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Financial Management; Autumn 1996; 25, 3; ProQuest Central
pg. 67

European Bankruptcy Laws: Implications for Corporations Facing Financial Distress

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This study presents brief summaries and comparisons of the reorganization opportunities within the current bankruptcy codes in the US, the UK, France, and Germany. I also discuss the main implications for firms facing financial distress according to the provisions available. The focus is on the usefulness of the applicable legal framework in ameliorating the difficulties facing a distressed debtor; mainly, asymmetries of information, conflicts of interest, distorted incentives, and ability to obtain financing to remain in business. In spite of some efforts to remedy the situation, continental European nations continue to provide mixed opportunities and provisions for resolving the problems facing a viable, liquidity-constrained firm. I present some very coarse summary data which support these insights. In the conclusion, I discuss very briefly some of the different philosophies and policies behind the different codes, and how these views impact the nature of the codes and the availability of reorganization in the different countries.

■ Corporate bankruptcy laws have been an area of nearly constant change in many countries over the past century. Even with new Acts and Codes passed every several decades, however, there are still enormous differences between the bankruptcy laws of the industrialized nations. There are also still large differences in opinion, among legal academicians, practitioners, creditor organizations, and politicians, about what constitutes the "best" bankruptcy law. Indeed, even though formed after much debate and participation from many sectors of the economy and legal community, the US Bankruptcy Reform Act of 1978 has recently come under an intense wave of criticism and was substantially reformed itself in 1994.

Most generally, there are two alternative corporate bankruptcy structures: liquidation and reorganization. Bankruptcy laws in most countries have provisions, with varying accessibility, for both of these structures. For example, in the US, the Chapter 11 provisions of the US Bankruptcy Reform Act of 1978 are designed to encourage and facilitate reorganization. The provisions of Chapter 7, on the other hand, are intended to implement a quick and efficient liquidation. The characteristics of these two general structures vary dramatically from country to country, and the accessibility of the two structures, especially the reorganization provisions, also varies from country to country.

Each of the three European nations included in this paper has revised its bankruptcy code in the past decade. While each intended to improve the odds of rehabilitating a viable but distressed firm, none permit the debtor such power as that given to the debtor in Chapter 11. In the interests of space, this study focuses on the opportunities to reorganize a distressed debtor within the bankruptcy laws.

The Role of Bankruptcy Law. Bankruptcy law should provide a framework to permit viable but liquidity-constrained firms (those which can be reasonably expected to earn at least their cost of capital if continued but which are presently unable to meet their financial obligations) to reorganize and continue doing business and nonviable firms to be liquidated. The

I would like to thank Marko Rus, of Price Waterhouse in Paris, Tim Grundon, and John Francis who helped to produce and distribute the surveys of the UK Society of Practitioners of Insolvency, and Mr. Richard Theisen, Director of the workouts department of Dresdner Bank AG in Frankfurt. I also thank the reviewers whose comments significantly improved the article. I bear full responsibility for any errors.

framework should be sufficiently clear and well structured that the process, be it reorganization or liquidation, and the identification of which process will be applied is as efficient as possible.

There are many factors which complicate the situation facing a distressed firm and its claimants, including; 1) information asymmetries, where different parties have access to different sets of information, 2) conflicts among claimants, and 3) the familiar holdout (or free-rider) problem. (For a recent synthesis of the theoretical literature on financial distress, see Chen, Weston, and Altman, 1995.)

The practical issues to be addressed by the bankruptcy code include determining whether reorganization should be attempted, assigning control and decision-making authority while the firm deals with its distress, and financing the viable, liquidity-constrained firm while it reorganizes. The success of the provisions which govern these decisions will depend upon how effectively they address the complicating factors mentioned above.

The efficiency of the code is determined by its ability to avoid costs. The costs of financial distress are both direct — those costs for which a check must be written, such as legal fees directly connected to the distress—and indirect—those costs which are less easily defined and measured, such as lost sales, use of management time, disruption of business, etc. As both of these are increasing as the time spent in distress increases (in addition to other factors), the efficiency of the code will hinge upon its ability to resolve the situation in a timely manner. These costs also depend upon the incentives of the controlling party in distress (to delay proceedings or resolve the distress quickly) and the incentives of the firm's management prior to insolvency (to seek the protection of the court or to engage in risk-taking in an attempt to avoid collapse).

In addition to these efficiency-oriented issues, I consider the more narrowly focused concerns of the corporation facing distress. For the management making the decisions facing insolvency, I examine the key features of each law from the management's perspective, as distinct from a politician's or a creditor's.

I begin with a presentation of the provisions provided by Chapter 11. This provides a benchmark and is also used to highlight the use of various provisions to attain the goals of a bankruptcy code as discussed. I then discuss and contrast the French, German, and UK codes.

I briefly discuss the out-of-court workout option. Of course, not being ruled by laws, this option is available everywhere. However, its use will be largely determined by the legal structure of the country, and thus this discussion must follow the presentation of the various national codes.

The purpose of this exposition, very simply, is to better understand the use and usefulness of the different provisions in achieving an efficient outcome, and the implications of those provisions for the management of a distressed firm. Among the most important factors will be the presence of an automatic stay, the ability to grant priority to post-petition financing, the legal role of the debtor in electing who will manage the assets during the proceedings and in determining the structure of the reorganized firm, whether time limits are imposed on the proceedings, the ability to offer new and contingent securities to satisfy existing claims, and the legal role of creditors in the management of the firm and the structuring of a reorganization plan.

I. United States Chapter 11

A. Initiation and Preventive Provisions

Either the debtor or creditors can petition for Chapter 11 proceedings. Once formal bankruptcy has been initiated creditors are automatically "stayed" from taking any action against the debtor to collect on their claims. This stay remains in effect until termination of the proceedings and prevents essentially all debt-collection activity by pre-petition claimants, although sometimes the creditor can obtain relief from the stay under section 364 (d) of the bankruptcy code.

In a Chapter 11 case, the debtor normally retains control of the property of the bankruptcy estate. The bankruptcy estate includes all of the assets of the debtor and all claims held by the debtor against third parties. In addition, certain distributions (preference payments[1] and fraudulent transfers) made by the debtor prior to the filing may be avoided by the court and added to the bankruptcy estate.

The automatic stay and, to a lesser extent, the ability to void preference payments are among the most important measures provided to resolve some of the complications facing the distressed firm. Upon learning that a debtor may have difficulties meeting payments, all creditors have an incentive to get to the debtor quickly to retrieve as much of their claim as possible before other creditors collect on their claims. This behavior could result in creditors pouncing prematurely and dismantling a viable business. The automatic stay ensures that the business will remain

[1] Preference payments are payments made to creditors for antecedent debt after the firm becomes insolvent (in a stock sense, market value of assets is less than liabilities) which exceed what those creditors would have received in formal liquidation.

in operation while the creditors and debtor examine the situation, enabling the business to realize more value for all claimants.

B. Control and Decision-Making Authority

As mentioned above, in most Chapter 11 cases the debtor maintains control of the assets and day-to-day operations of the firm as *debtor-in-possession*.[2] The debtor often retains this position throughout the reorganization and in many cases retains existing management to operate the firm (see Gilson, 1989). In addition to control of the business, the debtor obtains a 120-day "exclusivity period" in which no other party in interest can file a plan of reorganization. If the debtor does file a plan within this 120-day period, no other plan may be filed by a third party in the 180-day period while the debtor solicits votes in favor of the plan. Further, the bankruptcy court is empowered to extend (or reduce, though in practice extensions are the rule rather than the exception) either of these periods. While it is not unusual to have management retained to manage the firm, or at least aid a court-appointed trustee, Chapter 11 is unique in giving the debtor, and thus, in many cases, existing management, control over determining the structure of the reorganized firm. In no other country does the debtor have a legal ability to even impact, not to mention unilaterally structure, the reorganized firm.

