Journal of Cleaner Production xxx (2016) 1–12

Contents lists available at ScienceDirect

Journal of Cleaner Production

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

Can innovative reforms and practices efficiently resolve financial distress?

Nirjhar Nigam [a, *], Afef Boughanmi [b, c, d, e]

[a] ICN Business School, CEREFIGE, LARGE, 3 Place Edouard Branly, 57070 Metz, France
[b] IUP de Finance Nancy, University of Lorraine, France
[c] M2 Chargé d'Affaires Entreprises, France
[d] BETA (CNRS), France
[e] Faculty of Law, Economics and Management of Nancy, 13 place Carnot - C0 n° 26, 54 035 Nancy Cedex, France

A R T I C L E I N F O

Article history:
Received 11 July 2015
Received in revised form
11 May 2016
Accepted 24 September 2016
Available online xxx

Keywords:
Bankruptcy law
Financial distress
Out-of-court settlements
IInnovative reforms
Liquidation
Reorganization

A B S T R A C T

The last few years have seen a phenomenal upsurge in the number of corporate bankruptcies. The vulnerabilities that were lying dormant within contemporary bankruptcy regimes suddenly became apparent, causing concerns within the international corporate community. Consequently, researchers, practitioners, and policy makers from all over the world became actively engaged in emphasizing the importance of efficient bankruptcy reforms to promote a rescue culture. The primary objective of an insolvency framework should be to provide quick, transparent, and cost-effective solutions for resolving financial distress and promoting a synergetic environment conducive to the proliferation of healthy debt repayment practices, increased trust factors between creditors and debtors, and a better survival rate for viable businesses. In this paper, we present a qualitative review of various insolvency reforms introduced in several countries between 2005 and 2013 for efficiently resolving financial distress. We delve into a discussion of the prevalent practice of resolving distress through the courts (formal procedure) or out of the courts (private workout) settlements, the supporting literature, and the limitations involved in the process. Overall, our goal was to summarize and synthesize empirical data and highlight the strengths and weaknesses of the proposed insolvency reforms to provide a better understanding of common ways of resolving financial distress. The data shows evidence that several countries have improved their bankruptcy ranking (doing business reports) by empowering creditors (by expanding their rights under bankruptcy), speeding up court procedures, promoting out-of-court procedures, and regulating insolvency practitioners. Lastly, we adopt a normative approach by proposing a list of legal changes that should drive legislators' actions in order to provide sustainable ways for resolving distress (e.g., transparency, early filling, extension of floating charges, electronic management of bankruptcy files, etc.).

1Introduction

The recent financial crisis revealed the underlying vulnerabilities within insolvency frameworks worldwide. When a feeble bankruptcy system does not have the ability to accommodate viable formal and out-of-court procedures to address monetary pain, more obligations stay uncertain and more organizations languish. For the common man, the term bankruptcy usually carries negative associations with failed ventures and their dire consequences. According to a recent survey conducted by the European Commission (2012) on entrepreneurship, the fear of bankruptcy was found to be one of the biggest psychological bottlenecks in the minds of aspiring entrepreneurs and businessmen. Creative solutions to the negative consequences of the corporate indebtedness must be formulated to provide favorable mechanisms for rescuing viable businesses and result in sustainable and inclusive economic development. Hence, a bankruptcy system that facilitates debtors in finding harmonious solutions through quick, economical, and transparent procedures can foster healthy debt repayment habits, increase trust between debtors and creditors, encourage lending, and consequently lead to higher survival rates for viable businesses.

* Corresponding author.
E-mail addresses: nirjhar.nigam@icn-groupe.fr (N. Nigam), afef.boughanmi@univ-lorraine.fr (A. Boughanmi).

http://dx.doi.org/10.1016/j.jclepro.2016.09.190

At the end of 2008, amidst the automobile crisis, Chrysler reported that it was perilously low on money and might not survive beyond 2009. The company expressed concerns that it would in all probability file for bankruptcy and would have to cease all business activities. However, Chapter 11 of the US bankruptcy code proved to be their savior. Chrysler underwent a restructuring process and struck an alliance with Fiat, such that Fiat purchased a 20% stake in Chrysler. The US government also supported the entire rearrangement process. On December 16, 2014, Chrysler Group LLC changed their name to FCA US LLC, which is still live and operational.

The analyzed period (2005–2013) encompasses the financial crisis (2008) and the sovereign crisis (2010). The rising number of bankruptcies during this crisis period was not solely due to the operational failures of corporations but was largely due to the tough economic environment they faced. Sustaining viable businesses becomes crucial, especially in times of recession, and is one of the key objectives of bankruptcy frameworks. Based on our collected date (Appendix 1), we noticed 30–40 countries have directly or indirectly introduced reforms to facilitate the rescue of viable businesses. Bad management, poor decision making, or a temporary economic downturn may trigger financial distress for a firm and can steer it towards failure. However, all hope is not lost for such firms and they stand a good chance of a turnaround if appropriate financial rescue frameworks are in place. Creditors receive an opportunity to recoup a larger portion of their credit, more workers are able to prevent a loss of employment, and a system of suppliers and clients is preserved. However, not all the businesses that become insolvent are viable and a good bankruptcy regime weeds the bad from the good.

