



Center for Social & Economic Research

**The Economics of
Bankruptcy,
Reorganisation and
Liquidation:
Lessons for
East European Transitional Economies**

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I. Introduction¹

Entry and exit are fundamental underpinnings of the competitive process. They ensure that a sufficient number of firms remain in an industry, and produce efficiently, in order to satisfy the market demand at a competitive price. Moreover, entry and exit need not be in the form of firms actually appearing on, or departing from, the industry scene. They may well be in the form of an increase or a reduction in the volume of activities and the volume of resources engaged in the production process, or a change in the type of activity. The competitive process results in the flow of resources into efficient units and out of inefficient ones - a process which may also be interpreted as 'entry' and 'exit'. A contraction of demand for some products, for example, should lead to either the exit of resources from some of the production units, or the closure of some plants, in an industry. With modern large scale corporations the exit process is, most often, characterised by a reorganisation of resources- their withdrawal from some, and flow into other, activities. In this sense market economies can be characterised by an almost permanent flow of resources out of old, inefficient activities and into new ones. Only in a small number of cases, and generally rarely, is the exit of resources associated with financial distress, default on debt, insolvency and ultimately bankruptcy and the disappearance of the firm.

Modern firms are characterised by a web of formal and implicit contracts which integrate and articulate the interests of different parties with claims on a firm's assets. The interested parties, or claimants, include the firm's creditors with varying degrees of seniority: government, banks or creditors with secured collateral, employees, ordinary bondholders and unsecured creditors, customers, suppliers and, of course, managers and shareholders. These formal and implicit contracts are part and parcel of the system of property rights in developed market economies. Their operation is facilitated through the financial system and financial markets. The financial institutions and markets provide information on the performance of various economic units and agents (search light effect), invoke appropriate reactions from the market participants, and impose certain disciplines on those units and agents.

When, in an economy with developed financial markets, firms get into financial difficulty, the distress will manifest itself in lower share prices, and will set in motion a number of possible mechanisms. On the one hand, mergers and take-overs may be encouraged (or provoked) by the appearance of signs of financial distress and lower share prices. This is particularly the case if other market participants consider the firm's

¹ I am grateful to Cheryl Gray, Irena Grosfeld, Jacek Rostowski and John Wittaker for their helpful comments and suggestions on an earlier draft of this paper.

financial problems a temporary phenomenon caused by inefficient production or management systems or an inappropriate output bundle. Through the take-over mechanism the ownership of the distressed firm (together with its liabilities) may pass on to new owners who can get the firm out of financial difficulty by producing the right bundle of goods more efficiently. The take-over process effectively facilitates the exit of excess or inefficient capacity.

On the other hand, the distressed firm may embark on formal or informal negotiations with its creditors with a view to work out a programme of rehabilitation by rescheduling its debts and rearranging its financial status. Such programmes usually involve restructuring of the firm including downsizing and the closure of loss-making operations. Here, too, there will be some 'exit of resources' from the industry. A third possibility facing the financially distressed firm, of course, is its liquidation- the physical exit of the firm from the market - which is embarked upon when all other venues are closed.

In fact, if the financial markets and the take-over mechanism performed efficiently, with all the relevant information available to all participants, the take-over mechanism would have eliminated the need for a separate 'bankruptcy procedure'. The value of any firm, even those in financial difficulties and bankrupt ones, will be transparent to market participants and, given the right prices, any firm will find a buyer. As soon as financial distress sets in, one would expect a fall in the valuation of the firm and the appearance of some buyers on the scene. But the absence of fully efficient financial markets, together with the existence of asymmetric information between the firms' insiders (managers) and outsiders (claimants) require the existence of an additional mechanism of checks and balances to protect the interests of a firm's creditors. These checks and balances are codified into 'bankruptcy laws and procedures' to supplement the existing property laws.

The process of exit, whatever form it takes, is set in motion by either the firm itself (usually the managers) or by its creditors. The more common forms of exit - the flow of resources out of an activity taking place in downsizing and restructuring, mergers and takeovers - are generally planned and implemented by the management on behalf of the firm's owners. But the more drastic forms of exit - entering the bankruptcy proceeding with the possibility of liquidation - are usually forced upon the firm by its creditors or by legal provisions aimed at protecting the interest of creditors.

The creditors of a financially distressed firm play the crucial role of monitoring its performance and imposing financial discipline (including the threat of bankruptcy) on it. In sharp contrast to the transitional economies of Central and Eastern Europe where "creditor passivity" has been identified as a major cause of the continuation of the 'soft-budget constraint' regime, the creditors in a developed market economy have direct and strong incentives to insist on the implementation of the appropriate legal provisions when faced with a defaulting debtor. Here the creditors must respond to market signals relating to the debtor firm and act promptly (and aggressively) in the interest of their own

survival. Any sign of 'passivity' will reflect badly on the creditors and may quickly undermine their position via the financial markets.²

This paper is concerned with the ultimate form of exit, i.e. bankruptcy, and will concentrate on the implications of the bankruptcy process for the behaviour of economic agents associated with a firm in financial distress (different creditors, managers, owners, etc). The importance of bankruptcy laws and procedures lies in the fact that they complement, and help the enforcement of, property rights. They regulate the way each group of claimants is recompensed without undermining the claims of other groups. In the absence of bankruptcy laws, any sign of financial distress may result in a creditors' rush, like the run on a bank, as each creditor will try to seize a part of the firm's assets and realise her/his claim. Bankruptcy laws achieve the compensation of claimants in an orderly fashion and, as Baird (1991) observes, settle all creditors' claims at once and in one place.³

Furthermore, the bankruptcy laws in all countries establish a system of priority to settle the claims of different claimants, or stakeholders. Known as the 'absolute priority rule' (APR), the system generally starts with the government's tax and social security claims, followed by unpaid wages of employees, the claims of secured (senior) creditors with a lien on physical assets, unsecured (junior) creditors or bondholders, trade creditors and finally the firm's shareholders (themselves divided into the holders of preference shares and ordinary shares). The importance of APR lies in the principle that each category of claim, in the established order of priority, must be settled in full before the claims of the next class of creditors are attended to. The shareholders, at the bottom of priority pyramid, will thus receive something only if all other creditors' claims are met in full. The APR embodies the existence of a system of property rights and reflects the operation of an established legal system. The observance, or violation, of APR is an important aspect of the implementation of bankruptcy laws and a major source of controversy amongst bankruptcy scholars.

The operation of bankruptcy laws and procedures is closely related to the nature and level of information available to stakeholders. The managers of modern corporations are in the unique position of using resources owned by other people, "other people's money" as Miller called it,⁴ on their behalf. In this process, they also borrow money to supplement internal funds, and make investment and production decisions which influence the owners' net wealth. With the management's superior knowledge of the firm's true financial position, and the asymmetric information between them and creditors (existing and potential), there is always the likelihood of them embarking on imprudent investment decisions. In particular, if their position is threatened by a potential bankruptcy, the probability of highly risky investments (made in desperation) will increase, and the value of the firm driven down. The 'limited liability' form of

² For a discussion of causes and implications of creditor passivity, see Mitchell (1993).

³ Baird (1991), p. 223.