This strong bias toward the debtor is designed to ensure that creditors are willing, or forced, to negotiate with the debtor rather than simply present ultimatums and then liquidate the firm. Among the distorted incentives facing a distressed firm is the incentive of secured creditors to liquidate the firm. While this generally provides secured creditors with the highest present value payoff, it will be to the detriment of the estate in cases where the firm is worth more as a going concern. Thus, Chapter 11 has taken away the ability of secured creditors to force a collectively suboptimal resolution (liquidation) on the business, apparently at the expense of these creditors. Indeed, the structure appears to enable the equity holders to obtain more than they could were they forced to negotiate outside of bankruptcy, and regularly results in other violations of absolute priority.

As a result of this observation, the 1994 reform returned some control to the creditors. Among many small changes, creditors now will have an automatic right of appeal whenever the court enters an order extending the exclusivity period and will have more timely responses to requests for relief from the automatic stay.

There are several provisions working to resolve the holdout problem and the practical difficulty of working with hundreds, or perhaps thousands, of different creditors. Often, a committee of unsecured creditors is appointed by the court soon after entrance to Chapter 11. This, obviously, reduces the number of parties with whom the debtor and banks must negotiate. A much more significant aid is the voting procedure which requires a two-thirds majority by value and a simple majority by number within each class for acceptance. This resolves the holdout problem as it avoids the unanimity requirement necessary outside Chapter 11 under the Trust Indenture Act of 1933.

C. Financing the Business within Chapter 11

Chapter 11 contains special provisions to ensure that once in Chapter 11 a firm has access to badly needed financing (referred to as debtor-in-possession, or DIP, financing). All post-petition unsecured credit resulting from the debtor's "ordinary course of business" automatically has administrative level priority over pre-petition claims, and increasing levels of priority are available if deemed necessary by the court. These include priority over other administrative claims, a lien on the debtor's unencumbered property, or even a lien on the debtor's encumbered property. The last alternative, termed "superpriority," may only be authorized if the pre-petition secured creditor's interest is found to be "adequately protected." Only France, among the nations considered in this study, provides a similar (in fact, even stronger) measure.

D. Plan of Rehabilitation and Termination

The plan of reorganization must classify all of the creditors' claims into classes and outline the payments (amount and form) to be received by the various classes and the financing and business plan which will make these payments possible. In addition to cash, most plans also offer the pre-petition creditors both new debt and new equity claims. The plan may call for liquidating large portions of the firm or altering the governance or management structure or nearly any other change which is deemed to help turn the business around.

A debtor inside Chapter 11 has a slight advantage in issuing new securities in that normal federal and state registration requirements need not be met. Not surprisingly, given this fact and the debtor's lack of cash, we often see creditors accept new securities (equity or debt) in place of their pre-petition claims. Contingent securities are also used to reduce information asymmetries. Better informed creditors, such as banks, can credibly signal to other creditors their belief in a proposed plan by accepting equity securities in place of their debt claims. In a similar vein,

[2] A trustee may be appointed, though this is relatively rare.

the creditors, including the "sophisticated" creditors, may be concerned that they are being taken advantage of in a proposed plan in which they receive only cash or cash and new debt claims. Accepting an equity claim mitigates this concern by providing the holder with the upside benefit which is not realized by cash or a debt claim.

As discussed above, approval of a plan requires a simple majority in number and a two-thirds majority in value within each class. In the event that at least one impaired class accepts the plan but others reject, the plan can still be confirmed by the court under the "cram down" provision. While rarely used in practice, the impact of this provision is significant in a large number of cases in convincing (some would say coercing) reluctant claimants to vote to accept a plan. This is another demonstration of the advantage awarded to debtors in Chapter 11. No such provision exists in other countries.

Among the major failings of Chapter 11 is a satisfactory early assessment procedure for determining whether a firm should be maintained or liquidated. There is no obligatory third-party valuation or assessment upon entrance into bankruptcy of the viability of the firm or its relative value as a going concern *versus* liquidation. The bias is to accept that firms are worth more alive than dead and to seek a reorganization. As a result, far too many firms are likely to spend time in Chapter 11 rather than being immediately liquidated. Another failing of Chapter 11 concerns the ability to delay the proceedings indefinitely.

II. France

Of the European nations, France has perhaps gone the furthest toward providing opportunities for reorganizing or resuscitating a distressed firm. The legal text of the 1985 law, and also the 1994 revision, states that the objectives of the law, in order of priority, are to maintain firms in operation, preserve employment and, thirdly, to enforce credit contracts. The main outcome of the 1994 revision was to shift, though only modestly, some of the balance of power back to creditors.

French insolvency law provides three alternative procedures for dealing with a distressed firm. The first procedure is unique in many respects. Prior to ceasing payments on its debts but facing imminent insolvency, a firm may use the negotiated settlement (*réglement amiable*) procedure to attempt to restructure its liabilities. More conventionally, having ceased payments a firm enters judicial arrangement (*redressement judiciare*) in which it may attempt a reorganization. If reorganization is not achieved, or is deemed not feasible or economically efficient,[3] the firm will be moved from judicial arrangement to judicial liquidation (*liquidation judiciare*).

A. Negotiated Settlement *(Réglement Amiable)*

The negotiated settlement procedure is designed simply to permit a renegotiation of contracts. There is no automatic stay. Debtors who default during the negotiated settlement proceedings will be moved to judicial arrangement subject to the discretion of the creditor(s). The debtor remains in control of all operating decisions and will also be very involved in negotiating a resolution.

All parties are sworn to confidentiality. Thus, a firm in negotiated settlement proceedings is able to keep this fact secret from all parties except those with which it is negotiating. The right to petition the court for a negotiated settlement is reserved exclusively for the debtor. While this is intended to be available only for debtors which have not yet ceased payments, it may still be available provided no creditor whose payment has been suspended has yet requested judicial arrangement. The objective of the negotiated settlement procedure is to provide the debtor with a court-appointed conciliator with expertise in resolving such disputes in order to enable negotiation of an acceptable solution with its principal creditors. The result is a reduction in information asymmetries and management of the conflicts of interest by a professional, disinterested mediator.

Entrance to the procedure also lends credibility to the debtor's claims of financial difficulty, as the court will only admit a debtor for whom insolvency is deemed to be imminent without debt relief. While the conciliator has no power to impose a solution (as does the judge in judicial arrangement), any agreement reached in a negotiated settlement is binding. In addition, the creditors enjoy a much more active role in structuring the new financial structure in the negotiated settlement procedure than they are able to play inside formal judicial arrangement.

Unfortunately, while this procedure has considerable value in reducing the obstacles which normally prevent reorganizations outside of bankruptcy, it is only very rarely used in practice. One reason for this may be that the procedure is intended to be used on a small scale, to obtain relief from a limited number of all of the creditors of the firm. The creditors then face the risk of participating in the negotiated settlement, writing

[3] French bankruptcy law is, not surprisingly, heavily biased towards employees and job preservation. The possibility of continuation of the business is available mainly to preserve employment.

down their claims, but having the firm fail nonetheless. In this case, those creditors who participated in the negotiated settlement would enter judicial arrangement with only their reduced claims against the debtor rather than their original claims while nonparticipating creditors retain their original claims in full. No comparable procedure exists outside of France.

B. Judicial Arrangement (*Redressement Judiciare*)

Proceedings may be initiated by petitions filed by either the debtor or the creditors, or the commercial court if it becomes informed of the financial difficulties of the firm. While debtors in France are required to inform the court within 15 days of a cessation of payments, the majority of bankruptcy cases (66% in 1993, see Table 5) are opened either by creditors or the commercial court.

Judicial arrangement is broken into two stages; the observation stage and the decision and execution stage. The observation stage is intended to enable the parties to assess the situation calmly, make an early determination of the viability of the business, and permit parties to present potential rescue plans to the court. The observation phase is a maximum 18 months for the general procedure and 8 months for the simplified procedure.[4] Among the first steps taken by the court is the assignment of a "judge" from the *Tribunal de Commerce*. These judges are in fact business people who are likely to have a good understanding of the business and the economic viability of the firm. Their first assessment concerns the reorganization prospects for the firm. If reorganization is not considered a real option, the firm is moved to liquidation proceedings immediately. In 1993, 74% of all filings were immediately moved to liquidation with a further 12% being moved to liquidation at a later stage.

