55. What is bankruptcy?

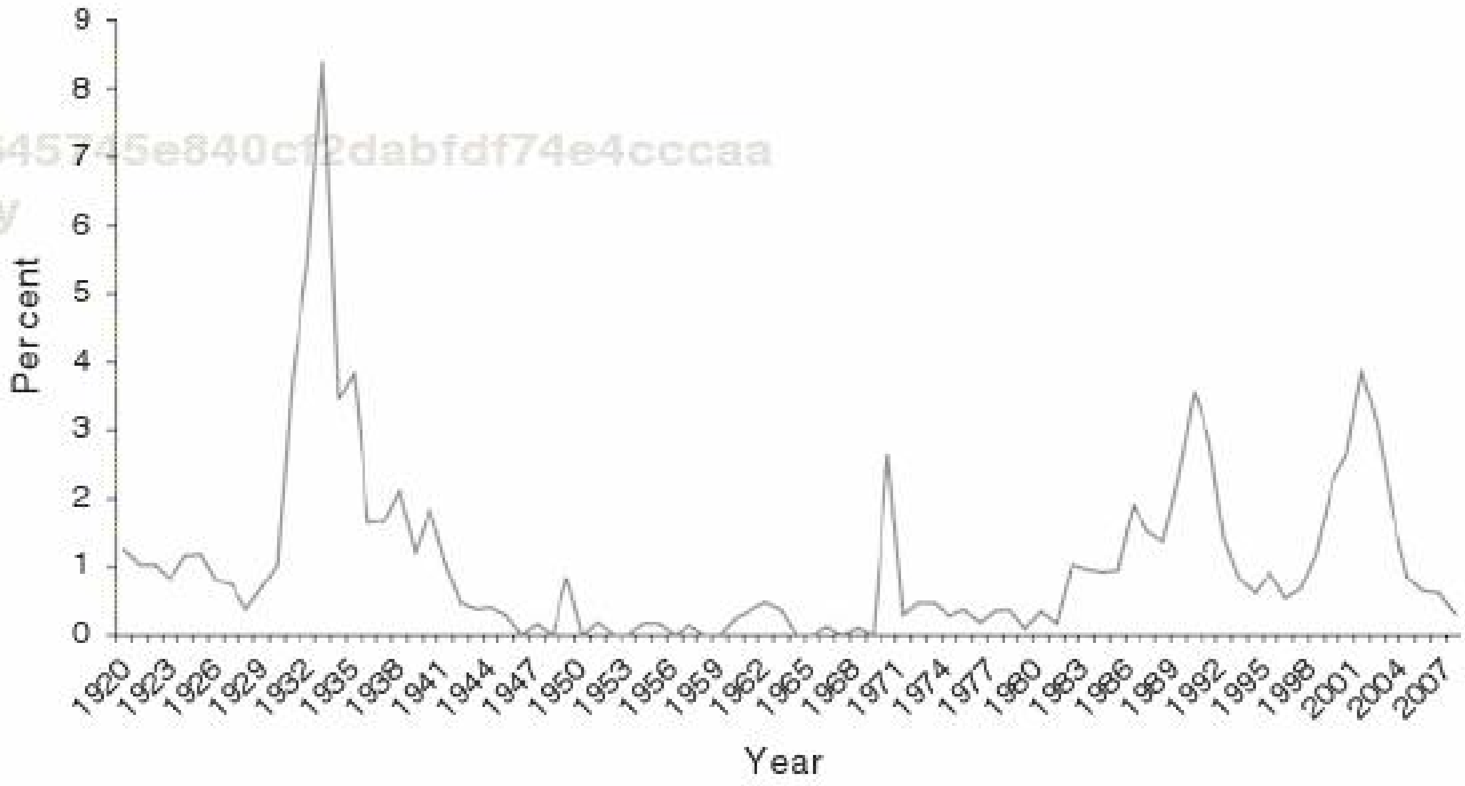
Short Answer

Bankruptcy is triggered when a company can no longer meet its short-term commitments and thus faces a liquidity crisis. This situation normally does not arise because the company has too much debt (which is the tip of the iceberg), but because it is not profitable enough.