⁴ Miller (1977), p.40. A more modern version of this concept is put forward in Akerloff (1993) notion of 'bankruptcy for profit'.

organisation (in comparison with individual proprietorship and partnership forms) allows the managers to make such risky decisions and grants them personal immunity from the consequences of these decisions. Furthermore, and again because of incomplete information and uncertainty, the managers are able to hide the real position of the firm from its creditors for a considerable length of time. The bankruptcy laws have, therefore, stipulated a number of mechanisms to ensure that all stakeholders are properly informed of the financial position of the firm. These laws specify the conditions under which the procedure is 'triggered off' and the person or body with legal obligation to initiate the process. The prevalence of incomplete information about the real position of the firm and the final division of the firm's assets in the event of insolvency, makes the triggering-off provisions all the more important.⁵

Given the management's exclusive knowledge of the firm's position, most bankruptcy laws place the onus of declaration on them. Even though the management, to a greater or lesser extent, may be considered responsible for the plight of the company, nonetheless, they are the best persons to initiate the process.⁶ They are the first to become aware of the firm's financial distress and the interest of creditors will be better protected if they are under legal obligation to set the bankruptcy process in motion. The existence of over 1000 cases of company director disqualifications for failing in their legal obligations to declare insolvency under the 1986 U.K. Insolvency Act, lends support to the view that managers should be responsible for triggering off the bankruptcy procedures.⁷ This is in fact the way the bankruptcy procedures operate in the four market economies studied here- the management is legally responsible to file for bankruptcy, within a short period of 2 to 3 weeks, in the event of insolvency or default on debt. In most countries, the creditors (or a specified group of them) are also entitled to trigger off the procedure if the information available to them (or collected by them) points in the direction of default and insolvency.

The bankruptcy procedure is usually triggered off when a firm defaults on its debt. But the procedure does not necessarily lead to the exit of the firm, or even the exit of some production capacity. Liquidation (or exit in strict sense of the term) is only one option facing the management. In this case, the bankruptcy procedures specify the manner in which the firm in the liquidation process is either sold as a going concern or its assets are disposed of piece by piece, in order to repay the claimants in accordance with the APR. If a firm is to be liquidated, the observance of the APR means that shareholders and managers will often receive little or nothing as the value of firm's assets may fall short of the claims against them.

Alternatively, the bankruptcy procedures may allow the management to choose the option of 'reorganisation'. Reorganisation or restructuring is aimed at finding a

⁵ For a discussion of the importance of incomplete information and its implications for the cost of bankruptcy, see Webb (1987). Webb maintains that, under perfect information, shareholders and bondholders could avoid costly bankruptcy.

⁶ Baird has reminded us of the 18th Century English law under which non-cooperating debtors in bankruptcy cases were hanged whereas cooperating debtors received 5% of the value of recovered assets! See Baird (1991), p. 225.

⁷ Franks & Torous (1992), p. 75.

method of rescuing the firm from financial distress and salvaging all or parts of it for the benefit of all claimants. Typically, it involves a process of negotiation between debtors and creditors with a view to establishing a new mechanism for the settlement of claims which may be different from the APR: writing off some of the claims, injection of new capital, swapping new equities for old ones, exchanging bonds and other debts with new notes, bonds or cash, etc. In short, it amounts to a re-writing of the debt contracts of different groups of claimants and creditors. Any bargaining aimed at rewriting the debt contracts will impart the debtors a bargaining power from which they may benefit at the expense of creditors. As such this will amount to a violation of the APR and, to many observers, it may undermine the basis of normal business practice and property rights, thus adversely affecting rational economic calculations. The insiders will have a strong incentive to prefer this option to liquidation and the strict observance of APR. But in addition to the insiders' self-interested motives, there are often other considerations which encourage the firms to opt for the reorganisation option - the chance to reduce the loss accrued to creditors, protection of jobs, retention of productive capacity and receiving government subsidies. Moreover, the availability of reorganisation as an option means that the management will be less likely to take high risk investment decisions under financial distress of the type to which we referred earlier. The important caveat about the procedural choice is that the bankruptcy law must be able to produce, and administer, an efficient rate of bankruptcy- i.e., it should prevent premature or delayed bankruptcies. In other words, the bankruptcy procedures should enable firms to survive only when their continuation value exceeds their liquidation value.

The legal provisions for reorganisation vs liquidation vary significantly in different market economies with different impacts on the incentives of different agents and their behavioural pattern. Although the debtor firms may have a strong incentive to opt for a formal, court-based reorganisation in order to try to resolve their financial difficulties and regain their health⁸, the legal provisions may not always be conducive to such preference.

The purpose of this paper is to analyse the economic implications of the bankruptcy procedures in Western market economies with a view to draw appropriate lessons for the transitional economies of Central and Eastern Europe. In Section II, we shall discuss the bankruptcy procedures in four major market economies, emphasising the conditions under which the financially distressed firms are reorganised or liquidated. Section III focuses on the relative efficacy of the 'reorganisation' option in comparison with the 'liquidation' option of the bankruptcy procedures. Section IV highlights the lessons that East European transitional economies may learn from the experience of market economies, drawing attention to a number of important areas of concern in any discussion of the design and implementation of bankruptcy procedures.

⁸ It is also possible to engage in a privately negotiated restructuring, avoiding the lengthier court-based procedures. More on this later.

II. Bankruptcy Procedures in Different Market Economies

In this Section we shall briefly discuss the bankruptcy procedures in four market economies: United States, United Kingdom, Germany and France. The emphasis throughout this Section will be on the relative position and powers of creditors and debtors, and on the impact of bankruptcy procedures on the incentives of different economic agents.

a. United States. The emphasis of the bankruptcy procedures in the United States (and also France as we shall see shortly) is on the survival of the firm and the saving of employees' jobs and the firms' productive capacities - thus the notion of 'debtor-oriented' procedures.⁹ This is achieved by providing the firm with a breathing space to enable it, free from the pressure of claimants, to negotiate with its creditors with a view to restructuring its debts and finding a way out of distress. The U.S. Bankruptcy Reform Act of 1978 allows the management of the firm to file for bankruptcy either under the Act's Chapter 7 (the liquidation option) or under its Chapter 11 (the reorganisation option). If the latter course of action is chosen, the managers will receive temporary court protection from their creditors and will be given time to prepare a reorganisation plan which has to be put to claimants for approval. During this period, referred to as 'debtor-in-possession', the management will remain in charge of the firm, protected by automatic stay of claims against the company. It would also be able to raise new finances on preferential terms (i.e., as high priority claims). Moreover, the firms in reorganisation will benefit from a number of explicit and implicit subsidies (mostly from the government).¹⁰ The management has 120 days to prepare a reorganisation plan (a period which may be-and often is- extended by the Court) and a further two months to gain the approval of its creditors.¹¹ Ultimately, the plan must be approved by the majority (representing 2/3 of claims) of creditors in each class of claimants.¹² The law groups claimants into different classes according to the nature of their claims: secured creditors are treated as one class, unsecured bondholders another, small claimants another, shareholders another, and so on. The plan may (and often does) include restrictions on management and conditions, such as a threshold debt-asset ratio or market valuation, aimed at protecting the creditors from unjustified risky behaviour by the management.

⁹ For detailed discussion of the American bankruptcy code, see White (1984), Franks & Torous (1989) and White (1989).

¹⁰ These include: the carry forward of tax losses in previous years, debt forgiveness, termination of under-funded pensions and their subsidisation by the State, non-payment of interest on credits during the period of preparing a reorganisation plan, and the possibility of abandoning unprofitable contracts without a penalty. These subsidies, as White has pointed out, largely accrue to creditors and not the equity holders -as the legislators may have intended. See White (1984), pp. 37.24-37.26.

¹¹ Although the debtor has extensive rights during the reorganisation period, these are not at the expense of creditors whose interests are also protected by the code. They usually set up a creditors' committee; they have 'rights of discovery'; and, occasionally, the court may appoint a trustee to supervise the work of management.

¹² This is often referred to as the 'unanimous consent procedure' (UCP). If the plan is not approved by all classes of creditors, an alternative procedure, called 'cram-down', may be embarked on. Under 'cram-down', a modified version of the reorganisation plan is approved by the Court and provisions are made for the 'fair and equitable' treatment of the dissenting classes of creditors under the Court's supervision.

The reorganisation option of the American bankruptcy code has proved to be extremely popular with the stakeholders (debt-holders and equity-holders) of firms in financial distress. The number of filings for court protection increased by six-fold between 1979 and 1989 - from 3042 in 1979 to 17447 in 1989. Some observers attribute this massive increase to the enhanced protection of debtors and the opportunity to protract the control of existing managers over the firm's assets (without any serious cost to them).¹³ It is alleged that managers and shareholders may try to 'protract' their control of the firm without bearing any (or little) of the costs. After all, if the firm fails in its attempt to regain its health, the expenses of the reorganisation period and plan fall on the creditors, with the managers/shareholders being no worse off than before.

