

# THE STATE OF FAILURE AND ESTABLISHING THE FINANCIAL DECISION IN CASE OF BANKRUPTCY

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*Abstract: The bankruptcy represents an absolutely normal market phenomenon, in our country it didn't reached yet to be part of "game's rule"; any investor wishes to know not only the manner of entering within a business, but also of going out of it, the business being carried out with a society which is at bankruptcy. The number of bankruptcy is an essential indicator on evaluating the functionality level of an economy. "The economists show that it is normally within a market economy with percent of 2-6% for all companies to suffer bankruptcy within a year".*

*keywords: financial decision, judicial reorganization, the insolvency, the bankruptcy, the creditors*

## 1. Generaly terms

Within a company's economic life, certain recessive and of failure moments can appear, which lead to putting under financial supervision, reorganization/restructuring and finally to liquidation. The failure can be interpreted in more ways, depending of problems involved or not by the collapse and dissolving that company, associated with a loss in total investment of creditors. In this way, clarifying the following terms becomes necessary<sup>56</sup>:

- the economic failure signifies the fact that a company's incomes do not cover the total costs, including the capital's cost;
- the company's failure refers to any company which stop its activity, having as result a loss for creditors;
- technical insolvency. A company will be considered technically insolvable if it cannot respect the current observations on their becoming payable. A company being in this situation is considered in technical stopping of paying the obligations. The technical insolvability denotes the lack of financial difficulties to customers;
- the insolvency in bankruptcy appears when within an enterprise, the total of duties exceeds the real value of assets. This situation is much more severe than the technical insolvency, because it generated the company's liquidation.

Within the Romanian regulations for the judicial reorganization and bankruptcy procedure, distinction is made between the insolvency and insolvability. The insolvency (inability of payment) comes when the debtor do not have necessary liquidities for paying his real, liquid and due debts. The insolvency or debtor's stopping of payment has to be delimited of so that called "financial constraint", which consists on just being lack of necessary liquidities for duties acquit. It is possible that, in short time, the debtor to cash the debts from his own debtors and to financially redress.

The insolvency doesn't mean insolvability, for as long as the debtors maintains in his patrimony goods which can be enforced executed, in the view of paying the duties towards the creditors. The insolvability consists on debtor's impossibility of respecting his obligations towards the creditors, both from liquidities' lack and other goods among which the creditors' debts have to be satisfied. Practically, the passive (duties) is bigger that the active (rights) of patrimony. In this way, the insolvability state regulated by the Romanian legislation is the same as the bankruptcy insolvability, while the insolvency is the same with technical insolvability, previously approached.

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<sup>56</sup> Halpern, P. ş.a. - *Finanţe manageriale*, Editura Economică, Bucureşti, 1998, p. 882.

The economic failure of a company is caused by more factors, among which the following can be presented:

- incompetence and managing failure (60%);
- the unfavorable evolution of the market (about 20%);
- the natural phenomenon, fire, calamities, Earth quakes (10%);
- other causes (10%).

It can be observed that the main cause has in view the failures of managing processes and of knowing the market. Therefore, the managers have to identify in time the signals of deteriorating the financial situation of enterprise, such as:

- achieving the negative net financial results;
- existence of a negative working capital;
- the impossibility of reimbursement the credits to their normal date of payment;
- the bankruptcy of some providers or main customers for the enterprise;
- the reduced impossibility or non-availability of a manager;
- persistence of strikes.

## **2. The legal frame**

The legal frame as concerns the commercial companies functioning, as well as the Law of enterprises' insolvency foresee the impossibility of declaring the bankruptcy state for the company, which is carried out, firstly by supervising activities, of reorganizing and restructuring-readjustment.

The bankruptcy is a judicial procedure in the view of reorganizing or liquidation of a company, when reorganizing or liquidation is organized by special courts. The bankruptcy can be of two types:

voluntary, when the bankrupted company presents to judicial instance a request and no order of supervising exists, and the manager of real patrimony/syndics is directly named;

involuntary, when the company's creditors presents to judicial instance a request and prove that the debtor do not respect the duties on date of payment. In this case, the instance institutes the order of supervision over the debtor and names the patrimony managers.

