Emerging Markets Review xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Emerging Markets Review

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

When secured and unsecured creditors recover the same: The emblematic case of the Tunisian corporate bankruptcies

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ARTICLE INFO

Article history:
Received 16 April 2016
Received in revised form 19 August 2016
Accepted 25 August 2016
Available online xxxx

JEL classification:
G33
K22
O16

Keywords:
Bankruptcy
Creditors
Development
Tunisia
Heckman model
Propensity score

ABSTRACT

Bankruptcy is an essential screening mechanism for developing economies. This paper focuses on the way bankruptcy is managed in Tunisia, a country characterized by the importance of its banking sector. We collected data on a set of bankrupt firms (1995–2009). We address several questions. Do the Tunisian bankruptcy procedures generate substantial overall recoveries? Are the secured creditors (mostly banks) well-enough protected under bankruptcy, and do they influence the courts' decisions? To which extent the creditors compete together? The highest recoveries are found mostly under reorganization procedures. Yet, despite a high level of competition between the classes of claimholders, the secured creditors' recovery rate remains similar to one of the unsecured creditors. Last, the court's decision to liquidate/reorganize the debtor seems not influenced by the structure of claims. The likely consequences on development are twofold: higher risks of capital misallocation/credit rationing, and stronger incentives for the banks to prioritize informal workouts.

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1. Introduction

Most developing countries have in common undersized financial markets and suffer from inefficient capital allocation. As shown by Wurgler (2000), on the period 1963–1995, the countries characterized by underdeveloped financial markets were less able than others to target their investments in the most

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http://dx.doi.org/10.1016/j.ememar.2016.08.021
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expanding industries. Tunisia is part of them: being ranked 47th out of 65 countries in terms of GDP *per capita*, the Tunisian elasticity of industrial investment to value added ranked 41st only out of 65 countries. As shown by Wurgler (2000), such elasticity is a good proxy of capital allocation efficiency, and is significantly correlated with financial development.

However, when compared to the other countries, Tunisia exhibits in the long run an interesting financial specificity: in the Wurgler's sample, Tunisia ranks relatively low (40th) regarding the development of its financial market (stock market capitalization to GDP), *but* ranks quite high (6th) regarding the relative size of its credit market (credit claims to GDP). This indicates that, in Tunisia, the underdeveloped financial market is being compensated by a rather well-developed credit market: the banks play a key role in the financing of the Tunisian economy. Such imbalanced specificity is shared by some other moderately developed countries (Egypt, Greece, Iran, Malta, Panama…).

This feature has important implications on the efficiency of capital allocation in Tunisia. As suggested by Wurgler (2000), capital allocation is expected to be more efficient in the presence of developed financial markets. Indeed, such markets offer the investors the ability to screen between the industries, by investing more into the growing projects, hence sanctioning the declining ones by offering them fewer opportunities to raise capital. Now, in a country such as Tunisia – where the banks act as substitutes to the lack of well-functioning financial markets – the quality of such screening process mainly depends on the way those banks are protected as credit dispensers. One important mean to protect them is to preserve the value of their claims, especially when those claims are hold against financially distressed debtors. Here, corporate bankruptcy Law plays a central role by protecting the recovery power of the various claimants (including the banks). Put differently, corporate bankruptcy Law can be viewed as a substitute for the lack of financial markets (Legros and Mitchell, 1995), as it provides a set of legal rules that both protect (more or less) the investors' claims, and sanction (severely or gently) the firms not being able to respect their financial constraints. As pointed out by Armour and Cumming (2008), the legal provisions prevailing under bankruptcy, and their degree of severity against the debtors, are likely to impact on entrepreneurship and innovation.

Corporate bankruptcy procedures are triggered when (1) a firm defaults, and (2) an informal workout cannot be reached with the creditors (Franks and Sussman, 2005). Bankruptcy may lead to either the reorganization or the liquidation of the bankrupt[1] firms. As shown by Hart (2006), once triggered, bankruptcy procedures follow two main (*ex-post*) objectives at the same time. A first objective is related to *efficiency*: bankruptcy procedures should aim at maximizing the value of the bankrupt firm, which is the basis for the creditors' repayment. The second objective is related to *sharing*: besides the maximization issue, corporate bankruptcy Law sets a specific priority order to reimburse the different classes of creditors. This "absolute priority order" (APO) has been extensively studied by the literature (White, 1989) and varies from one country to another. From that perspective, two main reasons justify why some claimants should benefit from a higher level of protection. First, some claims may be secured ones, *i.e.* hold by creditors who initially took collaterals to protect themselves, and consequently, who accepted to pay for the associated costs (as shown by Blazy and Weill (2013), collaterals generate controlling and registration costs). Such cost can be considered as the price to pay for a higher level of protection. Second, some other claims may be preferential ones, *i.e.* hold by creditors who should be protected *per se*, either because their bargaining power is low under bankruptcy (employees) or because they represent public interests (State and public claims). Both secured and preferential claims belong to the set of "senior" claims that outrank the "junior" ones (*i.e.* unsecured claims). Most of the time – provided the firms are in position to provide collaterals – the banks own secured claims. This provides them, either a higher rank on the proceeds of liquidation of the bankrupt firm (mortgages, pledges…), or an extended repayment basis on another patrimony (personal guarantees).

In a country like Tunisia, relying heavily on the banking sector, the degree of protection of the secured claims is of primer importance, as there are few substitutes to bank credit (especially regarding long term financing). If the banks' claims are not protected enough by the bankruptcy Law, the screening mechanism between profitable and non-profitable projects, as discussed before, might not prevail. Following Wurgler (2000), in the absence of well-developed financial markets, this may generate a risk of capital misallocation.

[1] In Tunisia, a firm is legally "bankrupt" when it cannot repay its creditors. The precise criterion relies on cash shortage (the Tunisian Law states that (in French): "*est considérée en état de cessation de paiement, toute entreprise qui se trouve dans l'impossibilité de faire face à son passif exigible avec ses liquidités et actifs réalisables à court terme*", Law n°95–34, 17th of April 1995).

Please cite this article as: Blazy, R., Letaief, A., When secured and unsecured creditors recover the same: The emblematic case of the ..., Emerg. Mark. Rev. (2016), http://dx.doi.org/10.1016/j.ememar.2016.08.021

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