C. Control and Decision-Making

If the case is not moved to liquidation, an administrator, a creditors' representative (both officers of the court), and a supervisory judge are appointed by the court. In addition, employees are invited to appoint an employees' representative.[5] The creditors lose the right to speak directly to the court in judicial arrangement. The creditors' representative, appointed by the court, has the sole capacity to act on their behalf and in their interest.

The debtor continues to manage the firm, at least in principle, though the administrator will often supervise management or even take a more active role. The administrator has the right to determine whether and which contracts outstanding will remain in force or be declared void in order to best ensure the survival of the business. The administrator's main role during the observation period is to analyze the business and file a report to the court outlining a plan of action (reorganization or liquidation) based on the state of the firm.

Upon entrance to judicial arrangement, a stay is imposed on all efforts by creditors to receive consideration for their claims. Creditors are required to submit their claims to the court within two months of the adjudication of bankruptcy—failing to do so means a forfeiture of any dividends to be distributed in bankruptcy. Interest does not accrue on most claims during the proceedings.[6] In addition, the 1985 Law introduced a "super-priority" status for creditors of origin after the entrance to judicial arrangement. This means that any creditor whose claim arises during the observation period has priority over all other claims (except uninsured employees salaries, which have highest priority, and court and administrative fees), whether secured or not, and these new claims have a secured right over the debtor's assets.

D. Plan of Reorganization and Termination

Before the end of the observation period, the court must either accept a rescue plan or move the firm into judicial liquidation. The reorganization plans are generally structured by the administrator working with the judge. The management may provide input in the form of information, but in general neither the managers nor the creditors actively participate in crafting a plan. In any case, the court can accept a proposed plan of reorganization, modify a proposed plan of reorganization in any way, refuse a plan of reorganization and move the firm into liquidation, refuse a recommendation for liquidation and reorganize instead, or take any other action it deems appropriate. Any plan of reorganization must satisfy the stated purpose of judicial arrangement: to safeguard the business, ensure continuation of operations and employment, and to discharge liabilities. While the court cannot force the creditors to write off any portion of their claims in a reorganization, it can alter the claims

[4] The simplified procedure, used by 97% of those firms entering bankruptcy, is applicable to firms with fewer than 50 employees and with sales below 20 million francs after-tax.

[5] Note that the employees are able to choose their own representative, but the creditors are not. This example clearly illustrates the bias of French bankruptcy law favoring employees over all other claimants.

[6] It may be that this forfeiture of interest can be extended beyond the duration of the reorganization proceedings. It is possible under the new law to force a creditor to defer its claim for an unlimited period of time (Art. 74 al. 2 loi no. 85-98). However, whether interest necessarily begins to accrue upon the firm's exit from the proceedings or is also subject to court discretion is not clear.

by extending the maturity and repayment structure. In many cases, the court will offer creditors an alternative between a quick repayment with a large write-off or no write-off but a very delayed repayment.

In the event that the court determines that sale of the firm is in the best interest of the business, it must choose that offer which ensures the best prospects for continued employment and repayment of liabilities. The purchaser must assume all employment contracts (as mandated under the French Labor Code in the event of any transfer of ownership of a firm whose business is maintained). In addition, the court can transfer contracts which it determines are necessary to secure the success of the firm as a going concern (such as leases on equipment or real estate, supplier contracts, etc.). The other party to such contracts does not have a right of appeal. Under the 1994 reform, secured loans can no longer be written off by the court in the event of a sale (as regularly occurred under the 1985 law). The purchaser must assume these liabilities and is not permitted to sell the assets on which the loans are secured prior to complete repayment. This is one of the notable changes in the 1994 law returning power to the creditors. Under the 1985 law, many secured creditors lost their security in these "sales" in which it was often argued the debtor was personally engineering the purchase out of bankruptcy to wipe out existing debt.

E. Implications for Firms Facing Distress

The 1985 French Code attempted to adopt the best attributes of Chapter 11 while avoiding the worst attributes. Generally, the law reveals a lack of trust in both debtors' and creditors' abilities to resolve distress without outside influence. Remarkable power is given to the court overseeing the case to impose whatever business plan is deemed "best" and to craft a new financial structure almost arbitrarily. In addition, the well-known French propensity to sacrifice various economic goals (individual or communal) to the interest of continued employment is apparent. While the 1994 law returned some power to the creditors, it has not weakened the role of the administrator and judge in designing and implementing, without input from the management or creditors, the reorganization plan.

In order to maximize the likelihood of continuation, the law attempts to encourage early entry to court proceedings. Under the 1994 law, government agencies (Treasury and Social Security) receiving payments from firms and the firm's own certified accountants are required to inform the commercial court when a firm enters distress. In practice, however, both often fail to do so. In addition, the rather light treatment of managers in judicial arrangement (99% of managers of reorganized firms remained in control of the reorganized firm following exit from bankruptcy in a study of the Toulouse region by Saint-Alary, 1990) should encourage them to enter willingly. Unfortunately, practitioners continue to report that too many firms arrive too late to be maintained. As a result, firms which might likely have been reorganized if they had received court attention earlier, wind up liquidated. Possible explanations for this may include the loss of benefits of control and the social stigma associated with managing a firm into bankruptcy, which prevent managers from entering even when it may maximize the probability of their continued employment.

By removing equity holders and debtholders from the process (replacing their self-appointed representatives with court-appointed representatives) many dead-weight costs associated with inefficient positioning and bargaining in the face of conflicts of interest and informational asymmetries, common in Chapter 11, are avoided here. In addition, giving the court broad powers further reduces the dead-weight costs associated with inefficient bargaining in the same way that giving extraordinary power to either side in a Chapter 11 case would result in a quicker, if less "fair," resolution. Insofar as companies are successfully reorganized at lower cost than Chapter 11, these are worthwhile changes. However, very few firms are successfully reorganized in France. Not surprisingly, the three stated aims of the law conflict with one another. Firms which would be viable if properly reorganized, with sufficient improvements in production efficiency and debt write-offs, are being continued instead as nonviable firms. Forcing these firms to maintain employment levels and contracts, and under the 1994 law to also maintain secured debts in full in the event of sale, prevents firms from being able to return to viability.

As a result, the French law is failing by trying to achieve too much. A 1993 study by Germain and Frison Roche of continuations in the Paris region following the 1985 law found that one out of two, during the period from 1986 to 1991, resulted in a second judicial arrangement procedure. Furthermore, more than 88% of these second cases resulted in liquidation. In effect, by trying too hard to maintain firms as going concerns in order to preserve employment, the French law fails to return viable firms to sufficient health, and thus fails to meet either of the first two objectives. By adding the creditor-oriented provisions of the 1994 law, this result is strengthened by reducing the ability to achieve a partial fix by selling the assets of the firm as a going concern to wipe out existing debt.

These effects outweigh the impact of the several measures which would appear to aid in the resolution of distress and avoidance of liquidation for viable firms.

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Otherwise viable firms are either liquidated because they cannot escape bankruptcy with employment contracts intact, or manage to escape but soon find themselves back in bankruptcy and being liquidated.

III. Germany

Current German law provides for two separate forms of court proceedings, composition (*Vergleichsordnung*) or compulsory liquidation (*Konkurssordnung*).[7] New legislation was passed in 1994 which combines these two procedures into a single unified code, but this code will not go into effect until 1999. While composition is intended to provide an opportunity to reorganize the firm, in practice reorganization within either procedure is extremely rare.[8] As a result, most debtors with a real chance of survival will be reorganized through an out-of-court workout.