The creditors can anticipate the incapacity of debtor for respecting the obligations to date of payments, upon the basis of bankruptcy deeds, which this committed, being the following:

- the false pretences transfer represents a transfer of properties towards a third party, on inadequate conditions, with intention of prejudicing the creditors;
- the preferential transfer represents the money or assets transfer by a insolvable debtor towards a creditor, giving to creditor a bigger part of duties unto other creditors will receive to liquidation. The preferential transfer is also called "false pretences preference";
- hiding or removal. Hiding refers to hiding certain properties on intention of prejudicing the creditors; removing the properties also has in view the creditors' prejudicing;
- assignation. If a debtor makes a general assignation on creditors' benefit, there will be an act of bankruptcy. This will allow to creditors that do not trust within the assignation process to transform this transaction into an involuntary bankruptcy;
- sudden leaving. If the debtor disappears in the view of cheating or delaying towards the creditors, then a request of bankruptcy can be submitted;
- admittance to a creditors' meeting. The debtor will commit a bankruptcy act if at a meeting of creditors, he presents a declaration of assets and duties which show that he is insolvable or admits in write that is unable of paying the duties;
- communication towards the creditors. If the debtor communicates to any creditor that he suspended or will suspend the duties' payment, a bankruptcy act will take place;
- order of officer of the court. If the debtor do not redeem the goods that were sequestered by an execution order issued against him, there will be a bankruptcy act;

- the technical insolvability is the most commonly act of bankruptcy and takes place when the debtor is unable of respecting, in generally, the conditions of indebted contracts to date of payment.

At this moment, the creditors will have to take the decision of they dissolve the company by the liquidation procedure or will maintain it alive by reorganization. This decision depends upon determining the company's value in conditions of its rehabilitation towards its assets values, if these are separately sold. As a result, the creditors choosing will depend upon their financial pain severity, by the existing financial structure's complexity and of company's dimension.

The creditors will have three available options:

- the creditors, by negotiations with the company, either length the time duration for paying the interest and/or the load, either will reduce the interest rate to overdue duties. Both procedures will decrease the financial heaviness over the company and allow it to continue the exploiting; moreover, the creditors contract minimal costs of transaction and payment of lawyers. This option is chosen when the financial sufferance is temporary, the company having a good economic situation, and the managerial team will present trust towards the creditors. This option is used for the companies with simple structures of capital, which have a reduced number of creditors and which has as result voluntary reorganization of duties payment;
- establishing the supervising regime. This is a procedure more expensive towards the first option and is practiced in cases of more severe financial sufferance. In this way, after setting the syndic, the creditors have to decide if the company “values more dead than alive”. If the value of market for the company which would continue the activity is less than the value of liquidation, the company has to be liquidated and encashment distributed in accordance to a n algorithm previously established. Contrarily, if the value estimated of the market maintained alive is greater than the value of liquidation, an economical restructuring plan has to be applied. It is also had in view the reorganization of financial arrangements, for reducing the company's duties, event if each class of creditors can loose a part of the initial investments. In many cases, the conditions of a successful commitment involves the replace of existing managing, liquidation of certain assets and emission towards the creditors of new immovable values, of whom efficiencies to be dependant of company's success.
- using the legal remedy offered by the bankruptcy law, by which the company is declared to be broke and liquidated, finally by applying the rules specified within this law.

If the creditors choose this option, it will be possible for the company's owners to make a last effort of saving the company. In this way, they can present to creditors a reorganization proposal. If they reach to conclusion that the company values more dead than alive, the proposal will be rejected and the company liquidated. That respective option is used especially to small companies.

As concerns the big companies, the owners have a certain influence within this process. Having at disposal financial resources, they can make appeal to accountancy and juridical consultancy; they can ask to judicial court a certain protection in the view of elaborating a new plan of reorganization, for presenting it both to creditors and justice. Concretely, the owners of great companies appeal to all kind of measures for stopping any activity of the creditors, which cannot enterprise anything in this duration. If the proposal is rejected, the company will be broke and liquidation will be carried out.

