

FREQUENTLY RAISED OBJECTIONS

"GOVERNMENT SHOULDN'T INTERFERE IN THE FREE MARKET"

Bankruptcy court is not a free market, it is an institution created by policymakers to resolve claims when debts cannot be repaid—something all parties accept when they make deals in the first place. How to allocate a bankrupt firm's assets is a policy choice, which should be made in the interests of fairness and well-functioning markets.

"INVESTORS WILL EASILY EVADE THESE OBLIGATIONS"

Equity holders and creditors will surely try, but that concern holds for every effort to resolve claims in bankruptcy, which is why the process operates under the control of a judge tasked with making fact-specific and equitable determinations.

"WE NEED INVESTORS WILLING TO TAKE BIG FINANCIAL RISKS"

Big financial risks can be good, but careless ones are not. If a transaction's biggest risks are borne by third parties (e.g., workers) that have no say and no stake in the upside, then the market is broken, risk-taking will be excessive, and outcomes will be poor.

FURTHER READING

John Graham, Hyunseob Kim, Si Li, & Jiaping Qiu. "Employee Costs of Corporate Bankruptcy." *Federal Reserve Bank of Chicago,* 2022.
An academic assessment of the economic damage an employer's bankruptcy causes to its workers.

Oren Cass. "Confronting Coin-Flip Capitalism." *American Compass,* 2021.
A pro-market agenda for financial reform that includes this bankruptcy reform proposal.

"A Guide to Private Equity." *American Compass,* 2021.
An in-depth exploration of the private equity industry: how it works, its poor performance, and its increasing risk.

Deborah D'Souza. "Foreign Investors Have Been Big U.S. Stock Buyers." *Investopedia,* 2020.
A helpful description of the shift in corporate ownership from U.S. households to institutional investors over time.

KEY FACTS

>90% U.S. corporate equity market held by American households in 1945[1]

34% U.S. corporate equity market held by American households in 2020[2]

10X increase in bankruptcy risk after private equity acquisition[3]

13% average wage loss for a worker in the year their employer files for bankruptcy[4]

87% of pre-bankruptcy annual earnings: the average present value of a worker's lost earnings over the six years following their employer's bankruptcy[5]

ABOUT AMERICAN COMPASS

Our mission is to restore an economic consensus that emphasizes the importance of family, community, and industry to the nation's liberty and prosperity. American Compass is a 501(c)(3) non-profit organization.

For more information, visit americancompass.org

[1] Ben Eisen. "Households Own More of the Stock Market These Days." *The Wall Street Journal*, 2016.
[2] Deborah D'Souza. "Foreign Investors Have Been Big U.S. Stock Buyers." *Investopedia*, 2020.
[3] "A Guide to Private Equity." *American Compass*, 2021.
[4] John Graham, Hyunseob Kim, Si Li, & Jiaping Qiu. "Employee Costs of Corporate Bankruptcy." *Federal Reserve Bank of Chicago*, 2022.
[5] *Ibid.*