Journal of Banking & Finance 37 (2013) 1936–1959

Contents lists available at SciVerse ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Building legal indexes to explain recovery rates: An analysis of the French and English bankruptcy codes ☆

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ARTICLE INFO

Article history:
Available online 12 November 2012

JEL classification:
G33
K22

Keywords:
Bankruptcy
Recoveries
Legal indexes

ABSTRACT

The paper analyzes the characteristics of bankruptcy procedures that may impact on creditors' recoveries. We propose 132 legal indexes accounting for the main functions of bankruptcy codes: namely, the accessibility of the procedures, their ability to disclose information, the protection of debtor's assets, the coordination of the claimants and their decision power, and the sanction of management. The French procedures are more protective of the debtor's assets and prioritize the coordination of claims. In England, liquidation procedures protect more secured claims, while unsecured creditors have more decision power under reorganization procedures. Our indexes are then used to explain recovery rates on a set of 833 bankrupt SMEs. Several bankruptcy rules are associated with higher recoveries: namely, accessibility of the procedure, protection of the debtor's assets, protection of claims, and sanction of faulty management. On the contrary, information disclosure has negative impact on recoveries, probably due to the breach in confidentiality.

1. Introduction

Corporate financial distress reflects the debtor's inability to meet previous financial commitments towards the creditors. There are three main ways to resolve such situation on a collective basis. For the most financially distressed firms, a court may order a piecemeal liquidation of the debtor's assets: the business is closed down and the liquidation proceeds are distributed to the creditors, following a specific repayment order, generally close to the absolute priority rule (APR hereafter). Alternatively, the court may order a sale as a going concern: the business is sold to a bidder and goes on under another ownership structure. Here, the main constraint is to find and select bidder(s) and to benefit from well-functioning capital markets. Anew, the proceeds of the sale are distributed according to a repayment order detailed in the bankruptcy code. Finally, the court may supervise a bargaining process in order to prepare a reorganization plan. More precisely, the various stakeholders have to agree on two issues: how to restructure the business in order to increase the future debtor's value and how such value should be divided between all the creditors (i.e. should APR strictly apply or not[1])?

Depending on the country, the way each solution (liquidation, sale, or reorganization) operates depends on the national specificities of the bankruptcy procedures. Researchers have first questioned the various designs of national bankruptcy procedures in

☆ We would like to thank the journal's referee for helpful comments and suggestions. This article is a revised version of a paper presented at the INFINITI 2011 conference. This study was financed by FNR (Luxembourg) and by OSEO (France). We thank for their constructive remarks Christopher Westley and Kathy Fogel. We are also grateful to John Armour and Afef Boughanmi for help, expertise, and implication. We finally thank all the other students involved in collecting data. The English data were collected by Nirjhar Nigam who is also one of the co-authors, and French data were collected mainly by Agnès Fimayer. We are solely responsible for any remaining errors. The national experts who filled and/or checked the legal templates are: (1) for France, Régis Blazy (co-author, professor at the University of Strasbourg), Philippe Roussel Galle (professor in Law at the University of le Havre), Jean-Luc Vallens (president of chamber – "Cour d'appel" of Colmar – and associate professor in Law at the University of Strasbourg), Albert Reins (judge, commercial court of Paris), Eric Assouline (liquidator, MJA, Paris), Lucile Jouve (liquidator, MJA, Paris), Valérie Leloup-Thomas (liquidator, MJA, Paris); (2) for England: John Armour (professor at the Oriel College, Oxford University), Sandra Frisby (Baker & McKenzie associate professor and reader in company & commercial law, University of Nottingham), Mike Norris (the Insolvency Service, director), Muhunthan Vaithianathar (the Insolvency Service, policy section), Alan Katz and Michael Mumford (research fellows at the International Centre for Research in Accounting, Lancaster University).

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[1] Following Hart (2006), a strict application of APR may be counterproductive if managers, acting on behalf of shareholders, try to delay bankruptcy filing because they anticipate that the shareholders' payment will equal zero under bankruptcy.

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http://dx.doi.org/10.1016/j.jbankfin.2012.10.024

order to measure, in a second time, their performance. But, to manage this research program, one must define some criteria of "performance". On this topic, Hart (2006) explains that the main objective of bankruptcy law should be to maximize the financially distressed firm's value to be divided between all the stakeholders. This now well known issue deals with the so-called *ex-post* efficiency and was pointed out by Bebchuk (1988), White (1989), Aghion et al. (1992), and more recently, by Blazy and Chopard (2004) and Fisher and Martel (2009). Hart (2006) also explains that there is now a large consensus on the various ways to increase/preserve the firm's value after the bankruptcy filing, i.e. on the rules of a "good" bankruptcy procedure. However, we find in the literature, very few empirical evidence of such relation between some desired bankruptcy rules (from a theoretical point of view) and some proxy of performance (meaning Law's ability to maximize financially distressed firms' value). The purpose of this paper is to provide some elements of empirical evidence. From this perspective, we mention hereafter the main characteristics that Hart (2006) identifies as the components of a "good" bankruptcy procedure.

