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Article

Relationship banking and bankruptcy resolution in Spain: The impact of size☆

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A R T I C L E I N F O

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A B S T R A C T

Within the framework of asymmetric information, the present work has the aim of analysing the influence of relationship banking in bankruptcy resolution, with particular reference to firm size. The obtained results, from a sample of 622 micro- and small and medium-sized enterprise (SME) non-financial and unlisted firms that filed for bankruptcy in 2010 (resolved by the end of 2014), allow us to conclude that: (1) SMEs are more likely to survive than micro firms; (2) the number of relationships banking is not relevant; (3) maintaining relations with one of the big banks, especially the largest bank in a country, increases the likelihood of reorganization, as opposed to liquidation.

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1. Introduction

At the international level, banks have traditionally been one of the most important financial sources for firms. In addition, the role of banks, and hence banking relationships, is of great relevance in countries such as Spain, with a bank-centred financial system and financial markets with limited development. In this sense, when compared to other creditors, banks present a comparative advantage because they are better-informed due to their continuous relations with firms (Diamond, 1984; Fama, 1985). Elsas (2005) defines relationships banking as an implicit long-term contract between a bank and its borrower. Because of the repeated interactions between the financial entity and its client, the former accumulates private information about the latter, which establishes a narrow relation between both of them. In this sense, the literature about relationships banking is based on the existence of information asymmetries between the banking entity and its clients, asymmetries that are more relevant in small firms. According to Shimizu (2012:857), "lending relationship attracts much concern of some economists and policymakers because small firms have many difficulties in obtaining funds from public capital markets".

That informative advantage achieves great relevance in the case of bankrupt firms because, in that situation, the problems related to the limited quality of information are greater. Thus, Rauterkus (2009) asserts that "bank lending leads to a lower cost of financial distress and increases the chances of successful debt restructurings." Additionally, in a bank-centred financial system, it is almost impossible that a firm can be reorganized without bank support (Dewaelheyns and Van Hulle, 2009). Along the same line, Park (2000) argues that the bank's value added, as principal lender, is its experience in collecting information about the borrowers. He asserts that banks usually favour reorganization in the bankruptcy process.

However, very few works have analysed the impact of banking relationships when firms are in financial distress. According to Li and Srinivasan (2010:3): "This is an important gap in the literature as the benefits of bank lending arise because of the (assumed) better screening ability or better refinancing decisions of banks relative to capital markets during borrower distress". Along those same lines of reasoning, Sundgren (1998) considers that studies of small and mid-sized firms are important because, although the majority of the insolvent firms are small, more empirical studies on bankruptcy are focused on large, publicly owned firms.

In addition, the literature on bankruptcy resolution identifies two opposite types of systems that act as a function of the applied legislation: debtor-friendly and creditor-oriented.[1] These systems are different in several aspects, such as the protection of rights of

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[1] For example, French "Redressement Judiciaries" or US Chapter 11 are debtor-friendly and a British Administration or Voluntary Arrangement is creditor-oriented.

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control in the event of an automatic suspension of assets (rule of automatic suspension), if managers can remain in operation during the reorganization or liquidation (rule debtor in possession), and if there are priorities for new funding (absolute priority rule). In creditor-oriented systems, creditors receive much more protection from the law, and they are granted an advantageous role in the negotiation process. However, in debtor-friendly systems, protection is limited. These differences in creditors' rights protection can be the cause of disagreement in the creditor's position during bankruptcy resolution proceedings. In this sense, Davydenko and Franks (2008) found that the national bankruptcy codes have been important determinants of outcomes of distress. As Wang (2012) argues, this occurs despite significant adjustments in banks' practices in response to particular provisions of their respective codes.

Related to the bankruptcy legislation in Spain, the current law was promulgated in 2003 (Ley Concursal, 2003), although afterwards several modifications have been made with the aim of improving its efficiency. Concretely, the Spanish legislation takes into account the priority of the preferred creditors to aid recover before other parties, and the opportunity of abstention in the approval of the agreement, which make possible that such creditors can preserve their rights. On the other hand, the Law establishes the suspension of processes of execution that had been initiated before the bankruptcy proceeding filing and, on the other hand, prohibits starting any other procedure until a year has passed from the date of the bankruptcy proceeding filing or the liquidation (a violation of the priority rule).