The American bankruptcy procedure also allows for 'privately arranged' reorganisations (or 'work-outs') as another option for firms in financial distress and their creditors. This type of reorganisation is, of course, speedier and less costly than that under Chapter 11 and, therefore, offers the potential that all claimants may gain from it. But it lacks the court protection, the temporary stay of claims, tax advantage and the relatively cheaper credit offered through the formal reorganisation procedure. Gilson, et.al. (1990) studied the characteristics of 169 firms listed on the N.Y. or American Stock Exchanges which experienced financial distress between 1978 and 1987. Altogether 80 of these firms succeeded in reaching an agreement with their creditors and to privately restructure their debts. They concluded that this method is more likely to succeed if (i) the distressed firm has more intangible assets (i.e. if there is a greater difference between the going-concern value of assets and their piecemeal values which may be lost in a lengthy procedure or in liquidation); (ii) it owes more to banks and financial institutions than to other businesses; and (iii) there are fewer creditors to deal with. When the number of creditors is large, the chance of reaching an agreement, which has to be unanimous, recedes.¹⁴

b. United Kingdom. In the United Kingdom (and also Germany), on the other hand, the emphasis of the bankruptcy procedure is on the protection of creditors' interest - the so-called 'creditor-oriented' procedures. The most important feature of this orientation is the fact that the management loses its unquestioned right to manage the firm's assets during the procedures. The 1986 Insolvency Act¹⁵ offers the management and creditors of an insolvent firm several options: liquidation, receivership or administration - all of which involve the appointment of an insolvency practitioner to protect the interests of creditors. Under the 'liquidation' option, the firm, or any of the creditors, applies to the Commercial Court for the appointment of a liquidator whose sole task is to sell the assets of the firm in order to meet the claims of creditors according to

¹³ See Bradley & Rosenzweig (1992), p.1090.

¹⁴ Under Chapter 11 provisions, it is also possible to have a 'pre-packaged' procedure combining private restructuring and Chapter 11 court protection. Here, a privately negotiated restructuring plan is filed with the Court at the same time as the bankruptcy application under Chapter 11. See Gilson, et.al. (1990), pp. 324-325.

¹⁵ For a detailed discussion of UK bankruptcy procedures, see Otter (1988), Wooldridge (1987) and Franks and Torous (1992). In the British legal terminology 'bankruptcy' applies to individuals and 'insolvency' to companies. Here, we ignore this distinction in the interest of simplicity and consistency with the procedures in other countries.

the APR. The 'receivership' option, which is available only if there are secured creditors¹⁶, is more complicated. Any secured creditor with a fixed charge may appoint its own receiver who will take control of the charge (the asset used as security for that particular creditor). Here the receiver represents the interests of the 'appointor' (the single creditor who appointed her/him). Alternatively, a secured creditor with a 'floating charge' may appoint an 'administrative receiver' to take control of all assets (except those with fixed charges) and be responsible to all creditors, albeit in some order of priority. Either type of receiver will have to decide on whether the firm should be retained as a going concern or be wound down. A receiver cannot dispose of the asset over which she has been appointed if it affects the normal operation of the company unless a decision is made to liquidate the company.

The receivers' preferences and behaviour are influenced by the prevalent incentive mechanisms. Most often, the receivers prefer to liquidate the company in order to meet the claims of their 'appointors'. Their lack of full knowledge of the firm's potential and, more importantly, because any of the other creditors can apply for the appointment of a liquidator at any time, encourages the tendency towards liquidation. (A receiver and a liquidator may be appointed at the same time.) Furthermore, a receiver faces a potential conflict between the interests of the individual appointor and those of other creditors. The law has placed various restrictions on the receivers in order to ensure that they will try to obtain the maximum possible proceeds from the disposal of assets and other activities.¹⁷ These restrictions also strengthen the receivers' preference for liquidation.

The 1986 Act offered the management and creditors of companies in financial difficulty a new option: administration. Here, the Companies Court appoints an 'administrator', with precedence over both the 'liquidator' and the 'receiver', to take charge of the company. The administrator has three months to prepare a plan for reorganisation which has to be approved by more than 50% of creditors. The court, too, can impose the plan on the creditors. With the administrator appointed, there is a stay of claims against the company while a reorganisation plan is being prepared.

One important distinguishing feature of the UK procedures is the fact that the reorganisation plan is prepared by the administrator and not by the management (as in the U.S.), whose powers are greatly reduced during the administration period. Another distinctive feature of the U.K. procedures is that secured creditors, with a fixed or floating charge, are able to block the appointment of the administrator by appointing their own receiver or liquidator. In other words, the administrator can only be appointed if the majority of creditors are convinced that it may serve a purpose. It was initially thought

¹⁶ Under British Law, there are two types of secured creditors: those with fixed charges and those with floating charges. A fixed charge is a fixed asset, usually an immovable object, which is used as a security for a loan. Any alteration to the use of the fixed charge by the company must be with the approval of the creditor. A floating charge is an unspecified asset used as security with the creditor while the company retains its freedom to change the use of the said asset. If the company gets into financial difficulty, specified by certain criteria, a floating charge will become a fixed charge and the creditor may appoint a representative (the receiver) to take control of it.

¹⁷ The 'receiver' is personally liable for events after her/his appointment. Other creditors, for example, may file law suits against the receiver if they feel that their interests have been damaged by the activities of the receiver - thus the tendency to opt for liquidation as the safest option. See Franks & Torous (1992), p.73 for an example of this type of law suit.

that the 'administration' option would usher in a procedure similar to the Chapter 11 provisions of the U.S. bankruptcy code. But, as Webb has pointed out, the limitations placed on the management and the emphasis on creditors' rights meant that the 1986 Act "stopped a long way short of giving the U.K. the equivalent of Chapter 11".¹⁸ The creditor orientation of the British law has meant that there was no repeat of the American experience of an explosion in the number of filings following the adoption of the new Act. The "few hundred" cases involving the appointment of 'administrators' compares very poorly with "several thousands" of cases involving the appointment of receivers.¹⁹

Finally, as in the U.S., the 1986 Act allows for the possibility of semi-formal, privately arranged reorganisations, known as 'workouts' or 'schemes of arrangement'. The Court must, of course, approve such arrangements which are agreed between the company and creditors.

c. Germany. The German insolvency procedures have always been 'creditor-oriented'. Until recently, they were explicitly aimed at complementing the competitive process of natural selection by facilitating the elimination of weaker firms. In the last two decades, however, it has been recognised that the survival of enterprises in financial difficulty may be beneficial in an economy with high unemployment. Nevertheless, despite this recognition and also the appointment of a Commission for the reform of the insolvency law in 1978, the legal framework has remained largely unchanged.²⁰

In Germany, a company in default may follow any of the two separate legal provisions: the Bankruptcy Act (for the purpose of liquidation) or the Judicial Composition Proceeding (for the purpose of reorganisation).²¹ The firm or the unsecured creditors can initiate the bankruptcy procedures by petitioning the Bankruptcy Court. It is of course incumbent upon the management of the debtor firm to file a petition with the Court within three weeks of ascertaining that the firm is insolvent. The company's control and management is then transferred to a court-appointed 'trustee' with the explicit objective of liquidating the company and realising the value of its assets in order to meet the creditors' claims in the order of APR. The secured creditors may also petition for bankruptcy even though they generally operate outside the bankruptcy procedures and use the security in their charge to recoup their claim. In Germany, as a defensive mechanism against bankruptcies, most loans to companies are secured in order to enable creditors to recoup their loan independent of bankruptcy laws.

A particular feature of the German law is that the majority of bankruptcy proceedings, up to 76% according to Fialski's estimate, are not completed due to 'lack of

¹⁸ Webb (1991), p. 156.

¹⁹ Franks & Torous (1992), p.75.

