

CONSIDERATIONS ON REORGANIZATION. A COMPARISON OF REORGANIZATION RATES IN EASTERN EUROPE

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In our paper, we discuss reorganization from two points of view: its purpose and the choice between reorganization and liquidation, by reviewing the existing literature. After setting an appropriate theoretical base for interpretation, we focus on comparing Romania's situation on reorganization with the situation in other EU countries from Eastern Europe. We find that the low reorganization rates in Romania are mirrored in most of the other countries, as well. Moreover, the fact that Romania has legal provisions inspired by international best practices can be considered a big plus.

Keywords: reorganization rate, reorganization versus liquidation, Eastern Europe

JEL: G33, K29

1. Introduction

Although Romania has a high insolvency rate⁴⁷⁵, the number of companies in financial distress that choose to reorganize in the insolvency procedure is very small. And because one cannot talk in comparing terms such as big or small unless there is a subject of comparison, we chose to look at the Romanian insolvency rates, and specifically the rates of reorganization, in a regional context. The countries we chose for our study (Romania, Hungary, Poland, Czech Republic, Slovakia, and Slovenia) are part of Eastern Europe⁴⁷⁶. We had in mind the similar geopolitical context of the countries in this region. A notable absence from this set of countries is Bulgaria. It is missing because it seems that no reorganization rates are published for this country. Consequently, we would have no use of including Bulgaria as well. A second criterion for choosing this particular set of countries was whether they are part of the European Union as Romania is. The reason for this is the partially harmonized legal framework that the EU "imposes" on member countries.

Our paper is organized as follows. The first two parts are theoretical discussions on reorganization from two points of view: the purpose of reorganization procedures and the choice between reorganization and liquidation in insolvency. We aim to set the appropriate base of interpretation for the analysis that follows in the next part. This last part focuses on comparing Romania's situation on reorganization with the situation in the selected countries. In order to do this, we started out by shortly describing the laws governing insolvency in these countries and then moved on to analyzing a set of data on reorganization rates. Valuable sources of information for this paper were the Coface statistics and country reports from 2006, 2007 and 2008.

475 Estimated to 1.3% for 2008, and calculated to 1.1% for 2007, according to Coface studies cited in the bibliography.

476 According to the United Nations Group of Experts on Geographical Names on <http://unstats.un.org/unsd/geoinfo/ungegndivisions.htm#ecsee>.

2. The purpose of reorganization procedures

Following principles set out by the World Bank and indications coming from the European Union⁴⁷⁷, European countries made serious steps towards adjusting their insolvency laws to what could become a common model (Brouwer, 2006). Principle number eight of the principles for effective insolvency promoted by the World Bank states that an insolvency law should provide both for efficient liquidation of nonviable businesses and those where liquidation is likely to produce a greater return to creditors, and for rehabilitation of viable businesses. Guidelines are offered as to what is meant by the terms used in stating this principle⁴⁷⁸, and a distinction is made between the strict, traditional meaning of liquidation and rehabilitation and the way in which different situations encountered in practice nowadays are entitled to altering the traditional meaning of these concepts. Consequently, the World Bank militates for a rescue regime – no matter what name this regime takes -, that would “permit a result that would achieve more than if the corporation was liquidated”. Many insolvency regimes around the world suffered major changes in the last years in order to comply with this view, changes that materialized into reorganization procedures.

Reorganization or restructuring is aimed at finding a method of rescuing the company from financial distress and salvaging all or parts of it for the benefit of all claimants. Typically, it involves a process of negotiation between debtors and creditors with a view to establishing a new mechanism for the settlement of claims that may differ from the absolute priority rule. (Hashi, 1997) This, in fact, means rewriting of debt contracts of different groups of claimants and creditors (Hashi, 1997), reorganizing activity in the company, selling part of it, disposing of unprofitable activities, closing down of subsidiaries, reducing the scale of production activities, partial lay-offs and so on. Reorganization means recontracting (Franks et al, 1996), recapitalization (Roe, 1983) which leads to deviations from the absolute priority rule. (Franks et al, 1996) It implies extended negotiations. The nature of a formal reorganization process affects the out-of-court resolution of financial distress. Private arrangements have evolved to avoid some of the costs of formal reorganizations.