A. Court Composition (*Vergleichsordnung*)—Initiation of Proceedings

The application for composition proceedings must be made by the debtor. Only unsecured creditors are subject to the composition proceedings. Secured and preferential creditors may continue legal action to obtain satisfaction for their claims—there is no automatic stay under the current code. The 1994 law provides an automatic stay of three months, and also removes the many different types of preferential creditors permitted under the current law. By law, the debtor must inform the courts within 15 days of learning of the company's insolvency. If it intends to request composition, it must do so at that time, and must provide details of the proposed composition plan.

All unsecured claims must be treated equally under the composition plan. The plan must provide a minimum cash payment to the composition creditors according to the formula:

- for payment to be made within one year— 35% of claims,
- for payment to be made after one year but within 18 months— 40% of claims,
- for payment to be made after 18 months— over 40% of claims.

Note that there is no possibility of replacing existing claims with new, in particular contingent, claims. A composition is simply an agreement wherein creditors accept partial payment over a specified time period in satisfaction of the entire pre-agreement claim.

A preliminary receiver is appointed upon the filing of the composition application whose main responsibilities are to assess the state of the debtor, supervise management and report to the court on the viability of composition. If composition follows, the preliminary receiver will normally become the composition receiver, though this is subject to the discretion of the court. The court will announce the date on which it will rule on the request for composition. The time between filing and this date can vary dramatically, and creditors have no opportunity to be heard during this period. The court will approve the request provided the legal technicalities have been observed, the statutory minimum payments will be made, there is a reasonable prospect of success, and sufficient assets exist to cover the expected cost of the proceedings. (Over the period 1985-1991, an average of 74% of requests for composition were approved.)

B. Control and Decision-Making

The court's order for composition proceedings automatically stays all actions by composition creditors to collect on their claims, though no restriction applies to non-composition (secured and preferred) creditors. The debtor management normally retains control but must seek receiver authorization for activities outside the day-to-day operations of the business.

The composition creditors have a limited role except in the creditors' meeting where they vote to accept or reject the composition plan. The non-composition (secured and preferential) creditors are not impacted or restricted by the composition proceedings except insofar as a request for bankruptcy will not be heard during the composition proceedings.

C. Termination and Acceptance of a Plan

At the creditors' meeting, the debtor will present the composition plan. Creditors present then have an opportunity to question the likelihood of success and the feasibility of the plan.

Acceptance of the plan requires approval by a simple majority in number and a three-quarter majority by value of creditors present or represented at the creditors' meeting. (If the total distribution is less than 50% of the value of the allowed claims, an 80% majority by value is required.) An accepted plan will normally be ordered binding by the court unless the rule of the law has not been followed. The court's order makes the

[7] There is a composition procedure incorporated into the bankruptcy statutes, *zwangsvergleich*, which is similar to out-of-bankruptcy composition and will be discussed within the termination of bankruptcy section below.

[8] Over the period 1985-1992, 60% of firms which entered composition proceedings successfully exited with the business intact. However, court compositions represented only 0.39% of all insolvency proceedings over this period, making for a dismal recovery rate overall.

agreement binding on all composition creditors including those who voted against it and those absent from the meeting. The new claims remain valid unless specific clauses are included in the agreement which reinstate the original claims if the debtor's health improves sufficiently, or if the debtor defaults on the agreement.

D. Implications for Firms Facing Financial Distress

Many of the beneficial features of Chapter 11 which provide or restrict participants' incentives and which aid in the resolution of information asymmetries are not found in this outdated composition law. Among its failings, the requirement that a complete plan be submitted at the time of notification of insolvency and the fact that there is no automatic stay doom the prospects for court-supervised reorganization in Germany. No debtor of any size or complexity could possibly formulate a plan of reorganization within fifteen days of learning of the company's insolvency. The fact that secured and preferred creditors are able to exercise their right to their security without hindrance by the court essentially ensures that the continued operation of the firm will be impossible. It also does nothing to remove the incentive or ability of secured creditors to disassemble the firm even where that is not in the common interest of all claimants. In addition, by having no disinterested third-party assessment presented to interested parties, as in the French observation period, and, by not permitting the use of new contingent claims, the provisions provide no means of resolving information asymmetries across participants. Finally, the required cash repayments within specified periods put an added strain on the firm and reduce the breathing space necessary for most distressed firms to get back on their feet.

On the positive side, the advantage of this approach is that the direct and indirect costs are probably much lower in German insolvency proceedings than in Chapter 11 proceedings. The bargaining situation between the firm and its various creditors has been removed, reducing the need for teams of lawyers employing costly negotiating tactics, many of which result in dead-weight costs. The proceedings are relatively quick and clean with few opportunities or incentives for participants to delay or hinder the process.

Another positive result is that virtually all reorganizations occur outside of court. As evidenced by several studies on US data (Franks and Torous, 1994), out-of-court workouts are considerably less expensive than court-supervised reorganizations. Thus, the total costs of financial distress may be lower in Germany. In addition, the strength of the creditors' bargaining position in financial distress in Germany should result in less credit rationing, though there is no strong evidence that this is the case.

IV. United Kingdom

Limited companies in the UK have access to four court-supervised reorganization procedures; receivership and administrative receivership, administration, company voluntary arrangement (CVA) under Part I of the Insolvency Act 1986, or arrangement under the Companies Act 1985. Perhaps the most significant fact for a distressed debtor is that in each of the British insolvency procedures, control of the company is transferred from its directors and given to a "licensed insolvency practitioner," usually a member of an accounting firm.

A. Receivership and Administrative Receivership

Although receivership does not exclude the possibility of reorganization and continuation of the firm, it usually results in the quick sale of the business (see Table 11), often within days or weeks of the receiver being appointed. The company normally ceases to exist following the proceedings. While CVAs are possible within receivership, they very rarely occur.

The difference between receivership and administrative receivership concerns the type of claim held by the creditor appointing the receiver. When the holder of a fixed charge[9] appoints a receiver, the firm is said to be in receivership, and the receiver's responsibilities are focused on realizing the asset securing the fixed charge and distributing the proceeds to the holder of the claim. The administrative receivership procedure is the method by which holders of floating charges enforce their security. A floating charge confers on the creditor the right to appoint an administrative receiver upon the occurrence of certain specified events.[10] Unlike the receiver, the administrative receiver assumes control of the entire firm in order to realize sufficient value from the assets to

[9] A debt may be secured by specific assets in which case the security is referred to as a *fixed charge* (such as a typical mortgage) or by a less clearly defined category of assets in which case the security is referred to as a *floating charge*. For example, I may accept a floating charge over a firm's equipment or inventories. In the normal course of business, the charge *floats* over the assets enabling the firm to dispose of or replace those assets as the business requires, with the replacement assets serving as the new security. In the event of default, the floating charge becomes fixed on those assets currently in the firm under the floating charge. The floating charge will be discussed further when I examine the administrative receivership procedure.

[10] The administrative receiver is then distinguished from a receiver by the fact that he has responsibility for the administration of the entire firm rather than just those assets securing the fixed charge the receiver is appointed to realize.

repay the floating claim. Fixed claims must be paid out of the proceeds from the corresponding securing assets. Only secured creditors are able to appoint a receiver.

In contrast to the French code, in the event of a sale, the sale assets are normally unencumbered by either executory contracts or debts. In addition, the employees are normally discharged by the administrative receiver prior to sale and the purchaser can reemploy those he feels are necessary.

B. Control and Decision-Making

The role of the administrative receiver is to realize the security and, after deducting his expenses and paying prior ranking interests (such as claims secured by fixed charges), to pay the proceeds to the debenture holder up to the amount of the secured interest. The balance is paid to the company, its liquidator, or any subsequent ranking security holder. Although appointed by a creditor, the administrative receiver acts as agent for the company and has broad powers, including the ability to manage the company's business and to sell assets. The administrative receiver has the power to continue or terminate any outstanding executory contracts, including employment contracts, and is not legally responsible to unsecured creditors.