²⁰ For a detailed discussion of the German bankruptcy laws, see Fialski (1994); and Klasmeyer & Kubler (1994).

²¹ These two acts are *Konkursordnung* (usually referred to as *KO*) and *Vergleichsordnung* (usually referred to as *VerglO*). The territories of former GDR (five *Länder* and East Berlin) are subject to different insolvency procedures known as the 'General Enforcement Act' (*Gesamtvollstreckungsordnung* or *GesO*), passed in 1990 as transitional measures. For more details see Klasmeyer & Kubler (1994), pp. 17-133 to 17-146.

resources' to meet the procedural costs and claimants' demands.²² The Court, too, may dismiss the petition for bankruptcy on the grounds that procedural costs can not be covered.²³ If the bankruptcy petition is dismissed for insufficient funds, the joint stock company will be dissolved in accordance with Section 1.7.1.1 KO.

The debtor firm may, alternatively, petition the Court under the Composition Proceedings (which dates back to 1935) and propose a composition plan. The composition plan must be approved by a simple majority of creditors, representing 75% of all claims.²⁴ Under composition proceedings, the management remains in charge of the company even though they are subject to the 'monitoring' and 'examining' roles of the court-appointed 'trustee'. As in the bankruptcy case, the composition petition may be dismissed if the available resources are insufficient to meet the procedural costs. Once a composition plan is confirmed by the Court, no application for bankruptcy will be entertained.

The legal framework for composition, however, is highly restrictive. First of all, unlike the American procedures, there is no stay of claims against secured creditors who can still liquidate their security to recoup their claims against the firm.²⁵ Secondly, the firm must be able to offer all creditors 35% of their claims in cash as a minimum condition for a composition. As a result of these restrictions, the Composition procedures play a minor role in Germany- only one percent of insolvencies are resolved through this option.²⁶ If the composition plan does not receive sufficient support, the liquidation procedure will come into force.²⁷

It is also possible, as in the U.S. and U.K., to arrange 'out-of-court compositions' which are not subject to strict rules of normal compositions. In fact, given the difficulties of the composition procedure, a large number of insolvencies (according to some estimates as high as 20-30%) opt for out-of-court arrangements.²⁸

In recent years, there has been much discussion concerning the reforming the German insolvency procedures. The Commission for Insolvency Law, appointed in 1978, has produced draft proposals which aim at unifying the three insolvency procedures (KO, VerglO and GesO of the former GDR territories) into one law and at bringing the spirit of the German law somewhat closer to the American Chapter 11 provisions- thus encouraging more reorganisations. The proposals, which are due to take effect in 1977 will, of course, not resolve the problems caused by the German practice of pledging nearly all assets to creditors. They will, however, remove the ability of secured

²² Klasmeyer & Kubler (1994), p.17-8; and Fialski (1994), p. 23..

²³ However, if the creditors are willing to pay the procedural costs, in advance, the bankruptcy petition will be heard.

²⁴ Under some conditions this may be raised to 80%. See Klasmeyer & Kubler (1994), p. 17-126.

²⁵ The Court may, of course, prevent such asset disposals.

²⁶ Klasmeyer & Kubler (1994), p. 17-7; and Fialski (1994), p. 27..

²⁷ Section 7.4 of the *VerglO*.

²⁸ Klasmeyer & Kubler (1994), p. 17-9.

creditors to dispose the secured assets during the bankruptcy or composition proceedings, and also enable the creditors to put forward composition plans.²⁹

d. France.³⁰ The present French Bankruptcy procedures is based on Laws passed in 1984 and 1985 and amendments of June 1994.³¹ Before the recent amendments, the law was strongly aimed at facilitating the rescue of financially distressed firms through reorganisation. The social and political motives behind the law were transparent: under conditions of high unemployment, jobs should be saved if at all possible. The 1984 and 1985 Laws replaced the previous procedures which emphasised the speeding up of asset disposal and the satisfaction of creditors' demands. The 1994 amendments, however, were adopted in order to strengthen creditors' rights and enhance the efficiency of the judicial restructuring process.

Under special procedures adopted since 1982, firms suffering from financial difficulties may obtain advice and support from counselling organisation, at national, regional and departmental levels. The 1984 Law also envisaged the appointment of a Conciliator by the Commercial Court who will assist the firm in raising new loans and negotiate with all or some of the creditors and suppliers in order to resolve the firm's financial problems. In practice, until recently, the conciliation procedures were not widely used as they depended on the mutual agreement of debtors and creditors. But under severe economic conditions affecting the property sector in the early nineties, they were successfully employed by the Paris Commercial Court to avert large scale bankruptcy of property firms. Apart from the official conciliation procedure, the Courts have also appointed, on *ad hoc* basis, 'guardians' to advise financially distressed firms before the enter the bankruptcy proceedings.³²

The bankruptcy procedure in France is set in motion by the application from the firm, the creditors, the public prosecutor's office, or the Court officials. The management is legally responsible to file a bankruptcy petition with the Commercial Court³³ within 15 days of default on payment (*cessation des paiements*). The Courts may impose a range of legal sanctions against non-compliant managers but, on the whole, the threat of sanctions is not very strong. Consequently, bankruptcies initiated by the management are

²⁹ For a discussion of the proposed bankruptcy procedures, see Fialski (1994) and *The Economist*, May 21, 1994.

³⁰ I am grateful to Sophie Bourguignon who provided me with information on the recent changes in French bankruptcy laws.

³¹ For details of the French bankruptcy laws and procedures, see Simeon, et.al. (1987); Chartier (1989); Mitchell (1990b); Derrida, et.al. (1991); and Lafont (1994). For the 1994 amendments (Law no. 94-475 of 10 June 1994), see Campana and Legeais (1994) and *Journal Officiel*, 11 June 1994. Mitchell's study includes a useful appendix comparing the bankruptcy laws of different countries (even though the discussion of UK Insolvency Act of 1986, and particularly the nature of different types of 'receivers' is rather confused). Mitchell's paper also includes a brief description of the Japanese bankruptcy code which resembles, in many important respects, the U.S. Bankruptcy Code.

³² Lafont (1994), pp. 18-19.

³³ In the case of agricultural organisations or private non-commercial legal entities, the petition is filed with the Civil Court.

exceptional.³⁴ Bankruptcy proceedings are often initiated by the firm's creditor(s) who only need to prove the firm's 'default on payment'.

The 1985 Law stipulated that the Court, upon the verification of the ground for bankruptcy, will initiate a 'decree on judicial restructuring' (*redressement judiciaire*). The decree involves an 'observation phase' (*periode d' observation*) and the appointment of a Receiver (*administrateur judiciaire*). During the observation phase, the Receiver (whose powers are determined by the Court) will assess the firm's economic and social conditions and the possibility of its rehabilitation. The Receiver, after the completion of his assessment and negotiation with interested parties, may recommend rehabilitation, in which case she/he will prepare a 'continuation plan'. The purpose of this plan is to create the necessary conditions for the restructuring of the firm (which may involve downsizing its operations or changing the management structure if necessary), to renegotiate its debts and undertake to pay some or all of the creditors within a specified time period. Alternatively, the Receiver may decide that the firm has little chance of survival and should be liquidated, in which case a 'disposal plan' will be prepared. This would involve finding a third party taking control of some or all of the firm's assets (but not its liabilities) for an agreed price.

The Receiver has six months to prepare a plan for the Court, a period which may be extended by six months normally (and a third six months in exceptional circumstances). Although there has been much discussion regarding the long duration of the observation phase and the 1994 amendments were expected to shorten this period, no significant changes were made by this review. Both 'continuation plan' and 'disposal plan' must be approved by the Court. During the observation phase, all proceedings initiated by the creditors against the firm will be suspended and so will any payment of pre-existing debts. Claims born during the observation phase and the implementation of the consequent plans will be priority claims.³⁵

Finally, if the Receiver cannot complete a 'continuation' or a 'disposal' plan, the Court will issue a judgment of 'judicial liquidation' and appoint a liquidator (usually the representative of the creditors) to complete the process of asset sale, at highest obtainable price, and to distribute the proceeds amongst creditors.

