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Employment preservation *vs.* creditors' repayment under bankruptcy law: The French dilemma?

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ABSTRACT

The paper investigates the French dilemma associated with court administered resolution of corporate financial distress. In such a legal system, the courts seek a double objective: maintaining job positions through continuation, and determining the best outcome for the claimants. We discuss this dilemma empirically, using a unique sample of bankruptcy files on French SMEs. We address successively three critical questions. First, we highlight the determinants of the final bankruptcy outcome (continuation through reorganization or sale, or piecemeal liquidation): does continuation (the most employment-friendly outcome) depend on the firm's characteristics, and/or on the way the procedure is managed? Second, we study the determinants of the creditors' recovery rates: do the courts play an active role in increasing recoveries? Third, we address the dilemma directly by focusing on sales as a going concern. We model the court administered selection process between rival buyout offers: do the courts balance the social content against the financial content of each offer? Is there an explicit arbitrage between employment preservation and creditor recoveries? Our main results are: (1) the French courts actively work to facilitate continuation against liquidation, and thus play a role in employment preservation. Besides, we find continuation is more likely to prevail when default is an outcome of specific difficulties (outlets, finance, and production). (2) We confirm the Radulovic (2008) findings: the global recovery rate mainly depends on the firm's *ex ante* characteristics at the time of triggering, while the way the procedure is managed by the court has little impact. Similarly to LoPucki and Doherty (2007), continuation via reorganization does not generate lower recovery rates on average than the other outcomes. (3) Last, the courts' choice between rival buyout offers confirms that social considerations prevail in the arbitration. Yet, the courts still consider financial issues as well (a higher sale price increases the chances that an offer is selected), but without clear connection with the amount of due claims (one direct consequence is a moderate recovery rate on sales).

1. Introduction

Since the end of the twentieth century, numerous countries have amended their bankruptcy codes making them more debtor friendly and rescue oriented. This is particularly true in Europe, where important countries – initially known for having quite pro-creditor systems – adopted several legal reforms introducing more debtor friendly rules. In particular, the United Kingdom (common law) and Germany (German civil law) engaged major reforms going in such a direction. In the UK, Part 10 of the *Enterprise Act* (2002) interestingly specifies a new objective of the Law: "to facilitate company rescue" in addition to "produce better returns for creditors as a whole". Moreover, since 2003, the former UK *Receivership* (a bank friendly procedure allowing a creditor – generally a bank – in possession of a floating charge, to appoint a receiver to protect his/her own interests) no longer exists. In Germany, a similar trend is observed through the new bankruptcy code *Insolvenzordnung* (1994), which has been in effect since 1st of January 1999. While the German legislation keeps prioritising the repayment of creditors, a new procedure was introduced (*Insolvenzplan*), allowing for continuation. Liquidation is not the sole possible outcome anymore, provided that the value of the debtor's assets exceeds the level of the bankruptcy costs. Overall, even if debtors are less protected in these countries than in France, a country known for having adopted a pro-debtor view for a longer period of time (since 1967), this trend reflects up to some extent the legislators' willingness to use bankruptcy as a tool to protect businesses and employment. Indeed, even if continuation might not reward (un)secured credi-

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tors as much as liquidation, the pursuit of activity should preserve relatively more human resources than is possible with piecemeal liquidation.[1]

From that perspective, the case of France is of high interest, as French law is explicitly intended to save bankrupt firms in order to protect employment: upon comparing French bankruptcy procedure with other European legislations and the U.S., we find the following differences,[2] which make the French code instructive to study regarding the economics of financial distress. First, the 1st article of the 1985 and 1994 French bankruptcy codes ranks the various objectives of the law as: firstly "safeguarding the business", then "maintaining the firm's operations and job positions", and last "discharging liabilities".[3] Second, the decision-making process is fully centralized, as the commercial court has genuine enforcement power during the procedure. The bankruptcy judge decides the adoption of the reorganization plan: contrary to other European countries (see the Finish case studied by Bergström, Eisenberg, & Sundgren, 2002), there is no voting procedure or veto power for stakeholders. Third, the French legislation offers the stakeholders a specific procedure dedicated to sales as a going concern, as an alternative way of continuing activity.[4] Last, since 1994, the French legal framework of bankruptcy has been promoting prevention: this is consistent with the 1st article of the French law, prioritising the safeguarding of businesses. Practically, the ignition of alert procedures was facilitated since 1994 and some courts (especially in Paris) implemented prevention units ("*cellules de prevention-détection*") aiming at meeting the firm's managers when the court receives signals of difficulties.

These recent changes in Europe suggest there has been a shift in the various bankruptcy codes in favour of the outcome(s) that preserve employment the most. We wonder here up to what extent the consideration of social issues might compete with financial objectives. Once default occurs, a choice has to be made on the debtor's fate: the design of bankruptcy law may influence such choice, and thus, impact on [1] creditors' repayment and/or [2] employment preservation. We focus below on both concepts.