The judicial system for resolving distress exists in every country in the form of two standard procedures: liquidations and reorganizations. Liquidation is primarily aimed at terminating inefficient firms while reorganization is concerned with ameliorating the financial distress of efficient firms and supporting their revival.

Besides formal procedures for resolving distress, out-of-court settlements are also available, which have registered very high success rates in some economies (Hoshi et al., 1990). Veritably, many firms first attempt to resolve financial difficulties through private out-of-court negotiations because of their lower costs and decreased disruption to the firm's operations than formal bankruptcy proceedings. Amidst all these prevalent procedures, it is natural that notions of efficacy might differ. Some countries focus on the rights of creditors (hard laws), enabling quick liquidations and faster recoveries, while others like the US and France allow debtors the freedom (soft laws) to continue operating their businesses, even after default. French bankruptcy law explicitly focuses on the continuation of businesses in order to preserve employment and social objectives. In contrast, some other countries like Sweden rely on the market for allocating the firm's assets. Furthermore, in developing nations, there either are no suboptimal regimes for handling financial crises, and there is a need to improve their systems with respect to insolvency procedures. Hence, established nations often end up as a reference point for further developing systems in these developing countries. The bankruptcy literature, as a consequence, has become an important topic of analysis and debate among researcher and policy makers.

This article has two aims. First, we seek to summarize and synthesize the empirical research. Second, we highlight the strengths and weaknesses of court and out-of-court procedures and facilitate a better comprehension of the nuances and the methodologies of resolving financial distress. We analyze and present reasons about a company's choice of resolving its distress through either the court or through out-of-court settlements (i.e., private or informal solutions). We also delve into the related literature and discuss the limitations of these procedures. Our discussion also includes the recent reforms (Appendix 1) introduced in various countries during an eight year period (2005–2013) and how they have impacted the process of resolving financial distress. We conclude by suggesting that adoption of new innovative reforms should occur in manner that protects the interests of both creditors and debtors and enables them to sustain themselves in the ever-changing economy and environment. Moreover, before adopting any reforms or emulating reforms found in developed countries, a deep understanding of the challenges of the economic, political, and social environment of the given country should be procured, as the efficiency of such reforms can vary from country to country. While there have been nationwide empirical studies studying the efficiency of bankruptcy reforms, for instance for United States (Bris et al., 2006; Baird and Rasmussen, 2003; Ferris and Lawless, 2000), the United Kingdom (Armour et al., 2008; Citron et al., 2004; Franks and Sussman, 2005), and France (Blazy et al., 2014), the literature largely lacks international empirical comparative works except for few (Djankov et al., 2008; Blazy et al., 2013; Davydenko and Franks, 2008).

The Doing Business report is a World Bank initiative that ranks countries based on the ease of conducting business in each country. The last chapter of this annual report is dedicated to closing of businesses and ranks 189 economies. Their methodology is based on the work of Djankov et al. (2008), who studied the efficiency of debt enforcement in 88 different countries that have different legal origins and represent different economic characteristics. To facilitate this above mentioned research, the authors build a hypothetical firm, namely an insolvent hotel. The same case study is presented to practitioners in 88 countries and their binary responses are recorded. The same approach has been adopted by the Doing Business Report and has been expanded to 189 economies. The Doing Business Reports also report any changes that occur in the bankruptcy laws of these countries. Consequently, these reports serve as our data collection methodology: we gather information from these reports for the period 2005–2013.

The rest of the article is organized into six sections. Section 2 provides an overview of the evolution of bankruptcy procedures from creditor-friendly bankruptcy systems to more debtor-friendly bankruptcy systems and describes the two dominant procedures (i.e., liquidation and reorganization) from an economic, financial, and social perspective. In Section 3, we try to address the following question: should financial distress be resolved privately (out-of-court)? In Section 4, we discuss the rationale for engaging procedures that might lead to reorganization, and in Section 5 we present a worldwide survey of the most popular insolvency reforms introduced in various countries during 2005–2013. We also report some empirical findings related to these reforms. We suggest a few improvements and additions to these insolvency frameworks and why some reforms should be removed from the insolvency frameworks, in particular the ones that demoralize the spirit of entrepreneurship. Section 6 concludes this article with the hope that our efforts will foster inquisitiveness in the minds of the readers and may help catalyze the spirit of innovation and further research into this topic and thereby lead to improved bankruptcy frameworks and help promote a more sustainable financial and entrepreneurial spirit all over the world.

2. Evolution from creditor-friendly bankruptcy systems to more debtor-friendly bankruptcy systems

Let us use a scenario to understand the term bankruptcy and the factors that trigger it: *When a firm has debts in excess of their assets and is not able to pay them as they become due, it is said to be in distress. Furthermore, the creditors have served multiple repayment notices to the firm but the firm has failed to respond beneficially to the notifications.*