The procedures outlined above, in particular the compulsory observation phase, have a strong orientation towards the debtor firm and likely to weaken the disciplinary nature of bankruptcy. The 1994 amendments removed the compulsory nature of the observation phase, leaving it to the discretion of the Court which may now decide to initiate a 'judicial liquidation' without going through the observation phase.³⁶ The change will, to some extent, strengthen the position of creditors and speed up the liquidation of firms with little chance of a successful continuation or disposal plan.

³⁴ Chartier (1989), p. 174.

³⁵ The priority of pre-bankruptcy secured creditors was somewhat unclear until the 1994 amendments which gave these claims priority over claims born after the initiation of the bankruptcy proceedings. See Campana and Legeais (1994).

³⁶ Even under the 1985 Law, the judges had the discretion of reducing the compulsory observation phase to a symbolic minimum, pronouncing the liquidation of a manifestly unviable firm on the same day as the decree on judicial restructuring. See Derrida and Sortais (1994), p. 274.

Unlike the U.S. code which requires the approval of the reorganisation plan by a specified proportion of all classes of creditors, the French code empowers the courts to approve or reject the plan prepared by the Receiver without requiring the creditors' majority approval. Of course the Receiver is required by the Court to 'consult' the firm's management, employees representatives, creditors and other interested bodies and ask for their views on the continuation (or disposal) plan. But the ultimate decision is made by the Court without requiring the approval of creditors. This aspect of the proceedings survived the 1994 amendments intact and is still a feature of the French bankruptcy laws.

III. Is Reorganisation Efficient?

The evaluation of the relative effectiveness of reorganisation versus liquidation is crucial for any appraisal of the efficiency of the bankruptcy procedures in a market economy. Whether or not the 'reorganisation' option is superior to the 'liquidation' option would depend on two important factors: (i) what are the costs of reorganisation and who will bear it? and (ii) would a reorganisation result in the distortion of market signals and the legal basis of rational economic calculations? Most of the research in this area is based on the American experience, where the reorganisation procedure offers greatest protection to the firm and greatest degree of autonomy and independence to its managers. This literature on reorganisation concentrates on a number of important issues such as managerial behaviour, the lengthy and costly bargaining and litigation process and the implications of the violation of APR.

Most of the contributors to the debate have argued that the incentive mechanism associated with bankruptcy procedure encourages high risk strategy and opportunistic behaviour by the managers. Precisely because they remain in power during the reorganisation, it is emphasised, the managers will have a tendency to embark on riskier investment decisions - a tendency strengthened by the fact that they do not bear the ultimate costs of their decisions. Stiglitz (1972) showed that, with the possibility of bankruptcy allowed, the firm will suffer from the effects of the conflict of interest between equity holders and bondholders, with the managers tending towards greater risky borrowing.³⁷ Later on Meckling (1977), Miller (1977), Moore (1977) and Bradley & Rosenzweig (1992) all argued that the protection offered by the Chapter 11 procedures results in higher borrowing and greater risk-taking by the debtor firm. Moreover, both Moore and Meckling argued that the cost of borrowing will also increase because the creditors have to be more careful in their lending policy, assess loan applications more thoroughly and monitor the progress of their borrowers more frequently. They will pass the additional costs of processing, observation and monitoring to borrowers.³⁸ Bradley and Rosenzweig go a step further and argue that managers' willingness to borrow money and take on additional debt has increased by the advent of Chapter 11-type protection. They studied the average debt-asset ratio of firms filing for bankruptcy before and after

³⁷ Stiglitz (1972), pp. 461 and 480. Stiglitz maintained that while bondholders are concerned with the affairs of the firm in all states, the equity holders are concerned about returns on their investment only in those states when the firm does not go towards bankruptcy.

³⁸ More recently Scott & Smith (1986) have argued that the 1978 Bankruptcy Reform Act has, for similar reasons, resulted in increased cost of borrowing for small businesses.

the 1978 Bankruptcy Reform Act and showed that the average debt asset ratio of firms under consideration increased after 1978.³⁹

If a firm is insolvent and is wound down, the shareholders (and managers) may receive very little or nothing upon liquidation. But if they embark on reorganisation, there is some chance of the shareholders receiving something as a result of their increased bargaining position. However, even if they fail to turn the firm around and return it to health, they may not be much worse off than before. Thus Miller (1977) has compared the reorganisation option a 'call option': the shareholders call on the option (to share in whatever benefits the reorganisation creates) if their plans succeed, but will not call on the option if their plans fail. Costs of reorganisation, of course, are borne not by the shareholders but by the creditors.

It is of course right to assume that managers have a personal interest in prolonging their reign and retaining the firm's control for as long as possible and that they would use the Chapter 11 provision for this purpose if they have to. Many alternative theories of the firm support this view. But this need not be the only reason for embarking on this course of action and the role of personal interest should not be seen in isolation. Managers (and their shareholders) also stand to lose in bankruptcy, not only their jobs and the associated benefits but also their reputation - a point ignored by the proponents of the 'call options' analogy. There is, in any market economy, a managerial labour market in which managers' performance are evaluated and which imposes a discipline on managers. Using a sample of 111 firms (61 filing for bankruptcy under Chapter 11 and 50 private restructuring), Gilson (1989) and (1990) has clearly shown that the majority (over 60%) of the chief executive officers and members of board of directors of firms involved in either bankruptcy or private restructuring lose their jobs after the end of the proceedings. What is even more serious is that their chances of being appointed to other directorships also declines. This observation severely undermines the argument that managers have nothing to lose in a bankruptcy.

The reorganisation procedure is obviously lengthy and costly, factors which should be taken into consideration when evaluating the relative efficiency of this option. The estimates for the time spent in reorganisation vary in different studies: 1.4 years for a sample of 26 firms completing reorganisation between 1980 and 1982 in White (1984); 2.8 years for a sample of 26 firms completing the reorganisation process between 1970 and 1986 in Franks & Torous (1989); 2.1 years for a sample of 30 firms successfully reorganising between 1979 and 1986 in Eberhart et.al. (1990); and 2.4 years for a sample of 30 firms which went through successful reorganisation between 1979 and 1986 in Weiss (1990).⁴⁰ It must, however, be remembered that the lengthy process is not primarily because of the bargaining between creditors and debtors. The possibility of

³⁹ Bradley & Rosenzweig (1992), p.1095.

⁴⁰ Weiss' sample actually contained 37 companies but only 30 of them completed the reorganisation process successfully. The time spent in reorganisation is calculated for these 30 firms. Similarly, Franks & Torous's sample contained 30 firms, included four railway companies whose reorganisation was extraordinarily lengthy because of the complications of the regulatory framework to which railways are subject. These firms are excluded from the calculations for the purpose of comparability with other studies. Their inclusion would have increased the average period in reorganisation to 3.67 years.

future legal claims against the company arising from such events as exposure to toxic waste material or unsafe pharmaceutical products account for many lengthy litigations.⁴¹

Similarly the estimates of direct costs of reorganisation (lawyers, trustees, administrators and various consultants' fees) vary widely in different studies.⁴² Measured as a proportion of the market value of the firm in the year prior to bankruptcy filing, the direct cost was estimated at 4.6% in Altman's study of 18 firms filing between 1972-78 (before the new Bankruptcy Code) and 2.8% in Weiss' study of 37 firms filing between 1979 and 1986.⁴³ On the other hand, measured as a proportion of the liquidation value of the firm (which is obviously lower than the market value a year before the bankruptcy filing), the estimates range from 3.4% in White's (1984) study of 64 firms to 7.5% in Ang, Chua and McConnell's (1982) study of 86 firms.⁴⁴ Specific industry studies seem to come up with bankruptcy costs slightly higher than mixed samples: 9.12% of the value of firms in Guffey & Moore (1991) study of 16 firms in trucking industry which filed for bankruptcy between 1971 and 1985; and 10% of the value of assets in James (1991) study of 412 bank failures between 1985-88. It is also generally accepted that the direct costs of reorganisation as a proportion of the amount received by creditors, is less in reorganisation than in straight liquidation.⁴⁵

The survival of firms in reorganisation is also an important issue which should be addressed briefly. While, as Warren (1991) points out, the data on the *overall* success rate is "virtually non-existent"⁴⁶, some observers incorrectly assert that, in general, the bulk of firms in reorganisation end up in liquidation.⁴⁷ These observers disregard the widely varying survival rates for firms of different size and different activity. The *available* empirical evidence paint a more optimistic outcome for this procedure, suggesting that the success rate is much higher for larger firms. LoPucki's study of all Chapter 11 cases (57 firms altogether) filed with the Bankruptcy Court of the Western Missouri District during the first year of the operation of the new Bankruptcy Code showed a success rate of 26% for all firms and 86% for large firms in the manufacturing

⁴¹ See Eastbrook (1990), p.416 for a discussion of this issue.