Regarding the bankruptcy resolution, the Law 22/2003 offers two alternatives to financially distressed firms: liquidation bankruptcy or reorganization, which requires the agreement of all of the creditors. According to the preamble of the Spanish bankruptcy proceeding Law, reorganization is the normal solution from the proceedings, causing the Law to promote a series of measures whose purpose is to reach a satisfactory agreement with the creditors. The reorganization proposal must be approved at the creditors' meeting. This meeting is made up of creditors whose credits make up at least half of the ordinary credit value. A classification of creditors can be established according to the credit priority established in the Law.[2] The Law is flexible with respect to the content of the proposed agreement. Thus, the proposal could consist of propositions of reduction and moratorium of debt or the accumulation of both; however, debt reductions cannot exceed half of the sum of each ordinary credit, and debt moratoriums cannot continue for more than five years after the approval of the agreement. Moreover, alternative propositions are admitted, such as a conversion of debtors credit into equity instruments or similar stakes.

Another possibility of the bankruptcy proceeding resolution is liquidation. Liquidation can occur at the request of the debtor at the moment of the bankruptcy proceeding filing or during the reorganization process if it is impossible to meet promised payments. Likewise, liquidation can be requested by the creditors. It is noteworthy that firm management and possession of patrimony are suspended during the liquidation process. Moreover, the court resolution that initiates the liquidation process entails the dissolution of the firm and the substitution of the managers by bankruptcy administrators. The objective of the liquidation procedure is to collect the assets of the firm, determine the outstanding debt, and pay the debt off in the way and order stated in the Law. The liquidation process can lead to a piecemeal or complete liquidation, in which case the creditors can retain the synergies generated by the firm.

[2] See articles 90–92 of the bankruptcy proceeding Law.

In this context, the aim of this work is to analyse the incidence of relationships banking in bankruptcy resolution, with special reference to firm size. Based on the theoretical arguments about asymmetric information, it is predicted, on the one hand, that larger firms and/or those that maintain relationships with fewer banks, will be more likely to reach an agreement with creditors. On the other hand, it is expected that when firms maintain relationships with a great and reputed bank, the likelihood of reorganization is greater.

The study has been made using a simple of 622 Spanish SME firms that have entered the bankruptcy process in 2010 and whose bankruptcies have been resolved by December 2014. Spain presents an opportunity of study for several reasons. First, Spain is a country with a great banking orientation, to the detriment of financial markets. Secondly, the country has a predominance of SME firms. Thirdly, the Spanish legislation about bankruptcy is situated in an intermediate position regarding creditors' rights protection, following the index of Djankov et al. (2007), and in Spain the use of the legal bankruptcy process is less common than in other similar countries (García-Posada and Mora-Sanguinetti, 2012). The obtained results show that larger firms and those that maintain relationships with larger financial entities are more likely to be reorganized. The number of banking relationships does not have significant incidence in bankruptcy resolution.

The remainder of the study is structured as follows. Section 2 analyses theoretical arguments and presents the hypotheses. Section 3 describes methodological aspects, while Section 4 presents the results of the empirical study. The fifth and final section is dedicated to our concluding remarks.

2. Theoretical background and hypothesis

2.1. Firm size and bankruptcy resolution

Size is considered in the literature as a proxy of asymmetric information. Thus, it is possible that the smallest firms, with greater information asymmetries, have a lower probability of reaching an agreement than the largest firms in the bankruptcy process. The reason is that creditors will be more willing to trust information from larger firms regarding the firm's viability, and the creditors probability of recovering the debt depends on that information (Ayotte and Morrison, 2009; Jacobs et al., 2012).

Furthermore, White (1994) theoretical model of bankruptcy emergence predicts differences in emergence between small and large firms. This author argues that a larger firm size increases the survival probability because assets are more specific, and this situation reduces the number of purchasers that are interested in such firms. In this line, Aghion et al. (1992) assert that reorganization would be, ceteris paribus, a better option for larger firms in financial distress because, if the firm is sold, few bidders may have the possibility of raising the financing.

For their part, Denis and Rodgers (2007) find that larger firms are more likely to survive bankruptcy and emerge as independent firms, which "may be because large firms are deemed too big to fail or because they are more likely to have sufficient resources to survive [...] or because the larger firms are more likely to be economically viable." (p. 112). In addition, the largest firms are generally supported by governments for strategic reasons. For example, the Korean government tends to protect large firms from liquidation because the liquidation of larger firms would cause social problems (Kim et al., 2008).

Finally, most empirical studies consider size to be a relevant factor in bankruptcy resolution (e.g., White, 1994; Campbell, 1996; Sundgren, 1998; Ravid and Sundgren, 1998; Thorburn, 2000; Bryan

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