While the administrative receiver is able to obtain new financing in order to maintain the business while attempting to sell the company or assets, the new financing does not receive priority over existing claims.[11] Moreover, the receiver is personally liable for all post-commencement financing.[12] Any new financing is typically provided by the debenture holder which appointed the receiver (the appointor). However, the appointor must then bear the downside risk of new money injected to attempt to resuscitate the firm, whereas the unsecured creditors will realize any upside from the new money. Thus, the receiver's incentive, supported and encouraged by the appointor, is to realize the assets as quickly as possible. As the receiver is not legally responsible for these creditors, and the appointor will often be unwilling to assume the downside risk inherent in attempting to preserve the firm as a going concern, many firms will be inefficiently liquidated.

Supporters of the UK code claim that the law encourages the sale of the firm as a going concern and thus is as effective as reorganization while reducing the deadweight costs. This may be the case. On the other hand, the incentives of the receiver and the appointor are not to maximize the value of the concern, but rather to realize the proceeds from a sale as quickly as possible at any value up to, but not necessarily above, the claim of the appointing creditor. Thus, given the choice between selling the firm in pieces for an amount just equal to the combined value of the secured claims immediately, or selling as a going concern through a bidding process for perhaps double the value of the secured claims, the appointor and receiver may quite likely prefer the first option. This may simply mean an *ex post* transfer of wealth from the unsecured creditors and equity holders, to the new owners. However, it may involve dead weight costs if the first best allocation of the assets is not obtained in the rush to sell, or if it results in credit constraints by suppliers and other unsecured creditors or distorted incentives for the debtor when facing insolvency.

C. Administration and Company Voluntary Arrangement — Initiation of Proceedings

While administration and CVA are two separate legal procedures, they are most effective when used jointly, which is their most common usage at present. CVA is a procedure intended to be used by viable firms to restructure their financial obligations in order to return to health. The proposal for CVA must nominate a qualified insolvency practitioner whose role will be to supervise the implementation of the reorganization plan (scheme of arrangement) and to report to the Court. When used in conjunction with administration, the administrator will assume this role. The CVA procedure does not provide an automatic stay or any other form of relief from creditors, nor does it provide any other provisions which would aid in resolving the difficulties with obtaining new financing, mitigating the holdout problem, or coercing reluctant creditors to participate.

Within 28 days of being given notice of the proposal, the nominee must submit a report to the court assessing the feasibility of the proposal and stating whether it should be submitted for creditors' consideration. If it is recommended that the proposal be submitted to the creditors for a vote, the nominee must also propose a schedule for the creditors' and members' meetings. Notice must be sent at least 14 days prior to the meeting to all members and creditors, however, no public notice is required. Any creditors who do not have notice of the proposals for a CVA, for whatever reason, are not bound by the decision obtained at the creditors' meeting. Approval of a scheme requires that three-quarters in attendance or voting by proxy vote in favor. All parties (members and creditors) who had notice of and were entitled to vote at the meetings will be bound to the proposal.

Administration is intended to provide firms without

[11] However, any claims arising for supplies or services provided after the appointment of the receiver and on his order will receive priority over all other unsecured claims.

[12] While personally liable for new financing, the receiver is entitled to an indemnity out of the debtor's assets for their liabilities.

floating claim holders with access to an administrator with powers similar to those enjoyed by the administrative receiver. Administration is initiated by the directors of the company petitioning the court for the appointment of an administrator. Although creditors have the legal right to submit a petition, they rarely do so because of their limited ability to provide the evidence required in support of the petition. Although administration is the UK's most advanced form of court supervised reorganization, it is rarely used compared to either receivership or liquidation.[13]

The administrator's first job is to outline the company's financial position, its assets and liabilities (including contingent liabilities) and detail any security held by creditors and whether the security gives the power to appoint a receiver. Holders of floating charges may prevent an administration order being made against the company by appointing an administrative receiver before the petition for administration is heard by the Court. All other actions by creditors are stayed as of the filing of the petition. An administration order cannot be made where a company has already gone into liquidation.

D. Control and Decision-Making

While the board of directors continues to have certain legal obligations, neither the board nor company officers have any power or control over the administrator. The administrator's powers are quite broad and include both management of the business and the power to put forward proposals for a CVA or an arrangement under the Companies Act 1985. All assets, whether used to secure fixed charges or not, fall under the control of the administrator.

The role of the administrator is to manage the company as a going concern, summarize the position of the firm for the court and propose a plan for its future. The administrator must continue the management of the firm in the interests of both the creditors and the shareholders, which affords him a wide range of powers including the right to borrow money and, subject to the court's approval, grant security over the company's property. He also has significant control over the structure of the operations and its employment practices. Any credits arising from the continuation of the business following the petition are granted priority over all claims except those secured by a fixed charge.

E. Plan of Reorganization and Termination

The administrator (or an authorized insolvency practitioner chosen by the administrator) is also charged with formulating a plan of arrangement. The proposal may be for reorganization and continuation of the company (in the form of a composition or a scheme of arrangement[14]) or for its liquidation. The proposal must be sent to the creditors within three months of the administrator's appointment, though this period can be extended by the Court. Once drafted, the plan of arrangement is then presented to a meeting of the creditors and the shareholders where modifications may be proposed and where it is ultimately voted upon. If the administrator's plan is accepted, he becomes the supervisor (and the trustee for a scheme of arrangement). Each secured and preferential creditor has a veto over the plan. Acceptance requires a simple majority by value of the creditors voting either in person or by proxy and a similar majority of shareholders.

If the plan called for liquidation, the court will discharge the administration order and commence liquidation procedures. In this case, the administrator will usually act as supervisor of the plan of arrangement and as liquidator. If the plan calls for rehabilitation, the court will return the company to the directors (who may be the original board or a new board proposed by the plan) and the supervisor of the plan.

F. Arrangement Under the Companies Act 1985

This procedure was introduced to provide an alternative to liquidation. However, the newer procedures of administration and voluntary arrangement introduced in the 1986 law render this alternative far less attractive, and it is rarely used in practice. The main difference between CVA under the Insolvency Act 1986 and arrangement under the Companies Act 1985 is that the latter requires acceptance by 75% in value *of each class of creditors* and shareholders. Each class of creditors must hold a separate meeting to vote on the plan. This may be more appropriate than CVA when the firm has a highly complicated financial structure making approval at a single meeting of creditors (as with the CVA procedure) difficult or infeasible.

G. Implications for Firms Facing Financial Distress

A firm facing financial distress has several reasons for preferring the administration/CVA combination to

[13] The Department of Trade and Industry statistics for 1989 report 10,440 liquidations and only 135 administrations. However, table 8 below shows a much larger percentage of administrations for a sample of insolvencies taken in 1992.

[14] A scheme of arrangement differs from a composition in that it may include, in addition to forgiveness of portions of the loans, conversion of loans to equity stakes, profit sharing, or other more complicated securities.

arrangement under the Companies Act 1985 or to (administrative) receivership. The main reasons are the automatic stay imposed in administration, the ability to exchange existing securities for new securities in a CVA, the simplified voting procedures of the administration/CVA procedure, and the increased ability and improved incentives to attract new financing to increase the likelihood that the business can be maintained either to be reorganized or sold as a going concern. The utility of the first three of these measures in reducing the barriers to resolution has been discussed above, and we state once again that they can be critical to a firm's successful reorganization. Also, the necessity of cash to keep a distressed firm alive is obvious, and provisions which enhance the firm's ability to obtain new financing will dramatically improve its chances of survival.

Unfortunately, Britain's best reorganization procedure suffers some important faults. The removal of management can, and often does, negatively impact the value and viability of the business. Also, the opportunities for new financing are not as developed as in Chapter 11. Finally, the law remains more creditor-oriented than Chapter 11, and this is reflected in the larger role played by creditors in formulating a plan of reorganization. In most cases, sale either as a going concern or piecemeal is preferred to an arrangement, as this reduces the downside risk which is borne by the secured creditors, as discussed above. This is also the case in administrations. The result is that managers always lose their jobs, and equity is highly unlikely to receive anything out of any procedure. This may partly explain why few firms have made use of this procedure. Managers prefer to attempt various other alternative means of avoiding receivership rather than deal with administration, with the result that firms which enter insolvency proceedings have reached a more advanced state of distress than would be the case for firms entering Chapter 11. This further reduces the likelihood of a successful reorganization.