⁴² As for the indirect costs (opportunity costs) of bankruptcy, i.e., lost sales and profit, tarnished image, loss of reputation, loss of skilled employees, etc., despite few rough attempts such as Altman (1984), no serious progress has been made. Altman estimated the indirect costs, for a sample of 18 firms filing for bankruptcy between 1972 and 1978 to be about 10%. See *Ibid.*, p. 1077.

⁴³ Altman (1984), calculated from Tables I and II, pp. 1074-1075; and Weiss (1990), p.290.

⁴⁴ White (1984), p. 37.45; and Ang, Chua and McConnell (1982), p.223. The latter study, it should be pointed out concentrated on firms filing for bankruptcy between 1963 and 1978, i.e. before the 1978 Bankruptcy Reform Act came into effect. Nevertheless, for the purpose of comparison with other studies, their estimate of direct bankruptcy cost is useful.

⁴⁵ See White (1984), Tables 37.4 and 37.5.pp.146-147.

⁴⁶ Warren (1991), p. 15.

⁴⁷ For example, see *The Economist*, August 1 1992 which in an article entitled "When Firms Go Bust", put the success rate of firms in reorganisation at 20%. Similarly, in an OECD report, Swain maintained that the success rate was between 10% and 27% - the basis of calculations in neither of the two studies is clear.

sector.⁴⁸ White (1984) study of a sample of 64 companies, filing for reorganisation between 1980 and 1982, found that at least 40% of them succeeded in ultimately adopting a reorganisation plan approved by all classes of creditors. On the other hand, Morse and Shaw's study of 162 firms in the 1973-82 period showed a success rate of at least 60% and Gilson, et.al.'s study of 89 firms filing under Chapter 11 between 1978 and 1987 showed that 95% of them succeeded in reorganisation.⁴⁹

In France too, concern has been raised about the success of reorganisation procedures. The overall rate of success (i.e., the percentage of firms adopting a continuation plan during the observation phase) is estimated to be about 7-8% and has remained relatively stable since the adoption of the 1985 Law.⁵⁰ For the Paris district, according to the information provided by the Commercial Court of Paris, the percentage of firms adopting a continuation plan was 13% in 1993 and 17% in 1994. The information is, however, not detailed enough to identify the success rate for larger firms and compare them with the American experience.

The last aspect of the reorganisation discussed in the literature deals with the implications of the violation of priority rules. The reorganisation or restructuring plan negotiated between managers and creditors reflects the bargaining power bestowed on the debtors by law, manifested in alterations to the original terms of contract (possibly in favour of equity holders and sometimes junior claimants). This is tantamount to violating the established property rights system (enshrined in the APR) in favour of the debtors. The alterations to the original terms of the contract, or the violation of the APR, has been the focus of much of the economists' contribution to this debate. Most of the research, however, is based on individual case studies and small sample investigations. Studies by Franks & Torous (1989), Eberhart, et. al. (1990), Weiss (1990), and Eberhart & Sweeney (1992), showing that the absolute priority rule is violated in majority of cases, are all based on samples between 27 and 37 firms filing for bankruptcy. There is, however, less consensus on the magnitude and the method of measurement of costs of this violation or the particular class(s) of creditors which are most affected by it. The amount received by shareholders, in excess of what they would have received under APR, varies between 2.4 and 7.6% according to different studies.⁵¹

To a large extent, the arguments outlined above fall short of a comprehensive assessment of the relative costs and benefits of reorganisation. The critics of the reorganisation option (its American or the continental versions) seem to have emphasised the 'potential' negative impact of this option on efficient operation of the legal process

⁴⁸ LoPucki (1983), pp. 100, 108-109. These results were confirmed when nearly a decade later LoPucki and Whitford studied 77 "megabankruptcies" (firms with assets in excess of \$100m which filed under Chapter 11 between 1979 and 1988) and found that their success rate was between 89% and 96%. For details see LoPucki and White (1991), p.41, f.n. 105.

⁴⁹ White (1984), pp. 37.40-37.41; Morse and Shaw (1988), p. 1198; and Gilson, et.al. (1990), p. 321.

⁵⁰ See Credot (1994), p.12; Derrida & Sortais (1994), p.268; and Saint-Alary-Houin (1994), p. 107.

⁵¹ See Eberhart, et.al (1990), p. 1464; and Eberhart & Sweeney (1992), p. 944. In a typical reorganisation, share holders often receive new securities and creditors receive varying types of securities, cash, bonds or notes. These figures have to be treated with caution as they are based on inaccurate -or inappropriate- methods of valuation of the new assets. The complications of comparing the new securities with the old ones and other problems of measuring the extent of deviation are discussed in Franks & Torous (1989), pp. 754-758 and Weiss (1990), pp. 292-293.

without considering its 'potential' benefits. To begin with the issue of management behaviour under limited liability conditions, we have already pointed out the weakness of the argument that managers have little to lose in a reorganisation or bankruptcy. Moreover, it is sometimes ignored that the limited liability form of organisation (which is blamed for the risk taking tendency of managers) is one of the most dynamic and efficient organisational innovations of the last century. The existence of outside finance, and firms and individuals who provide the financing, has been a major element guaranteeing the efficient operation of joint stock companies. Bond-holders and other creditors (especially institutional creditors) have made the managers less insular and more responsive to market signals. They engage in collection and analysis of information and impose a market discipline on the managers. In their absence, firms will be almost closed to outside scrutiny and the shareholders in danger of being manipulated by the managers. As Gilson (1990) and Wruck (1990) have demonstrated, when financial distress sets in, non-equity claimants take an active interest in corporate governance and put pressure on managers to find a solution - a pressure that might not materialise from equity holders.⁵²

Secondly, in all reorganisation procedures, the creditors do have the choice of rejecting the reorganisation plan. The reason they accept this procedure is that they, like managers, believe it is possible to reverse the firm's financial difficulty. And if the course of action taken by the managers succeeds, the creditors will be the main beneficiaries. It should also be remembered, as many bankruptcy cases show, that the creditors can (and often do) impose certain conditions on the firm and its managers which prevents them from excessively risky or opportunistic behaviour. Reorganisation plans have, for example, stipulated threshold debt-asset ratio above which managers cannot borrow on secured terms, threshold market capitalisation levels below which certain corrective mechanisms will automatically come into force, maximum allowable administrative expenses, restrictions on asset disposals and investments, etc.⁵³

Thirdly, on the crucial issue of the violation of the APR, there is no reason to believe that unequal treatment of different claimants (which often arise in reorganisation plans), small as it is, creates significant market distortions. In a bankruptcy, creditors will lose out to varying degrees depending on how secure their claims are. The amount of loss, which is part and parcel of business risk, will vary from case to case depending on the value of claims and the value of assets (either their liquidation value or their going-concern value). We have already pointed out that there is no systematic, large scale study of the magnitude of the costs of reorganisation and those who suffer most.⁵⁴ The essential point is to note that if some of the claimants wish to form coalitions with other

⁵² Wruck even argues that it is more efficient to be highly leveraged because the creditors will have a stronger incentive to monitor the managers and press them for restructuring in the face of financial distress. Wruck (1990), p. 433.