First, let us consider the *creditors' repayment issue*. Two approaches, broad or narrow, can be considered. From a broad perspective, bankruptcy procedures have to promote the reallocation of the debtor's assets towards the project(s) that maximize(s) the financial value of the firm. A narrower perspective restricts this reallocation issue to a single alternative: i.e. should the distressed firm be liquidated or continued (through reorganizations and/or sales) so that the creditors' repayment is maximized? Such issue has been extensively studied by the literature on bankruptcy: following White (1989), we consider bankruptcy procedures are likely to maximize recoveries if they favour the outcome (liquidation, reorganization, sales) associated with the highest value of the firm, defined as the aggregated value of all claims. For instance, a firm should be piecemeal liquidated as soon as the discounted value of its present and future expected outcomes is higher under liquidation, as compared to continuation. From an empirical point of view, measuring such trade-off between liquidation, reorganization, and/or sales is obviously difficult to perform, as this requires comparing rival values, hardly computable for the same debtor. Thus, most of the papers restrict their approach to a measure of global recovery rates, for each observed outcome, as a proxy of the financial impact of bankruptcy (Armour, Hsu, & Walters, 2006; Davydenko & Franks, 2008). In this paper, we provide such recovery rates too, but we extend the approach while focusing on sales and comparing the *alternative values* of rival buyout proposals.

Second, let us consider *employment preservation*. With the noticeable exception of Korobkin (1991), and Warren and Westbrook (2000),[5] few papers investigate the extra-financial implications of bankruptcy. This is quite a serious concern as recent legislations explicitly take into account the social stakes related to bankruptcy. The employment preservation issue may be considered, once again, broadly or not. From a broad perspective, we consider that the bankruptcy procedures are employment friendly if they promote the reallocation of the debtor's workforce towards the alternative project(s) preserving most job positions (present and future). For obvious empirical constraints, this broad view is quite hard to implement. A narrower perspective restricts this reallocation issue to a simpler arbitration: i.e. which outcome (liquidation, reorganisation, and/or sale) is likely to preserve most job positions? In that perspective, continuation (either through reorganization or sale) is *always* equivalent or superior to liquidation, as the latter mechanically implies the destruction of all job positions. This is the rationale of the 1st article of the French legislation that advocates for more continuations in order to preserve employment. Our approach follows the narrow perspective. Again, we use the information arising from rival buyouts to assess the plausible social impact of every proposal, for each bankrupt firm.[6]

Practically, there are two major means of encouraging employment preservation and/or creditors' repayment. Either the law settles particular rules of collective decision making (vote), or grants some enforcement power to the Court. When there is a vote, the respective weights given to the different stakeholders and/or the possible deviations from the absolute priority rule indirectly impact the final outcome (i.e. liquidation *vs.* continuation), as it affects the identity of the residual claimant (Blazy & Chopard, 2004). When the Court is entitled to enforce a solution, as in France, the orientation given by the law is of high importance, as this may impact the way financial distress is resolved. Yet, whatever the decision making process (democratic or court-oriented), the adoption of a pro-debtor system (or, at least a shift towards it) stems from the following trade-off: protecting job positions and pursuing more businesses may undermine the welfare of the creditors who finally bear the financial cost of more continuations.

In this paper, we aim at giving some elements of answers, exploring a unique sample of 942 French bankruptcy files: 230 individual data per file were manually collected from the French courts (Paris and the suburb area) for the years 1989–2005. Our aim is to provide a benchmark for discussions of the relative merits/drawbacks of such a strong pro-debtor model. More precisely, we test whether the hierarchy of objectives set by the French bankruptcy code decisively drives the actions of the commercial courts, since liquidation, reorganization, and sale of bankrupt firms

[1] Yet, this trend does not mean the number of continuations is getting higher, compared to liquidations. On the contrary, in UK, Germany, and France, bankruptcy procedures end up with liquidation in more than 90% of cases. However, the quite recent change in the objectives of national laws means the institutional environment of default is evolving, which may finally affect the strategies, taking place in or out bankruptcy.

[2] See White (1996) for a more detailed comparison of U.S. and European countries.

[3] Weber (2005) explores the effects of this French legal priority set on agency problems between bankrupt firms and their debtholders. Weber argues that French firms have little incentives to file for bankruptcy, due to the court administered process and the civil and criminal sanctions associated with bankruptcy.

[4] Since 2006, the sale as a going concern is viewed more than a liquidation procedure. However, in our views, sales protect more employment than pure liquidations, as a part of the job positions is saved through sales.

[5] The authors study 3200 business cases originally filed in Ch. 7, Ch. 11, and Ch. 13 in 23 judicial districts in 1994. They report that "*The social impact of bankruptcy is emphasized by its effect on employees. Although many of businesses are small by most measures, extrapolation from the reported data suggests that as many as 2 million employees a year find their employers going into bankruptcy*".

[6] Note that, even if the social commitments – as formulated by the buyers – are not fully executed later on – once the bankrupted firm is sold to them – these are the basis of the Court's assessment, at the time the decision is made, which we want to test here.