Moulton and Thomas (1993) define successful reorganizations as “firms which maintained their corporate identities, continued as publicly traded firms on national stock exchanges, and had postreorganization assets of more than 50 percent of prebankruptcy levels”. In their view, to which we subscribe, if a new successor company can be clearly identified, even if a liquidation of the initial company is involved, it still classifies as reorganization.

3. Choosing between reorganization and liquidation

As we have seen in the previous part of this paper, companies facing financial distress now have to make a choice: liquidation or reorganization⁴⁷⁹. Hashi (1997) opinionates that if financial markets and the acquisition mechanisms were to function efficiently and transparently, there would be no need for a supplementary insolvency procedure. The value of any company, including those in financial distress or bankrupt, would be known on the market. For the right price any company would find a buyer. However, the absence of completely efficient financial

477 We agree with a remark that La Porta et al (1998) made: “Laws in different countries are typically not written from scratch, but rather transplanted from a few legal families or traditions”. The American insolvency model seems to pervade most of the world’s insolvency systems.

478 “In its strict sense, liquidation refers to immediate or early cessation of a business, the sale of the business or its productive units or the piecemeal sale of its assets. In contrast, a strict view of rehabilitation refers to the restructuring of a corporation that can be restored to productivity and become competitive” (World Bank, 2001)

479 For most countries, these two procedures are the ones that constitute the insolvency procedure. However, there are variations from this structure. As an example, see the UK Insolvency Law which provides three procedures for companies in financial difficulty: receivership, administration and company voluntary arrangement (Stigma study, 2002)

markets, together with the informational asymmetry between insiders and outsiders calls for a special mechanism to supplement existing property laws – the insolvency law.

“Reorganization has supplanted liquidation as the normal consequence of the failure of large corporations. It is offered as an alternative to the sacrifice of going concern values which usually far exceed liquidation values. Reorganization must offer equivalent opportunity for realization of creditors’ rights and expectations of priority – yet the attempt to insist on strict enforcement of priorities usually interferes with the conservation of going concern values.” The reorganization implied here presupposes shrinkage, at least in present realizable values, below the aggregate of creditors’ claims. Every reorganization plan is itself a launching of a new financial structure to carry the expectations of investors. (Foster, 1935)

Insiders are highly motivated to prefer reorganization instead of liquidation and a strict application of priority rule. This is the case because reorganization means recontracting, with less regard to the absolute priority rule. Often, for creditors, reorganization implies loss of share (Franken, 2003). Negotiations for recontracting give the debtor power and a position that could be used for the debtor’s advantage at the creditor’s expense (Hashi, 1997). Besides such selfish reasons, there are other considerations which encourage companies to opt for reorganization: the chance to reduce the loss caused to creditors, protecting jobs, maintaining productivity, or receiving government subsidy. Moreover, the fact that reorganization *is* an option means that very risky investment decisions taken by a hasty management under pressure of financial difficulties are less likely (Hashi, 1997).

4. Eastern European reorganization rates – analyzing the data

In order to compare Romania’s situation on reorganization with the situation in the selected countries, we shortly describe the laws governing insolvency in these countries and then move on to analyzing a set of data on reorganization rates.

The Czech Republic replaced the old Insolvency Act at the beginning of 2008. From this date on, insolvent companies have access to two types of procedures: bankruptcy and restructuring. The form of the last type of procedure is new for the Czech Republic. It allows for business continuance under creditors’ control so that debts could be repaid in a gradual manner. Since our paper uses data collected in 2006 and 2007, it is useful to mention the design of the old Czech Insolvency Act, as well. According to an OECD Economic Survey of the Czech Republic from 2004, the then bankruptcy legislation had some serious weaknesses: debtors were in the position of asset-stripping without being held responsible, the legal proceedings were long and time-consuming, and reorganization prospects were bleak.

The Hungarian insolvency system allows for a settlement with creditors (called “bankruptcy proceeding” interestingly enough), for reorganization or liquidation for insolvent companies (“business reorganization proceedings”) and for voluntary liquidation. Specialists have signaled serious flaws (such as creditors not being sufficiently represented or time-consuming procedures) that reflect in insolvency rates in this country.