⁵³ See Gilson (1990), p. 367 for more examples of restrictions imposed by creditors on the management. Furthermore, it has been observed by some bankruptcy scholars that the 1978 Bankruptcy Code was largely what the creditors had wished for and met their needs. See Eastbrook (1990), p. 413.

⁵⁴ Some studies such as Franks & Torous (1989), pp. 755-757 and Weiss (1990), pp. 294-296 identify the junior creditors as the main losers. Others such as Eberhart and Sweeney (1992) maintain that bondholders (a subset of junior creditors) benefit from APR violation -albeit only by a little - at the expense of senior creditors.

stakeholders which may be more beneficial to some and less to others, they are legally entitled to do so. After all, the senior claimants may appreciate the value of managers' knowledge of the firm and their ability to preserve the firm's value, and be prepared to strike a deal with them which offers the shareholders something in excess of that warranted by the strict application of the APR. As Baird & Jackson (1988) have pointed out, the 'recontracting' associated with the reorganisation plan is at the discretion of senior claimants who may "convey an interest in (the assets of the firm) to anyone (they) please."⁵⁵ The gains by equity holders is "because the senior creditor has concluded that doing so is in its interest."⁵⁶ There is nothing intrinsically inefficient about this recontracting process.

Finally, in any assessment of reorganisation, the wider social costs and benefits of bankruptcy has to be taken into account. A reorganisation which prevents premature liquidation will lead to the preservation of jobs and productive capacities that may otherwise disappear forever.⁵⁷ What is crucial for the economy is that firms with a chance of survival should not go bankrupt prematurely. The optimum rate of bankruptcy is one that involves least cost to the society as a whole, and results in the preservation of firms over a longer time period than that dictated by short term financial considerations.

Reorganisation is aimed at raising the value of a firm in financial difficulty above its liquidation value and may potentially benefit most of those concerned. The fact that a large number of firms embarked on reorganisation succeed is an indication of the social efficiency of this process. Therefore, we may say that firms opt for reorganisation not solely (or even primarily) for opportunistic reasons but also because: (i) they believe they are in *temporary* financial difficulty and a short respite will allow them to return to health; (ii) their liquidation value is (or may be) less than their value as a going concern; and (iii) the post-reorganisation situation may be more beneficial to most of the stakeholders.

IV. Bankruptcy Procedures and Transitional Economies

What lessons can the East European transitional economies draw from the bankruptcy procedures of developed market economies? What are the options facing these reforming economies and how can the experience of other countries help them choose the appropriate option? In the past five years most East European economies (certainly the Czech Republic, Hungary and Poland) have adopted new bankruptcy laws and procedures, or revived their old ones. These are examined elsewhere in detail. Our discussion in Sections II and III highlights a number of important areas which are of particular relevance to transitional economies. In the remainder of this Section we shall discuss these areas briefly.

a. Causes of Financial Distress

⁵⁵ Baird & Jackson (1988), pp.742-743.

⁵⁶ *Ibid.*, p. 743.

⁵⁷ Hudson (1990), pp. 210-211.

While in Western market economies the firm and its management are generally considered responsible for financial distress, the position in Eastern Europe is more complex. The type of bankruptcy procedure (reorganisation or liquidation) the firm should embark on depends on why the firm has got into financial difficulty. Here, the reason for the insolvency of a large number of firms is not that they are either inefficient or that they produce the wrong bundle of goods.⁵⁸ External shocks and government policies during the early stages of transition, too, may result in financial distress. The restrictive macroeconomic policy, liberalisation of foreign trade and the collapse of CMEA markets all resulted in financial difficulties for a large number of firms for which they cannot be held responsible. The necessary adjustments, in production method, resource deployment, choice of output bundle or marketing, were not easy for many of these firms and could not be achieved with sufficient speed. The uncertainty about future ownership and the method of ownership transformation combined with the inability to raise sufficient funds for new investment compounded the problem. Many firms would have been able to sort out their problems if they could raise funds on financial markets and alter their production technology and product mix and find new markets.

In market economies, the number of firms in financial distress is relatively small with the number of those going bankrupt even smaller. In transitional economies, however, the number of financially distressed firms is very large, constituting the majority of large and medium size firms in many of these economies.⁵⁹ The liquidation or exit of these firms is not a minor issue, a by-product of the competitive process and natural selection. Given the magnitudes involved, a potentially explosive situation may be created if such firms were allowed, or forced, to go into liquidation. At stake is a massive productive capacity which may be lost forever as a result of these firms' exit. Moreover, the financing of unemployment benefit to the redundant work force and the maintenance of the social safety net will put additional pressure on the State budget with adverse implications for macroeconomic policy. Neither implications are socially desirable and may not be tolerated by the citizens of these emerging democracies.

The socially undesirable implications of large scale liquidation means that 'reorganisation' should be seriously considered, and strongly encouraged, as an alternative to liquidation.⁶⁰ Naturally, reorganisation would involve lengthy negotiations between the enterprise, government agencies, banks and other creditors. Most observers in this area have proposed reorganisation procedures involving debt-equity swaps combined with appropriate incentives for enterprises and banks (such as writing off the interest on senior debts of enterprises, bank recapitalisation, rescheduling

⁵⁸ For a detail discussion of financial distress and indebtedness, see Begg & Portes (1993); Ickes & Ryterman (1993); and Kornai (1993).

⁵⁹ It is possible to provide the numerical magnitude of debt for over 1700 Czech and 500 Polish enterprises, if necessary. For the extent and magnitude of indebtedness in Hungarian enterprises, see Mizsei (1993), pp.50-54 and Kornai (1993).

⁶⁰ The support for reorganisation procedures has been expressed by many scholars including, among others, Abel & Gatsios (1993); Gray (1993); and Mizsei (1993).

of other debts, etc.).⁶¹ The bank-led restructuring legislation in Poland (which came to an end in April 1994) was a major attempt at encouraging reorganisation and will be discussed elsewhere. Given the incentive mechanisms applied, reorganisation may also create conditions for rent seeking and opportunistic behaviour by some of the agents involved.

b. The Design of Bankruptcy Laws

Efficient bankruptcy laws should, in principle, result in the exit of those firms whose resources could be deployed more effectively elsewhere. To this end, they should prevent the managers (or creditors) applying for reorganisation and prolonging the process when the firm has little chance of survival. But, at the same time, they should also prevent premature liquidation - i.e., the disappearance of those firms which can be successfully reorganised.

The encouragement and support for reorganisation, of course, should not detract policy makers from the formulation of effective bankruptcy legislation dealing with both liquidation and reorganisation. The "design" of the law is particularly important in transitional economies because of the impact of incentives (or disincentives) that it creates for the debtors and creditors. It also has major implications for the effectiveness of the overall exit process.⁶² The following are some of the major issues that have to be taken into account in the "design" of effective bankruptcy laws.

(i) Declaration. The process of transition has created a fertile ground for opportunistic and self-interested behaviour by enterprise managers which must be taken seriously by policy makers and legislators. The managers of firms in financial distress wish to prolong their tenure by enlisting the support of government agencies (such as their founding bodies), banks and suppliers, and by lobbying the government for financial assistance. In some cases (e.g. in Poland) they have dealt with their financial difficulties by simply allowing their debt to the State (taxes and social security arrears) or banks to rise. In other cases, e.g. in the Czech Republic, they have allowed their debt to other enterprises to increase. Inter-enterprise debt (or secondary indebtedness) has become a common problem in all transitional economies.

Bankruptcy procedures may involve effective mechanisms to prevent this situation and to impose a discipline on such managers. The legal obligation to declare default on debt payment is the first step in this process. It can be backed up by other sanctions against the managers of insolvent or defaulting firms, ranging from financial penalties and dismissals to the appointment of a 'trustee' or 'liquidator' empowered to annul previous suspicious transactions. The Hungarian experience, whereby some 3500 cases of bankruptcy were filed in April 1992 alone (when the new bankruptcy law came into effect), shows the potency of the 'obligation to declare' provision.⁶³

⁶¹ For a discussion of several reorganisation options, see Aghion, Hart and Moore (1992) and Wijnbergen (1994).