Example

Rating agencies also estimate the probability that a company will go bankrupt in the short or long term.

When US energy giant Enron filed for bankruptcy at the end of 2001, rating agencies were criticized for not anticipating financial difficulties and warning creditors. In this case, the rating system (Figure 1.50) did not work properly.



Source: moody's 2008.

Figure 1.50: Bankruptcy rate of companies rated by Moody's

Long Answer

Every economic system needs mechanisms to ensure the optimal utilization of resources. Bankruptcy is the primary instrument for reallocating means of production from inefficient to efficient firms.

Theoretically, bankruptcy shakes out the bad apples from sectors in difficulty and allows profitable groups to prosper. Without efficient bankruptcy procedures, financial crises are longer and deeper.

A bankruptcy process can allow a company to reorganize, often requiring asset sales, a change in ownership and partial debt forgiveness on the part of creditors. In other cases, bankruptcy leads to liquidation – the death of the company.

The problems generally stem from an ill-conceived strategy, or because that strategy is not implemented properly for its sector (e.g. costs are too high). As a result, profitability falls short of creditor expectations. If the company does not have a heavy debt burden, it can limp along for a certain period of time. Otherwise, financial difficulties rapidly start appearing.

Generally speaking, financial difficulties result either from a market problem, a cost problem or a combination of the two. The company may have been caught unaware by market changes and its products might not suit market demands (e.g. Smoby, producer of wooden toys and Boo.com). Alternatively, the market may be too small for the number of companies competing in it (e.g. online book sales and satellite TV platforms in various European countries). Ballooning costs compared with those of rivals can also lead to bankruptcy. Alitalia, for example, was uncompetitive against other airlines. Eurotunnel, meanwhile, spent twice the budgeted amount on digging the tunnel between France and the UK.

Nevertheless, a profitable company can encounter financial difficulties, too. For example, if a company's debt is primarily short term, it may have trouble rolling it over if liquidity is lacking on the financial markets. In this case, the most rational solution is to restructure the company's debt.

One of the fundamental goals of financial analysis as it is practiced in commercial banks, whose main business is making loans to companies, is to identify the companies most likely to go 'belly up' in the near or medium term and not lend to them.

The bankruptcy process is one of the least standardized and homogenized legal mechanisms around the world. Virtually all countries have different systems. In addition, legislation evolves rapidly.

Nevertheless, among the different procedures, some patterns can be found. In a nutshell, there are two different types of bankruptcy procedure. The process will be either 'creditor (lender) friendly' or 'debtor (company) friendly'. But all processes have the same ultimate goals although they may rank differently:

- pay-down the liabilities of the firm;
- minimize the disruptive impact on the industry; and
- minimize the social impact.

The way in which default on payment is managed in different countries (Table 1.50) modifies the percentage of the debt that creditors (and more specifically banks) are able to recover. By examining bankruptcy law in three European countries (France, Germany and the UK), Davydenko and Franks (2008) show that banks seek to tailor their loans to make the most of legislation in force. They reproduce the rankings from a now famous article that awarded France the

Table 1.50: Management of default payment in different countries

	UK	France	Germany	India	Italy	USA
Type	Creditor (lender) friendly	Debtor (borrower) friendly	Creditor (lender) friendly	Creditor (lender) friendly	Debtor (borrower) friendly	Debtor (borrower) friendly
Possible restructuring	Rare after opening of a proceeding	Yes	Yes (rare)Creditor (lender) friendly	Yes	Yes	Yes
Management can stay in place	No	Yes*	Yes*	No	‡	Yes
Lenders vote on restructuring/liquidation plan	Yes	No	Yes	Yes	Yes†	Yes

Priority rule	Proceeding charges; secured debts on specific assets; tax and social security; other secured debts; other debts	Salaries; tax, other social liabilities; part of secured debts; proceeding charges; other secured debts; other debts	Proceeding charges; secured debts; other debts	Secured debts and employees proceeding charges; tax and social liabilities; unsecured debts	Proceeding charges; preferential creditors (inc. tax and social) and secured creditors; unsecured creditors	Secured debts granted after filing; employee benefit and tax claims; unsecured debts

*Assisted by court designated trustee.
†Yes in the case of restructuring (pre-emptive arrangement) but only consultative committee in case of liquidation (fallimento).
‡No in the case of liquidation (fallimento).

lowest score for creditor protection, compared with a score of three for Germany and a maximum four points for the UK.

