



## Article

## Causes and resolution of bankruptcy: The efficiency of the law



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## ABSTRACT

The principal aim of this study is to analyze the effect of bankruptcy causes in its resolution. In furthering this purpose, a bankruptcy index is proposed, like a combination between the profitability and the leverage of bankrupt firms. This index tries to determine if the origin of the bankruptcy is mainly economic, financial or a combination. This study uses a sample of 1025 Spanish firms that went bankrupt in 2008 and obtained a resolution (reorganization or liquidation) by the end of 2012. The results reveal that a high bankruptcy index, which means low viability, reduces the reorganization probability of bankrupt firms. In addition, these results show that Spanish bankruptcy proceedings have a certain degree of efficiency, in such a way that the viable firms are reorganized and the nonviable firms are liquidated.

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## 1. Introduction

Several reasons support counting on legislation to regulate bankruptcy proceedings: the impossibility of creditors designing individual processes to recover from debtors (because the contracts are incomplete) (Hart, 2000); the reallocation of assets to better use (Jacobs et al., 2012); and the search for temporary protection by creditors from managers/shareholders with the aim of solving their liquidity problems or looking for a purchaser for the firm's assets (Baird and Rasmussen, 2002). In this sense, bankruptcy legislation should provide a framework that allows economically viable firms to reorganize and continue their business activities and simultaneously forces inefficient firms to be liquidated. Nevertheless, asymmetric information, such as conflicts of interest and inefficiencies in procedures, can result in two types of errors: liquidation of a viable firm and the survival of firms that should be liquidated.

The literature on bankruptcy resolution identifies two opposite types of systems that act as a function of the applied legislation: debtor-friendly systems (e.g., French "Redressement Judiciaire" or US Chapter 11) and creditor-oriented systems (e.g., British Administration or Voluntary Arrangement), and a wide debate exists about the efficiency of each one. In the first type, creditors try to

maximize their credit recovery, while the second system focuses on the firm and, at the same time, safeguarding the interests of other agents, especially workers (Celentani et al., 2010). In the last few decades, many countries in Western Europe (e.g., Germany, France, Italy, and Spain) have reformed their bankruptcy legislation with the purpose of encouraging the survival of firms (Dewaelheyns and Van Hulle, 2009). The current Spanish legislation (2003 Bankruptcy Law)<sup>1</sup> can be positioned as an intermediate one between both extremes. In fact, Spain received a score of two out of four in the creditor rights protection index prepared by La Porta et al. (1998) and Djankov et al. (2007). Nevertheless, Spanish Bankruptcy Law emphasizes creditors' protection.

As has already been mentioned, there is a wide debate in the literature about the efficiency of bankruptcy legal proceedings. Thus, in debtor-friendly systems, it is unlikely that viable firms will be liquidated, but inefficiency rises in the continued existence of non-profitable firms. In this sense, some authors assert that debtor-oriented systems (e.g., USA Chapter 11) have a bias toward the continuation of nonviable firms (Hotchkiss, 1995). In Spanish legislation, the 2003 Bankruptcy Law gives less protection to debtors than in the previous law, which raises some doubts about its efficiency (Fernández, 2004). On the other hand, Gennaioli and Rossi

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<sup>1</sup> Law 22/2003, dated 22 July, bankruptcy proceeding law, LC hereinafter, which entered into effect on September 1, 2004. This regulation has been modified by, among others, the Royal Decree 3/2009, dated March 27, by Law 13/2009, dated November 3, in a reform of the procedural legislation, by law 38/2011 dated October 10 and by the Royal Decrees 4/2014 and 11/2014.

(2010) find that greater protection of creditors in the reorganization process provides judicial incentives to solve the bankruptcy in an efficient way, which prevents inefficient uses of judicial discretion. However, the efficiency of bankruptcy legislation is conditioned not only by the type of system but also by other factors linked to the institutional characteristics of the firm, such as the degree of ownership and debt dispersion and the mechanisms to discipline managerial activity (Thorburn, 2000; Fernández, 2004).

A way of evaluating the efficiency of the legislation is to analyze a situation in which only viable firms are reorganized, while the nonviable ones are liquidated. To do this, some authors suggest analyzing the causes of the bankruptcy, distinguishing between financial and economic bankruptcy (White, 1994; Hotchkiss, 1995; Andrade and Kaplan, 1998; Denis and Rodgers, 2007; Lemmon et al., 2009; Balcaen et al., 2011; Fischer and Wahrenburgh, 2012). Firms that face financial bankruptcy are economically viable, but they have greater leverage and problems repaying their debts. Firms that face economic bankruptcy can also have difficulties repaying their debts, but they are characterized by a very low or negative operative result, and for this reason, their continuation is doubtful, even when there is no leverage (Lemmon et al., 2009). These authors and Fischer and Wahrenburgh (2012) conclude that when the cause of the bankruptcy is financial, firms have a greater likelihood of reorganization, based on agreements with their creditors to repay their debts, because they have expectations of good results. However, when the cause of the bankruptcy is due to bad operative results, it is more likely that firms will be liquidated.