As part of the European Union, Slovakia has adjusted its insolvency system according to EC Regulation no 1346/2000 on insolvency proceedings. Liquidation and reorganization are the options provided. Unlike in other systems, a debtor who has been classified as bankrupt may continue business activities until a court decision against such behaviour is requested by the trustee on behalf of the creditors. Reorganization must be approved by the court under the legitimate assumption that creditors will receive a larger settlement than in bankruptcy.

In Slovenia, forced settlement allows the insolvent debtor to submit a reorganization proposal to the court. The proposal focuses mostly on extending payment terms and will be subject to creditors’ voting. Bankruptcy proceedings are carried out by a court-appointed administrator and involve liquidation of the debtor. Also, there are legal provisions for forced liquidation initiated for “technical” reasons (e.g. unregistered documents or forms).

The Romanian insolvency law: Law no 85/2006 replaced law no 65/1994. Unlike the old law, Law no 85/2006 has provisions regarding two forms of insolvency procedure: the general procedure and the simplified procedure. The general procedure means that, after an observation period, the debtor may enter reorganization and then bankruptcy, or separately, only reorganization or only bankruptcy. According to Tandareanu (2006), the new insolvency law increases the number of cases in which a company cannot reorganize. It is desired that Law 85/2006 be a big step forward for increasing the efficiency of the insolvency procedure, assuring a balance of rescuing opportunities of insolvent companies and a controlled exit of nonviable debtors (Munteanu & Mihai, 2006). Under the auspices of the old law, reorganization has been used as a way of prolonging the life of the debtors. Law no 85/2006 aims at increasing the efficiency of the reorganization procedure, eliminating abusive invoking of reorganization in order to delay the exit moment by expediting the procedure and plan proposal (the plans are to be discussed, analyzed and compared in one creditors' assembly meeting), imposing discussions between debtor and creditors and improving creditor voting system.

		Reorganization rate 2006(%)	Reorganization rate 2007(%)	Reorganization rate first half 2007(%)	Reorganization rate first half 2008(%)
Country	Czech Republic	0,16	0,68	0,31	0,00
	Hungary	0,23	0,20	0,28	0,18
	Poland	16,67	15,66	19,05	15,98
	<i>Romania</i>	33,85	0,70	0,68	0,16
	Slovakia	0,00	0,00	0,00	0,00
	Slovenia	12,65	11,25	10,94	12,65
East European mean		10,59	4,75	5,21	4,83
Standard deviation		13,49	6,89	8,00	7,42

Table 1: Reorganization rates in Eastern Europe (calculated based on data from Coface studies)

Indeed, figures show that Romania has a low reorganization rate defined as number of reorganizations in total number of insolvencies, both opened strictly in the considered period of time. This is mostly the case for years following 2006, when the new insolvency law came into act (2007 shows a 0,70% reorganization rate, while in the first half of 2008 this is 0,16%). A 33,85% rate of reorganization in 2006 and a 33,15% drop in 2007 compared to 2006 proves that the reorganization option was used abusively under the old law to tergiversate the insolvency procedure. One of the striking facts that table 1 reveals is that after the new Insolvency Act came into effect on January 2008, no reorganizations were initiated in the Czech Republic. Poland has a high reorganization rate, but a low insolvency rate which means that debtors are encouraged to reorganize or that they really deserve to be kept as going concerns. In 2007, figures put Romania above Hungary and the Czech Republic, while in the first half of 2008, the order changes a bit. Compared to the East European reorganization rate mean, in 2007 and 2008 Romania is well under this value (e.g. 0,70% compared to the mean on 4,75% in 2007, or 0,16% compared to 4,83% in the first half of 2008). However, the standard deviation is also quite high. A high standard deviation implies that the reorganization rates in these countries are scattered away from the mean, which actually gives less significance to the mean.

5. Conclusion

All in all, besides showing a low reorganization rate, figures also show that Romania does not make a distinctive note from the other countries in the Eastern European region. All reorganization rates are under 20% and most of them are under 1%. Also, there are countries such as Slovakia that, though having provisions for reorganization in insolvency, have no initiated reorganizations (at least not in the years studied). Though it has its drawbacks, the changing of the insolvency law in 2006 was beneficial, at least from the point of view of the economic efficiency an insolvency law must bring to the marketplace. The mere fact that the legal provisions regarding insolvency, and reorganization especially, are in accordance with the world's best practices on the matter place Romania ahead of other countries in the region (such as Hungary) that are reluctant to make changes in this area.

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