In France, the absolute priority given to keeping the business going and protecting jobs has the side effect of reducing creditor protection. Banks require more collateral – over 100% of the value of the debt (compared with 40% in Germany and 60% in the UK). There is very little use of mortgages as assets tend to be sold off at far below their market value once bankruptcy procedures are launched. Banks prefer personal guarantees that they can activate directly. In the UK, default on payment leads to a procedure in which first ranking creditors have a veto on all decisions made by the directors. This means that first ranking creditors obtain *de facto* control over the company. In Germany, creditors do not enjoy quite as much protection but are better off than their French equivalents, retaining some power in the restructuring of loans.

> *Notwithstanding the efforts made by banks to adapt, there is still a huge gap between recovery rates in the three countries, which are 92% in the UK, 67% in Germany and only 56% in France.*

However, it should be noted that spreads used by UK banks are higher than those used by French banks (16 base points for an equivalent loan). Davydenko and Franks attribute this to less competition between lending establishments, the result of a financial system that is dominated by markets. Moreover, by focusing on firms that have defaulted on their loans, the article fails to analyze the abilities of the three systems to prevent debtor default (such as the 'alert procedure' in France). Competition between banks and prevention of debtor default are factors that should be taken into account for a fuller comparison of the merits of legislation in place in different countries in this domain.

Depending on the severity of the bankruptcy process and in particular whether or not it allows and promotes restructurings, *two opposite inefficiencies may arise*. The process may:

- allow restructuring of an inefficient firm that destroys value. This could be an issue as such restructuring may destabilize the whole industry; or
- lead to liquidation of efficient companies. A firm can be caught in a bankruptcy procedure because of a liquidity problem. In this case, liquidation could be value destroying.

It is important to understand that not all financial difficulties lead to voluntary or court-mandated reorganization or liquidation, which is often costly, lengthy and sometimes ineffective. *The first step is usually private negotiation between the company (shareholders and/or managers) and its creditors*. The more numerous the company's sources of funding – common shareholders, preferred shareholders, convertible bond holders, creditors, etc. – the more complex the negotiations.

Barring private negotiation, the potential conflicts between the various parties necessitate the intervention of a judge.

The business plan submitted by the company in financial distress is a key element in estimating its ability to generate the cash flows needed to pay off creditors.

A restructuring plan requires sacrifices from all stakeholders. It generally includes a recapitalization, often funded primarily by the company's existing shareholders, and renegotiation of the company's debt. Creditors are often asked to give up some of their claims, accept a suspension on interest payments and/or reschedule principal payments.

Creditors and shareholders are naturally at odds with each other in a restructuring. To bring them all on board, the renegotiated debt agreements sometimes include *claw back provisions*, whereby the principal initially foregone will be repaid if the company's future profits exceed a certain level. Alternatively, creditors might be granted share warrants. If the restructuring is successful, warrants enable the creditors to reap part of the benefits.

To succeed, financial restructuring must always be accompanied by operational restructuring.

Only financial restructuring will enable the company to return to profitability. As part of the effort to improve productivity, operational restructuring is very likely to involve headcount reductions. Certain businesses might be sold or discontinued. Note that restructuring a company in difficulty can sometimes be a vicious circle. Faced with a liquidity crisis, the company must sell off its most profitable operations. But as it must do so quickly, it sells them for less than their fair value. The profitability of the remaining assets is therefore impaired, paving the way to new financial difficulties.

Bankruptcy generates both *direct* (court proceedings, lawyers, fees, etc.) and *indirect* costs (loss of credibility *vis-à-vis* customers and suppliers, loss of certain business opportunities, etc.). These costs have an impact on a company's choice of financial structure.

Financial distress will generate conflict between shareholders and creditors (agency theory), and conflict among creditors (free rider issues).

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