⁶² For a detailed discussion of the importance of the "design" of bankruptcy procedures, see Gray (1994), pp.13-18.

⁶³ The situation in the Czech Republic and Poland is very different though. In the Czech Republic, the bankruptcy laws do not require the managers to file for bankruptcy on default thus creating incentives for opportunistic behaviour without any penalties. In Poland, despite the legal requirement, many managers have failed to declare their conditions and, so far, none have been prosecuted.

(ii) Protection of interests of all creditors. Reorganisation or liquidation should be overseen by outside specialists (judges, liquidators, trustees) in order to ensure that all creditors' interests are protected. An essential element of the design of the law is the obligation to provide information on the firm's financial position, through reliable means, to all creditors. A related issue is the choice of the proportion of creditors needed for the conclusion of a reorganisation agreement. In some countries, such as Hungary, reorganisation was possible only with the unanimous agreement of all creditors.⁶⁴ In others, such as Poland, the support of 50% is sufficient for reorganisations. While in the Hungarian case reorganisations were very difficult (thus the need to lower the threshold), in the Polish case the interest of minority creditors will be violated. The creation of separate classes of creditors (as in the American legal provisions) combined with the majority approval seems to be a sensible compromise. Such a provision will prevent the debtors reaching private agreements with some creditors at the expense of others. They will also ensure that reorganisations involving accommodation between enterprises and banks (such as the 'bank conciliation process' in Poland) are not carried out without the support of the majority of creditors.

(iii) The role of managers during reorganisation. An important question which should be addressed by the bankruptcy law is: who should be in charge of the company once bankruptcy proceedings have been embarked upon. As already mentioned, the bankruptcy procedures in many countries leave the existing managers in charge, particularly during reorganisation, because of their superior knowledge of the firm and its potential. Given the shortage of alternative management personnel, bankruptcy practitioners and other experts in transitional economies, this seems to be a desirable model for them too. But, in order to prevent managers from taking advantage of their position as 'debtors in charge', the procedure should impose a time limit on the managers to prepare a reorganisation plan with the proviso that after the expiry of this time the creditors should be able to propose their plan. Furthermore, provisions may be made for automatic conversion of reorganisation to liquidation should the debtor and creditors fail to reach an agreement within a given time period. These mechanisms, together, may produce the right incentive package for managers and encourage them to reach an agreement with creditors speedily.

(iv) Absolute priority rule. The establishment of a system of priority rules is essential for the efficient operation of the bankruptcy process. Of equal importance are the establishment, or strengthening, of a system of secured credits and the setting up of a national register of assets used as collateral in order to prevent fraudulent use of the same asset as collateral against several loans.⁶⁵ These would allow banks and other creditors to provide secured loans to firms at reduced costs (due to lower risks). They would also enable the firms in distress to borrow new funds during the reorganisation process since these loans will have priority over pre-bankruptcy loans.

A peculiar feature of many financially distressed firms in Central and Eastern Europe is the phenomenon that the State is, at the same time, the most senior claimant

⁶⁴ This was later changed to 50% (by number) and 67% (by value) of creditors.

⁶⁵ See the case study of Cottex Hrunov in Hashi, Mladek and Sinclair (1995) for a specific example of multiple collateralisation. For a more general comment see the Economist April 16, 1994.

(with tax and social security arrears) as well as the most junior stakeholder (being the ultimate owner or part-owner of the enterprise). Moreover, as the owner (or part-owner) of commercial banks, it is also amongst junior creditors along with other creditors. This unique position occupied by the government creates weaknesses as well as opportunities for resolving the firms' financial problems. The main weakness is that it accommodates creditor passivity (see below) and slows down the hardening of budget constraints. There is potential for implicit understanding being reached by bank and enterprise managers to roll over past credits and lobby for (and await) government support.

On the positive side, the redistribution resulting from any violation of the APR will not be very severe - the State may lose in one capacity but will gain in another. With government acting in several capacities, the number of claimants involved in any negotiation will be relatively small and the chance of reaching a settlement will be higher. In fact the opportunity for private restructuring, which is quicker and less costly, will be enhanced. The legal provision for bank-led enterprise restructuring in Poland shows that a large number of enterprises may survive without much loss to the State budget or creditors as a whole.

(v) Incentives for liquidators and trustees. Once the liquidation of the company (either as a going concern or piecemeal sale of assets) becomes inevitable, the remuneration of the liquidator or the trustee (as the case may be in different countries) becomes an important issue. On the one hand the appointee should have an incentive to complete the process as quickly as possible. On the other hand, she should try to realise the maximum possible value for creditors. The incentive package, therefore, should include a fixed sum augmented by a proportion of the recovered value of the firm. In the Czech Republic, for example, very few lawyers are prepared to accept trusteeships because they are very poorly remunerated. But, at the same time, the liquidators are paid very generously, to the extent that their incentive to complete the case quickly is weakened. Furthermore, in order to prevent fraudulent disposal of the assets, the appointees should be held liable for their actions. The threat of legal action by creditors who have suffered losses will impose some discipline on the liquidator or trustee.

c. Creditor Passivity

The existence of bankruptcy laws will not, in themselves, ensure their application. Laws can only be applied if creditors have an incentive to pursue the debtors and demand their claims. Creditor passivity, as Mitchell (1993) has shown, is one of the main obstacles to a faster restructuring of enterprises on the one hand and the relatively small number of bankruptcies on the other. The passivity of banks, which are the main creditors of most financially distressed enterprises, is of particular importance here and should be highlighted. In many cases, banks prefer to wait and retain some chance of recovering their claims (or parts of them) rather than push the debtor into bankruptcy and receive nothing or very little. In some cases, they expect that at some time in future the value of debtors' assets will rise and some of the debts will be honoured. More importantly, the loans are part of the 'assets' side of the banks' balance sheet and their writing off will reduce the value of the bank - which is not in the interest of banks' managers. In some transitional economies, the banks expect that, in the end, enterprise debts will be written off by the government and the banks will be recapitalised, thus the incentive to wait rather than embark on the bankruptcy process. Case studies of

financially distressed enterprises confirm the reluctance of banks to embark on lengthy bankruptcy proceedings.⁶⁶

The main reason for the passivity of banks in transitional economies is the fact that they are, and for the foreseeable future will remain, state-owned banks.⁶⁷ New private banks, with the ability to compete with state-owned banks, will not appear on the scene in the near future. The privatisation of banks will proceed very slowly and the State will retain large share holdings for a long time. The incentive to impose financial discipline on the debtors will remain at best weak until the emergence of competitive and independent private banks. Consequently, it is up to the State to use its moral position and voting power to enforce some discipline on bank managers, making them responsible for their lending policy. Any reorganisation, encouraged by the State, must take into account the incentive structure of not just the enterprise managers but also the bank managers. They too should be subject to strict performance criteria with the threat of financial penalties and loss of employment for poor performance combined with rewards for good performance.

d. Mergers.

In addition to reorganisation, a financially distressed firm may be encouraged to merge with a healthy company in the same industry. Again, the East European governments are in the unique position of being able to influence (if not exercise direct control over) the decision making process in many firms. In such cases, the implications of mergers for the competitive process would have to be weighed against the consequences of bankruptcy and liquidation. As Miller (1977) and Peele and Wilson (1989) have shown, mergers may provide an efficient and viable alternative to liquidation, provided the anti-monopoly rules are relaxed, or interpreted more favourably, in order to preserve all or most of the distressed firm.

⁶⁶ See case studies of Cottex Hrunov and Zelenina Terezin in Hashi, Mladek and Sinclair (1995).

⁶⁷ For a discussion of the interaction between the banking system and the bankruptcy process, see Wijnbergen (1994).

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