On the positive side, the UK procedures are much more successful (as a result of the incentives outlined above) at selling viable businesses to interested sellers. In this respect, the UK code may be able to preserve at least a portion of the going-concern value of the distressed firm and employment more effectively than would be the case if the courts insisted that existing owners and creditors resolve the distress and keep the corporate entity intact.

V. The Private Workout Option

To the extent that bankruptcy laws should facilitate an efficient liquidation of an economically nonviable firm or permit a quick restructuring of a viable firm, many of the national bankruptcy laws have failed. Reorganizations within insolvency proceedings in most European countries are extremely rare. However, there is nothing to prevent creditors and shareholders from agreeing to a private reorganization outside of court proceedings. Unfortunately, the feasibility of this option varies greatly from country to country depending on the rules regarding *formal* reorganization procedures.

The effect of bankruptcy rules on private restructurings can be seen by comparing the United States with Germany. As a result of legal precedent in the US regarding lender liability, banks are discouraged from forming close working relationships with their clients. Banks become hesitant about providing advice to a company for fear of being held financially liable for any directions that may result in a loss in firm value. The result is an unwillingness on the part of banks to form advisory relationships with their clients or to participate in private reorganizations. Recent court rulings and tax changes have further reduced the attraction of private workouts relative to Chapter 11 reorganizations in the US. In the case of LTV Corp., the court ruled that holders of public bonds who participated in an exchange offer had allowed claims equivalent only to the market value of the new bonds whereas non-participating bondholders in the exchange had claims equal to the full face value of the original claims. The effect of such a precedent would be to increase the holdout problem in an out-of-court workout and thus reduce the ability of a distressed firm to achieve such a resolution.

In the US, the response has been to utilize a hybrid form of workout which blends aspects of the out-of-court informal procedure with the formal procedure provided by Chapter 11, termed a pre-packaged Chapter 11. (See Betker, 1995; and Chatterjee, Dhillon, and Ramírez, 1996.) In these cases, the debtor and its major creditors working together formulate a plan of reorganization. Once the major parties are in agreement, the firm files for Chapter 11, often having already solicited votes from the interested parties. The success of this method hinges upon the provisions of Chapter 11 as detailed above, and, therefore, cannot be considered an out-of-court workout in the traditional sense. Specifically, the procedure relies on the voting and cram down procedures available in Chapter 11 to ensure acceptance (though cram down is rarely used, its impact is apparent in many cases as a *threat point*).

In contrast, entirely private reorganizations dominate in countries like Germany where banks often take responsibility for organizing creditor/debtor negotiations and frequently hold equity stakes in the firms to which they lend. In such an environment, a bank's behavior is affected by its desire to maximize

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Table 1. Estimates of Chapter 11 Cases Confirmed

	1979-80	1981	1982	1983	1984	1985	1986	Total
Total Chapter 11 Filed	7,944	10,085	18,915	20,351	20,311	23,408	24,624	125,638
Closed Confirmed	661	605	991	904	681	889	295	5,026
Projected # of Pending Cases to be Confirmed	683	818	1,430	1,865	2,289	2,694	3,430	13,209
Projected Future Confirmed	14	33	89	157	357	697	1,780	3,127
Estimate of Total Confirmed	1,358	1,456	2,510	2,926	3,327	4,280	5,505	21,362
Overall Confirmation Rate	17.1%	14.4%	13.3%	14.4%	16.4%	18.3%	22.4%	17.0%

Source: Administrative Office of the United States Courts.

Table 2. Confirmation Rates by Asset Level

	Asset Range ($000s)			
	<100	100-500	500-1,000	>1,000
Percent of Cases Filed	29.4%	38.5%	14.3%	17.8%
Percent Confirmed	7.4	13.8	22.2	35.9
Percent of Total Confirmations	12.8	31.1	18.6	37.5

Source: Administrative Office of the United States Courts.

firm value, as opposed to just the value of its credit claim, and to maintain its reputation as a supportive lead bank. German banks have a reputation for being much more willing to "rescue" ailing clients than banks in other countries. This is also not surprising given that German creditors must write down the claims voluntarily or face an inefficient liquidation of the firm, leaving less to be distributed and an even smaller value received. Thus, the main result of the extremely poor reorganization provisions in German bankruptcy law is that the banks unilaterally determine the optimal treatment of distressed firms. If it is determined that a firm will be resuscitated, the house bank will organize an out-of-court workout to effect a reorganization, usually granting considerable concessions while lower priority creditors are paid in full. Thus, firms which wind up in insolvency proceedings have already been deemed nonviable by the banks.

Additional factors which impact the decision to attempt a private workout concern the relative cost of private workouts compared to reorganization within the bankruptcy laws. One of the main conclusions of the examination of various national laws is that Chapter 11 in the US, by encouraging interested parties to negotiate an agreement, perhaps with considerable delay, may likely result in the highest costs. Other national laws have sought to reduce the possibilities for bargaining, and to put control of the proceedings into disinterested hands who will seek resolution in an efficient way. As a result, firms which fail to reach an out-of-court settlement in the US face high costs (direct and indirect) upon entrance into Chapter 11. For this reason, creditors are more willing to grant concessions to successfully conclude a workout in the US, than, say, Britain where their security is protected and the costs of reorganizing (or failing and then liquidating) within insolvency proceedings are lower.

VI. Measuring the Effectiveness of the Laws

While many bankruptcy statistics are available to

Table 3. French Reglements Amiables (Loi du 1 mars 1984)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	Avg.	Avg. (87-93)
Ongoing at End of Previous Year	0	2	14	14	9	10	14	17	34	13	16
Opened	10	28	18	12	5	6	7	34	81	22	23
Total Carried Over and Opened	10	30	32	26	14	16	21	51	115	35	39
Closed with Settlement											
Number	1	5	0	1	6	2	2	9	20	5	6
% of Total Carried-Over and Opened	10%	17%	0%	4%	43%	13%	10%	18%	17%	15%	15%
Cessation of Payments Declared											
Number	7	9	4	2	5	2	4	9	—	5	4
% of Total Carried-Over and Opened	70%	30%	13%	8%	36%	13%	19%	18%	0%	15%	11%

Source: Tribunal de Commerce de Paris, November (1994).

Table 4. Recovery Rates in French Insolvency Cases

	Fraction of Liabilities	Recovery Rate
Wages, Treasury, Social Security	15%	60%
Banks	40	40
Suppliers	45	5
Total	100	28

Source: Robert (1994).

tell us the number of firms failing each year in a given country, few tell us the outcome of the many different cases. Fortunately, we do have some statistics of interest. These figures address the central question in the paper which concerns the relative effectiveness of the bankruptcy law in resolving a corporate crisis and providing an opportunity to reorganize under court supervision. However, these numbers do not include private workouts. Therefore, while illustrating the effectiveness of the bankruptcy laws in resolving crises within bankruptcy, we cannot assess the impact of the different legal structures on the ability to resolve crises outside of bankruptcy. This would be most important for Germany where the law results in the majority of workouts being conducted outside of court supervision.

In 1989, Edward Flynn, an analyst in the Division of Bankruptcy at the Administrative Office of the United States Courts, compiled a number of statistics based on the court's data and a study done by Ernst & Young on Chapter 11. The main result for our purposes is the Ernst & Young finding that approximately 17% of all Chapter 11 cases filed between 1979 and 1987 were confirmed or were likely to be confirmed.[15] This success rate appeared to be rising in the later years of the sample. It is also apparent from Table 2 that the confirmation rate is higher for larger cases. Table 1 presents a view of the Ernst & Young confirmation rate estimates.