Along this line, it is necessary to point out that in Spain the use of the legal bankruptcy process is less common than in other similar countries. Nevertheless, during the period of the financial crisis, bankruptcy rates have increased from 2.6 to 14.6 bankruptcies per 10,000 firms. That level is similar in Canada, for example, but is significantly lower than the rates in the U.K or France (137 and 217, respectively) (García-Posada and Mora-Sanguinetti, 2012). This lower use of the legal process is a consequence of the firms' preference to use alternative resolution mechanisms for bankruptcy, such as private renegotiation processes with creditors or the mortgage system. In fact, in Spain, the financial structure of the firms has a high proportion of mortgage debt, which allows avoiding the legal bankruptcy mechanism and negotiation through the mortgage system, which is less costly than the legal process (García-Posada and Mora-Sanguinetti, 2014). In this sense, "In Spain, the foreclosures could be a more attractive mechanism for creditors than the bankruptcy legal process...due to the lower length of the proceedings, the lower costs, and presumably, the higher rates of credit recovery" (García-Posada and Mora-Sanguinetti, 2012: 33). Additionally, the preference for those alternative resolution mechanisms contributes to an understanding of the level of damage in the firms that file for bankruptcy. Along this line, Van Hemmen (2009b) asserts that the firms file for bankruptcy with almost no possibilities of reaching an agreement, nine out of ten have clear signs of structural crisis, liquidation being the only feasible solution.

Lemmon et al. (2009) and Fischer and Wahrenburgh (2012) create an index to measure the type of bankruptcy through a combination of profitability and leverage. Following those studies, the aim of the present work is to analyze the efficiency of Spanish bankruptcy legislation by the relationship between the causes and resolution of bankruptcy. To do this, an index is created, called the "Bankruptcy index", which is inspired by the aforementioned studies. The study uses a sample of 1025 non-financial, unlisted firms that went bankrupt in 2008 and obtained a resolution (reorganization or liquidation) by the end of 2012. The results of the present study show that less viable firms, especially those that present mixed causes of bankruptcy (financial and economic), are less likely to reorganize than firms that are exclusively financially bankrupt. The results also allow us to determine the importance of

considering an index that relates profitability and leverage, instead of just considering individual factors.

The primary contributions of this study are that it is the first to analyze the causes of bankruptcy in Spanish bankrupt firms and, above all, it connects those causes with the bankruptcy resolution. In this sense, this study provides new outstanding empirical evidence to be considered in future studies, so that future studies about bankruptcy resolution must consider, at least as a control variable, some proxy of the viability of the firm. In fact, most of the studies consider this aspect indirectly when they include profitability and leverage.

The remainder of the study is structured as follows. Section 2 analyzes bankruptcy resolution proceedings under the framework of Spanish bankruptcy legislation. Theoretical arguments are then described concerning the position of bank creditors in bankruptcy resolution proceedings, and the hypotheses are presented in Section 3. Section 4 describes the methodological aspects, while Section 5 presents the results of the empirical study. The sixth and final section is dedicated to a discussion of the results and concluding remarks.

## 2. Insolvency resolution under Spanish bankruptcy law

Bankruptcy resolution is the stage of the proceeding in which it is decided whether the firm goes on in its activity with the approval of an agreement or is liquidated. Concretely, in Spanish Law, this moment is the end of the common phase and the beginning of the successive phase.

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. That does not prevent the legislation from taking into account other groups in the firms, and in this sense, the preamble of the Law says: "Although the objective of the process is not the financial restructuring, an agreement of continuation can be an instrument to solve the total or partial viable firms, of benefit to not only the creditors, but also the debtor, the workers and other interest ..." (VI, paragraph 7°).

In order to facilitate this solution, the admission of the "early proposal of agreement" stands out, allowing the debtor to present a proposed agreement in a volunteer bankruptcy or even in a necessary one.<sup>2</sup> If an early proposal of agreement is not approved and the debtor does not choose liquidation of assets, the agreement phase is opened.

The Law is flexible with respect to the content of the proposed agreement. Thus, article 100 establishes that there can be propositions of reduction and moratorium on the debt or the accumulation of both; in the first version of the Law, debt reductions could not exceed half of the sum of each ordinary credit, and debt moratoriums could not continue for more than five years after the approval of the agreement. However, in RD 11/2014, those limits were eliminated.<sup>3</sup> Moreover, alternative propositions may be admitted, such as a conversion of the debtor's credit into equity instruments or similar stakes. In addition, propositions of alienation can be included in the agreement. Those propositions can be over the set of goods and rights of the bankrupt firm, related to its corporate or professional activity or certain

<sup>2</sup> Until the end of the period of credits communication, with the condition that it is accompanied by the acts of adhesion of the creditors, in the proportion of the Law. The regulation of the early proposal of agreement even allows the judicial approval of the agreement during the common stage of the process, with an important reduction of time and costs regarding the current bankruptcy proceedings.

<sup>3</sup> Royal Decree 11/2014.

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