For establishing a financial decision in case of bankruptcy, the financial service proceeds on determining the most of financial information. At the beginning, by the legislation research as concerns the companies, the bankruptcy law and other judicial provisions, the methodological information is established. Upon their basis, the information as regards the financial expenses and financial incomes are determined. The information as concerns the financial expenses refers to expenditure made in the view of process managing of bankruptcy and to eventual organizations and restructuring, being thus determined by the procedure of quotation. The payment obligations refer to amounts payment towards creditors and their proportion, the payment of wages for the staff and to the level foreseen by the law of bankruptcy, the payment of taxes remained towards the central and local budget.

The information as concerns the financial incomes are determine by the market value of the asset sold by public auction by the bankruptcy process managing. The financial decision as concerns the bankruptcy

makes part of the documentation that attaches the company's bankruptcy, being the last financial distribution in the name of economic agent in discussion.

Using the changing strategies represents a practice often met, both in countries with economy on functional market and those being in transition. Adopting these strategies is imposed both in crisis situations and also in those being favorable, when the enterprise is adapted to exigencies of business environment, but also wishing to consolidate the position, thus essentially changing the financing manner. Mostly, the changing strategies are regarded as avoiding solutions for affecting the financial situation and implicitly, of bankruptcy.

With all these advantages, within the mechanism of changing, both elements which determine the changing act, as well as elements that stop it. From the first category, the following take part: changing the conditions of work, changing the structure of work force; these elements offer tensions for changing. At their turn, the elements that stop the changing and form the resistance to changing is: the old mentalities, the fear of new, the fear of failure, the reduced level of professionalism and the mental blocking.

Mainly, an enterprise being in difficulty can apply the following strategies<sup>11</sup> of changing, with great impact over the payment capacity of it and of its evolution on market:

- strategies of changing in conditions of temporary inadaptability;
- strategies of transforming and reorientation;
- strategies of recovering or of making efficient.

The first type of strategies is adopted by those enterprises being temporarily in an unfavorable situation thanks to certain unfavorable conjuncture phenomenon, but which can be surpass in the future, by adopting some objectives and concrete measures of activity. Adopting such a strategy is based upon issuing an adequate diagnosis, which is able to support certain vanguardist manifestations, of launching in business that can reward the courage by adopting certain decisions in risk and uncertainty conditions thus assuring the economic recovery.

At their turn, the strategies of transforming and reorientation can be adopted by those enterprises which achieve in present the adequate economic performances and are well adapted to existing economic context. But, upon basis of diagnosis strategically done, the enterprise observes that it should activate in the future to an environment totally different from that existing in present, under all views, reason for which it will perform to transformations to business organizing forms, of the property's structure, of the technical potential, strategies of supplying and sale, etc.

Finally, the recovering or making efficient strategies can be adopted when the enterprise achieves weak or unfavorable results, thus recording loss or it is not well adapted to the existing economic context, being absolutely necessary for the enterprises being on bankruptcy start; it needs a high spirit of responsibility from the managers, the future of enterprise having to be taken into consideration. Within the process, two strategic directions which have to be thought are aimed, meaning:

the strategy of business activity, where what, how and how much is supervised;

financial strategy, where how much is cached and what is the profit is taken into consideration. Therefore, the financial restructure is observed in Table:

Strategy of changing by business restructuring	Strategy of changing by financial restructuring
Organizational and dimensional restructuring	Liquidities management
Issuing of sector's and territorial strategies on short and mean term	Reducing of duties
Segmenting of business	Adequate using of economic – financial lever

*Table : Strategy of enterprise restructuring*

Successfully applying of changing strategies needs the following steps respecting:

- understanding the need of adopting the strategy and changing the mentality frame of enterprise. The mental frame represents a particular form of thinking which characterizes individuals that lived and worked in the same environment for long time, thus representing the result of a culture and specific structure. He has to become receptive to changing and to impose the steps necessary to changing;
- defining the objective of changing strategy, depending the nature and structure wished to enterprise's level;
- choosing the type of strategy, which is adapted the best to enterprise's problems;
- execution of strategy and evaluating the achieved results.

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