While the data are not presented here, further findings of the Ernst & Young study were that the length of proceedings increased with the size of the assets, and the payment/obligation ratio appears to decrease as the time between filing and confirmation increases until this interval reaches 5 years. The cause of this decrease may not be the length of the proceedings. Rather, the two characteristics, lower payout/obligations and longer interval between filing and confirmation, may be a result of the types of firms which take longer to resolve their problems. For example, firms which will have low payout/obligations ratios due to insufficient assets may also take longer to reach agreement with creditors *because* the creditors

[15] The Ernst & Young researchers also estimated that roughly 20 to 30 percent of all confirmed plans were liquidations rather than reorganizations. Thus, the percentage confirmed is an upper bound on the percentage reorganized.

Table 5. French Redressements Judiciares (Loi du 25 janvier 1985)

	1986	1987	1988	1989	1990	1991	1992	1993	Avg.	Avg. (87-93)
Opening of the Proceedings										
Cessation of Payments	2,142	1,734	1,835	1,979	2,002	2,512	3,417	4,114	2,467	2,513
Debtor Initiated	1,428	1,254	1,110	1,148	1,120	1,356	1,620	1,932	1,371	1,363
Court	127	182	159	149	201	264	393	534	251	269
Upon Resolution of Plan				36	41	42	68	48	47	47
Court (following failed)	4	5	1	4	4	3	2	31	7	7
Total	3,701	3,175	3,105	3,316	3,368	4,177	5,500	6,659	4,125	4,186
Procedure Opened										
General	128	105	115	96	106	184	304	437	184	192
Simplified	1,050	676	540	466	585	732	1,068	1,309	803	768
Simplified with Immediate Liquidation	2,523	2,394	2,450	2,754	2,677	3,261	4,128	4,913	3,138	3,225
Closure of Proceedings: Failure to Sell or Reorganize										
Immediate Liquidation	2,523	2,394	2,450	2,754	2,677	3,261	4,128	4,913	3,138	3,225
Eventual Liquidation	798	600	421	382	393	515	649	782	568	535
Termination via Sale	48	101	97	109	113	125	141	177	114	123
Termination via Reorganization	66	133	87	83	88	72	109	146	98	103
Total	3,435	3,228	3,055	3,328	3,271	3,973	5,027	6,018	3,917	3,986
Other Judgements										
Extension	2	15	35	5	0	0	0	0	7	8
Faillite Personnelle	0	59	120	438	522	596	423	605	345	395
Forfeiture of Right to Manage	3	948	602	536	322	485	631	441	496	566
Responsabilite Pencuniare /du Passif	0	5	17	48	116	228	229	164	101	115
Rejets Sanctions Personnelles				304	390	411	488	667	452	452
Rejets, Responsibilite du Passif							195	198	197	197

Source: Tribunal de Commerce de Paris, November 1994.

must accept larger write downs and are therefore more aggressive in their bargaining tactics, which cause longer delays.

Tables 3 through 5 present statistics on French bankruptcies. Several additional statistics are discussed in the section on the French bankruptcy law. Notable in Table 3 is the dramatic rise in the use of the negotiated settlement procedure in 1992 and 1993. While more recent official numbers are not available, it is believed that this trend is continuing. Unfortunately,

Table 6. Germany: All Filings (Corporate and Personal)

		Bankruptcy				Court Composition	
Year	Insolvencies	Opened	Insufficient Assets	Total	Following Request for Court Composition	Requested	Opened
1960	2,958	1,742	947	2,689	74	417	343
1970	4,101	2,081	1,762	3,843	66	390	324
1980	9,140	2,420	6,639	9,059	13	107	94
1985	18,876	4,292	14,512	18,804	33	138	105
1986	18,842	4,098	14,695	18,793	33	115	82
1987	17,589	3,800	13,743	17,543	38	122	84
1988	15,936	3,649	12,238	15,887	8	65	57
1989	14,643	3,403	11,204	14,607	21	78	57
1990	13,271	3,214	10,029	13,243	14	56	42
1991	12,922	3,236	9,667	12,903	20	59	39
1992	14,117	3,691	10,403	14,094	14	51	37
Avg. (85-92)	15,775	3,673	12,061	15,734	23	86	63

Table 7. Financial Result of All German Filings (Corporate and Personal)

	Completions				Shortfall				Payments as Percent of Face Value		
		Bankruptcy				Bankruptcy			Bankruptcy		
	Overall	Normal Termination	Insuff. Assets	Court Composition	Overall	Normal Termination	Insuff. Assets	Court Composition	Secured	Unsecured	Court Composition
Year	Number				DM (millions)				%		
1960	1,791	1,265	261	265	284	217	40	27	54.2%	9.0%	46.5%
1970	2,069	1,465	356	248	1,248	964	145	139	43.5	4.5	39.8
1980	2,122	1,483	571	68	3,119	2,326	657	136	32.1	5.8	37.0
1985	3,653	2,795	789	69	8,131	6,528	1,488	115	34.2	7.5	50.8
1986	3,461	2,598	822	41	7,428	4,995	2,384	49	31.3	3.8	61.7
1987	3,160	2,474	648	38	8,086	6,446	1,588	52	36.7	4.7	41.0
1988	3,082	2,431	611	40	6,094	4,656	1,418	20	27.8	6.3	48.0
1989	2,885	2,302	544	39	5,185	4,224	911	50	33.7	4.1	64.3
1990	2,985	2,368	595	22	4,778	3,602	1,154	22	37.1	3.1	48.8
1991	2,841	2,301	514	26	4,828	3,951	860	17	25.5	4.7	50.6
1985-1991	22,067	17,269	4,523	275	44,530	34,402	9,803	325	—	—	—

Source for Tables 6 and 7: (German) Statistical Yearbook.

Table 8. UK Insolvency Cases by Type of Appointment, SPI Survey Sample, 1992

	Type of Appointment					Liquidation without Prior Insolvency Procedure		Liquidation after Prior Insolvency Procedure	
	Receivership	Admin. Receivership	Admin.	CVA	Total	CVL	Compulsory Liquidation	CVL	Compulsory Liquidation
Sample	670	622	167	157	1,616	857	388	207	198
Percent of Total	41.5%	38.5%	10.3%	9.7%	100%			13%	12%

Source: First Survey of Member's Activities, Society of Practitioners of Insolvency. The sample covers the period October 1991 through March 1992.

Table 9. UK Insolvency Cases by Type of Appointment, Total UK, July 1993 - June 1994

	Type of Appointment					
	Reorganization Procedures				Liquidations	
	Receivership	Admin.	CVA	Total	CVL	Compulsory Liquidation
Total UK	2,497	166	218	2,881	11,039	7,198
Percent of Total	86.7%	5.8%	7.6%	100.0%		

Source: Fourth Survey of Member's Activities, Society of Practitioners of Insolvency. The sample covers the period July 1, 1993 through June 30, 1994. It does not distinguish between administrative and non-administrative receiverships.

the success rates are not impressive. The successful outcomes represent just 15% of cases on average from 1987 through 1993, and there is no clear trend in this number.

Table 4 presents an estimation of recovery rates to different claimants as calculated by Robert (1994). In line with the objectives of the law, wages and the government agencies enjoy the largest average recovery rate of 60%. Banks take a back seat to those claims, recovering 40% of their claims on average, and suppliers average a 5% recovery rate.

From Table 5, it can be inferred that the judicial arrangement procedure results in liquidation in over 94% of cases on average. Approximately 3% of the cases result in continuation of the business through a sale with another 2.5% continuing through a reorganization.

Not surprisingly, given the discussion above, the French law is failing to achieve any of its objectives of continuation of the firm, preservation of employment, or enforcement of credit contracts.

Tables 6 and 7 present statistical data relating to German insolvencies since 1960. Looking at the completions, it appears that court compositions, when firms are able to enter the proceeding, are quite successful. In 1960, 77% of the firms admitted to court composition successfully exited. This figure was the same in 1970 and was 72% in 1980. Since 1985, the successful exits have averaged 60% of the cases opened in a given year. Moreover, from Table 7, unsecured lenders receive roughly 50% of their claims in composition. This compares to roughly 30% for secured lenders in bankruptcy and 4% for unsecured lenders in bankruptcy.