First of all, Hart (2006) indicates that bankruptcy law should improve coordination between the various creditors by restricting their individual rights to sue the debtor. Indeed, a creditors' race might lead to suboptimal dismantlement of the debtor's assets, and finally to an overall loss of value. This "common pool problem" has been widely addressed by Bulow and Shoven (1978), Gertner and Scharfstein (1991) and more recently by Longhofer and Peters (2004). Then, by implementing specific rules (stay of claims and of individual proceedings, creditors' representation, creditors' consultation...), bankruptcy procedures can help in freezing the creditors' individual right and, more generally, in solving their coordination problems. Besides the resolution of coordination issues, we consider that the protection of the debtor's assets has similar effects, as it prevents them from loosing value before or after default. For instance, the law may order that bankruptcy practitioners recover some assets if the purpose of their sale is to impoverish the creditors, or to strategically file for bankruptcy. In the same topic, courts might authorize various managerial rules during the bankruptcy procedure in order to protect the firm's assets (forced extension of previous contracts, supervision of the manager(s), assets sales in auction procedures...). Finally, preventive rules (i.e. rules taking place prior to default) can speed up bankruptcy filings, and hence preserve the firm's value (cf. "alert rights", account certification, interview of the managers...).

Second, Hart (2006) indicates that bankruptcy can be viewed as a tool that helps stakeholders, (especially the creditors) to agree on a collective solution. Intuitively, finding such solution on a collective basis is more complex when creditors with conflicting interests are numerous. Without any efforts to organize the decision process, the creditors might not reach an agreement, and consequently might select an outcome that does not maximize the overall recoveries. To overcome this difficulty, economic theory suggests that the residual owner (i.e. the stakeholder who benefits from any marginal increase in the firm's value) should ultimately decide. However, the identification of the residual owner requires that APR is clearly defined and that the firm's value can be assessed without any ambiguity. Thus the question now arises as to how the creditors can collectively decide on the debtor's fate? In practice, a first way is to give them the right to vote on the final outcome (and to approve reorganization or not). Here, the creditors' decision power is maximized, but the final decision may depend on the firm's capital structure. As mentioned by Bergström et al. (2002) and Morrison (2007), the more secured the creditors are, the lower is the likelihood of reorganization under bankruptcy systems requiring that (all) creditors approve the reorganization plan.[2] The second solution is to transfer the decision to a Court. Here, the creditors' decision power is minimized as it relies in the hands of one sole decision maker. As a consequence, the final outcome should not depend on conflicting interests anymore. But, errors may arise if the primary objective of the judge does not align with the maximization of the firm's value. As a result, having the power to influence the final choice might have positive (direct and indirect) effects on recoveries. It first gives the creditors more incentives to trigger the procedure earlier as they know they can influence its outcome. In addition, it makes them more involved in the procedure, seeking for the solution which maximizes their interests. Further, benefiting from more decision power under bankruptcy might lead to contrasting effects. It might increase the recoveries of the classes of creditors having the highest decision power at the expense of the others.[3]

Third, following Hart (2006), we suggest that another means to preserve firm's value is to ensure that bankruptcy procedures are both accessible to the stakeholders and attractive enough to those who are higher in the hierarchy of the firm, mainly managers or shareholders. The underlying idea is that the sooner distressed firms file for bankruptcy, the higher are the chances to resolve financial distress quickly without incurring excessive bankruptcy costs (Povel, 1999). Consequently, the triggering criteria should not be too restrictive, so that a wide set of stakeholders can opt for bankruptcy as a credible alternative to private attempts of debt renegotiation. Further, to create strong incentives to file for bankruptcy, either managers or shareholders should benefit[4] from this filing (if not, they would have incentive to over-invest in order to delay bankruptcy filing[5]). For instance, shareholders could benefit from deviations of APR under bankruptcy in order to receive some portion of firm's value. But, facilitating an easier access to bankruptcy procedures, or improving the managers/shareholders incentives to file for bankruptcy, has a cost. First, bankruptcy procedures should not be triggered too easily and/or too early, so as to prevent the stakeholders from leveraging the bankruptcy environment for their individual interests (strategic default: see Delaney, 1999). Second, the bankruptcy procedure should also preserve the bonding role of debt. Indeed, to create good incentives to reimburse their debts (and therefore making an easier access to credit, prior to bankruptcy), there has to be some punishment if the firm defaults, and APR applies this principle. As a result, shareholders are ranked at the bottom of the stakeholders ordering which implies that they are the most penalized ones under bankruptcy. And, managers who were supposed to act in the shareholders' interest would run the risk of losing their jobs in case of bankruptcy. However, punishing managers for their errors has two opposite effects. On the one side, it preserves the bonding role of debt. On the other side, it creates strong incentives to delay bankruptcy filing (with the risk to reduce the bankrupt firm's value).

Finally, the crucial difficulty that Hart (2006) identifies at the time of bankruptcy is the lack of information on the bankrupt firm's

[2] The intuition of this result runs as follows. As claimholders will vote according to their expected payoff post bankruptcy, totally secured claimholders will rather vote in favor on liquidation as they are sure to be fully reimbursed in that case. At the opposite, junior claimholders will be biased toward continuation, especially when the expected liquidation value does not cover their claims once senior claims are reimbursed. So, depending on both liquidation and continuation values, the voting process, and the structure of claims, some bankrupt firms may be excessively liquidated if senior creditors have the pivotal votes; or firms may be wrongly kept as a going concern if junior claimholders have the pivotal votes.

[3] For instance, if shareholders have the right to vote on the final issue, they may obtain some payoff whereas claimholders who are ranked before according to the APR are not fully repaid.

[4] Or, at least, they should minimize their losses.

[5] It means that bankruptcy law could order some leniency to them. For instance, law can order some protection to managers by allowing them to present a reorganization plan.