While these numbers are impressive, one must remember that only a very small fraction of all insolvencies are able to enter court composition proceedings. In 1960, 11.6% of all insolvency proceedings opened were court compositions. By 1970, this ratio had dropped to 7.9%, and it dropped further to 1% by 1980. Over the period 1985-1992, court compositions averaged only 0.39% of all insolvency proceedings. It is not immediately apparent whether the decrease in court compositions is due to the courts or to other factors, however, as the number of requested composition proceedings has declined with the number admitted. In 1960, 82% of all requests for court composition were granted (with the remaining being rejected and admitted to bankruptcy). This ratio was 83% in 1970, 88% in 1980, and averaged 74% over the period 1985-1992. Thus, debtors and creditors do not appear to be willing to utilize the court composition

Table 10. Outcome of UK Solvency Cases, First SPI Survey

Company Survival	Complete Going-Concern Sale to Mgmt.	Complete Going-Concern Sale to 3rd Party	Part Going-Concern Sale to Mgmt.	Part Going-Concern Sale to 3rd Party	Break-up Sale of Assets	Total
141	91	87	225	63	387	1,024
14%	9%	8%	25%	6%	38%	

Source: First Survey of Member's Activities, Society of Practitioners of Insolvency. The sample covers the period October 1991 through March 1992 and insolvency cases which do not begin in liquidation.

Table 11. Outcome of UK Insolvency Cases by Type of Procedure, Percent of Cases, Second SPI Survey

	Company Survival	Complete Going-Concern Sale to Mgmt.	Complete Going-Concern Sale to 3rd Party	Part Going-Concern Sale to Mgmt.	Part Going-Concern Sale to 3rd Party	Break-up Sale of Assets
Administrative Receivership	15%	4%	13%	5%	10%	53%
Administration	17	13	21	4	13	33
CVA	75	—	6	—	—	19

Source: Second Survey of Member's Activities, Society of Practitioners of Insolvency. The sample covers the period April 1992 through September 1992.

proceedings. Explanations from German workout specialists are that the insolvent firms' balance sheets are considerably worse now than they were in the 1960s or 1970s. It seems unlikely that this could explain this phenomenon.

The other remarkable feature of the German statistics is the large number of cases not permitted entry into bankruptcy due to insufficient assets. In 1960, 35% of the applicants were not admitted to court bankruptcy proceedings for this reason. By 1970, that figure had climbed to 46%, and by 1980 it had reached 73%. From 1980 through 1992, it averaged between 73% and 78%. This increase indicates that it is becoming increasingly difficult to enter bankruptcy. Related to this is the fact that 17% of those firms exiting from bankruptcy did so due to insufficient assets in 1960. This ratio increased to 28% by 1980 but has hovered around 20% since and was at 18% in 1991, the most recent year for which data are available.

From this, it appears that the courts are not improving upon their ability to judge which firms will be able to meet the costs of the proceedings. Thus, the dramatic increase in the percentage of firms not admitted to bankruptcy due to insufficient assets is due to some other factor, such as the timing of filing (it may be that firms are now waiting longer to file, perhaps making risky attempts to resuscitate the firm), or an increased use of security by lenders, which reduces the assets available to the bankruptcy court to cover unsecured claims and the expenses of the proceedings. As discussed above, German lenders go to considerable lengths to secure their claims in ways that will void bankruptcy. Thus, this phenomenon indicates that German lenders are becoming more successful in this respect. The 1994 law, which returns these preferred claims to the control of the bankruptcy court, should help to solve this problem.

Tables 8 and 9 present the number of UK filings by type of appointment. Voluntary arrangements (CVA) and administrations, many of which are combinations, do not account for a large percentage of insolvencies. However they are increasing in importance, rising from less than 1.5% of reorganization proceedings in 1989 to over 10% in 1994. Table 10 indicates that a large number of insolvencies result in at least partial continuation of the firm. In 14% of cases which do not begin in liquidation, the firm survives intact. In another 17%, the company's business survives via a complete going-concern sale to either management or a third party.

Table 11 presents the numbers by type of proceedings. Not surprisingly, CVAs are the most successful at preserving the business, with administrations following and administrative receiverships ranking third. Both administration and administrative receivership appear to be quite successful in achieving a sale either as a complete concern, or of portions of the concern, though these numbers cannot reflect whether the price obtained was fair or below the true value. The survey did not analyze non-administrative receiverships.

VII. Summary

Bankruptcy laws have a major impact on lender/borrower relationships and on the structure of ownership and capital in corporations. While Chapter 11 is not alone in believing that a main goal of the bankruptcy code should be to facilitate the continuation of viable firms, it is alone in providing strong encouragement for creditors to negotiate with the debtor while in bankruptcy.

Creditors in Germany feel very strongly that their rights to their security should not be compromised by bankruptcy laws, and lawmakers have chosen to uphold this right. However, by not providing a stay of claims against secured creditors, German law has very little power to impact the outcome of a given bankruptcy. The success of each case, therefore, relies heavily on the administrator assigned. The result has been a removal of responsibility from the courts to the banks. By forming close relationships with their borrowers, banks are much more involved in out-of-court settlements than banks in countries whose laws provide this facility.

France and the UK lie somewhere between Germany and the US in believing that creditors' rights should dominate the concerns of bankruptcy law. France provides the court the right to intervene in a bankrupt firm and resolve the crisis for the benefit of government policy. Unfortunately, because the three primary objectives of the French law, to continue viable firms, preserve employment, and enforce creditor contracts, are in conflict with one another, the most common outcome is a failure to attain any of these objectives.

The UK code may be the most successful in the sense that many businesses are successfully sold, either in whole or in part, preserving employment, while also repaying secured claims, and not incurring high costs, direct or indirect, due to protracted bargaining. However, the emphasis is on repaying secured claims, so that sales are often quick and probably not at the best price. The result is that few serious attempts are made to rehabilitate the firm or to maximize the sales value to realize the largest return for unsecured creditors. Correspondingly, because management are always removed and equity rarely receives any consideration in insolvency, the incentives of management and the debtor to avoid insolvency are large, leading to distorted incentives prior to filing. This may reduce the value of the firm (a form of indirect cost).

It is interesting to note that the German approach is much less interventionist than the others in that the courts leave reorganizations completely in the hands of the parties involved, and will only deal with a firm when it must be liquidated. The US view appears to be that while the parties involved should make the determination of viability, they should do so while under the supervision of a bankruptcy court. The UK and France appear to be less comfortable with permitting the market to determine the outcome of distress. Both seek to encourage reorganization within administration, but both remove management from active control within administration. While the UK appears willing to trust accountants to manage the distressed firm properly, France prefers government-appointed "judges" who are in fact business people, ideally with expertise in the business and in workouts.

Among the key features aiding a reorganization, the stay of claims and the definition of the bankrupt estate can be critical. Creditors of German firms have learned to use a wide variety of security devices to proof their claims in ways which are not voided by bankruptcy laws. As a result, the German bankruptcy code cannot effectively address the difficulties associated with restructuring debt. With the recently passed 1994 legislation, Germany's prospects for court-supervised reorganizations will improve by adding a three-month automatic stay and voiding the various types of preferred claims which are currently outside the control of the bankruptcy court.

While some of these systems achieve similar results through different bankruptcy frameworks, some have quite different objectives and consequently adopt different approaches to the problems facing firms in financial distress. As the new trading communities evolve and the international marketplace continues to integrate, the importance of uniform bankruptcy laws will increase. While we point out a few of the different aims and approaches, the difficulty of writing a bankruptcy code that incorporates the various objectives of the nations concerned and provides an effective means of achieving them will be daunting. This is evidenced by the fact that the European Community, in spite of several attempts over the past two decades, has been unable to formulate even a draft of a bankruptcy code. ■

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