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Reorganization in US and European Bankruptcy law

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Abstract European countries have amended their bankruptcy statutes in the past decades to increase the likelihood of a company's continuation in bankruptcy. Liquidation procedures are ill suited to realize the full value of the company as a going concern. An infusion of new finance raises company valuation and makes continuation through reorganization more likely. Reorganization preserves value, if general creditors as the main beneficiaries of reorganization play a crucial role in reorganization proceedings. Legal origins of national bankruptcy legislations are less important in explaining the incidence of reorganization than national attitudes towards failure and the prevalence of equity over debt finance.

Keywords Financial structures · Bankruptcy laws · Legal origin

JEL Classification K12

Introduction

Company bankruptcy law sets rules to either liquidate a company or restructure its debt in reorganization. The US has a larger share of reorganization in bankruptcy proceedings than European countries, which demands an explanation. Differences in the incidence of reorganization could ensue from differences in bankruptcy legislation. US bankruptcy proceedings are considered debtor-friendly in contrast to more tough policy stances taken by other countries. More important than the harshness or gentleness of codes towards debtors is the efficiency of bankruptcy procedures. Reorganization

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should be preferred to liquidation or acquisition, if more value is preserved in that way.

The paper starts out by analyzing the differences between common and civil law legislations. The effects of legal origin on creditors' rights are discussed. The paper discusses US bankruptcy procedures and practices and compares them with European countries. Recent changes in bankruptcy legislation in the UK, the Netherlands, France and Germany are discussed in order to find out whether bankruptcy legislation is moving towards a common model.

1. Legal origins and their consequences

The law and finance literature analyzes the effects of differences in legal origin, especially the difference between civil and common law, on economic performance. Common law is of English origin and prevails in Anglo-Saxon countries and former English colonies. The judge has a great degree of discretion in common law systems. He may do anything that has not been explicitly forbidden, as long as his judgments are reasonable and in compliance with the rule of precedent. Common law evolves gradually through decisions in specific disputes. Judges' rulings can set the tone for future judicial decisions, if higher courts uphold them. The Civil law tradition is the other widespread legal system. It depends on legal statutes and comprehensive codes. It may, therefore, be less flexible, but more calculable. The legislator in civil law systems wants to provide rules for as many situations as possible. The judge can only use his discretion, if the legislator either overlooked the problem or left it deliberately open for the courts (Buetter, 2002, 29). Civil codes spring from the French Code Napoleon of 1804. The French Revolution created the desire to replace the fragmented system that prevailed hitherto by a uniform legal system. Custom law was applied in the North of France, while Roman law ruled in the South (Danet, 2002). The Code Napoleon abolished feudal rights and offered equality under the law to everybody (although not to married women). The Napoleonic Code was imposed on subjugated territories during Napoleon's rule. However, many of these countries voluntarily adopted the Napoleonic Code after the French withdrawal. The French Civil Code also had a paramount influence on the Dutch Civil Code (Burgerlijk Wetboek) of 1838. Several attempts of writing a new Dutch Civil Law had failed, because these proposals were rejected by Parliament (Meijer and Meijer, 2002). The country adopted the French Code Civil, because it constituted a coherent legal system and was acceptable to broad social groups. The States of the Rhine Confederation also adopted the French Code to break up the stalemate between aristocratic and bourgeois interests in Germany (Weinacht, 2002). The German Civil Law of 1896 is considered an offshoot of the Code Civil, but constitutes a separate class due to its differences from the French Code. Scandinavian law countries are also considered to differ from both common and civil law countries. Legal origin, therefore, divides countries in four groups; common law countries, French and German civil law countries and Scandinavian law countries.

Countries that became independent could either have written new laws from scratch or adopt a foreign Code by tooth and nail. The latter procedure seemed preferable for both reasons of practicality and legal principle. Legal codes that have proven their value during many centuries pose a smaller risk than a new code that has not withstood the times. Many former colonies adopted the legal codes of their former rulers. This applies

a.o. to Australia, Canada, the United States, India and Nigeria that have adopted the English common law system. Argentina, Spain, Italy, Belgium, Mexico and Portugal are a few examples of countries that have adopted the French Civil Code. Japan, China and Switzerland are countries with legal systems of German origin (La Porta et al., 1998).

Codes differ in the degree to which they allow systematic review and revision. French civil law by putting the State above the courts relegated the judges to a minor, bureaucratic role (Dawson, 1968). In England, by contrast, the law was put above the crown, which limited the monarch's ability to alter property rights and grant monopoly rights (Beck and Levine, 2004, 12). Moreover, a common law system is supposed to be more open to discussion of legal interpretations than a state dominated system.

2. Legal origin, financial development and creditors' rights

2.1. Financial development

Finance and law researchers argue that common law countries are more conducive to economic development due to the greater autonomy of the judiciary in those countries and less procedural formalism (Beck and Levine, 2004, 9). Moreover, common law countries do protect outside debtors and investors best against expropriation by insiders (i.c. management). Evidence was found supporting the hypothesis that common law countries are financially better developed than (French) Civil Code countries. Cross-country research found that French civil law countries have smaller stock markets; less active initial public offering markets and lower levels of bank credit as a percentage of GDP than common law countries (La Porta et al., 1997). The large involvement of the state in French Civil law countries seems to hinder the development of financial markets in these countries. The Netherlands is exceptional within the group of French law countries, because it has a well-developed equity and especially debt market. External debt finance is twice as important as equity finance in the Netherlands. The predominance of debt over equity finance is characteristic of civil law countries. Debt finance is especially important in Germany and Japan. Debt finance is nine times more important than outside minority equity finance in Germany and four times more important in France. This differs from common law countries, where outside equity and debt finance were almost equally important. Table 1 summarizes the data for the five countries investigated in this paper.

2.2. Creditors' rights

The effects of external investors' rights (shareholders and creditors rights) on financial development were examined for a number of countries in a cross-country analysis. La Porta et al. (1998) and Beck and Levine (2004) found that shareholders' rights are more developed in common law than in civil law countries. French legal origin countries have weakest liability rules and information disclosure requirements of managers vis a vis shareholders. Weak shareholders' rights could explain the relative underdevelopment of equity finance in civil law countries.

Table 1 Outside finance as a percentage of GNP for 5 countries

	Minority equity finance [a]	Debt finance[b]
United States	0,58	0,81
United Kingdom	1.0	1.13
France	0,23	0,96
Netherlands	0,52	1,08
Germany	0,13	1,12

[a]Comprises the ratio of stock market capitalization held by minorities to gross national product for 1994.
[b]Comprises bank debt of the private sector and outstanding non-financial bonds to GNP in 1994.
Source: La Porta et al., 1997, 1138

La Porta et al. define creditors' rights as the inability of management to seek protection from creditors' claims in bankruptcy proceedings (La Porta et al., 1998, 1116). Managers are considered insiders, who can expropriate outside investors to benefit themselves. La Porta et al. investigated the prevalence of 4 creditors' rights in bankruptcy proceedings in a cross-country fashion.

1. Filing for a reorganization petition does not imply an automatic stay on the assets of the firm, so that secured creditors can still gain possession of the assets.
2. Secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm.
3. Creditors can decide on whether a reorganization petition should be filed (and not managers)
4. Managers are removed during reorganization proceedings.

La Porta et al. (1998) found that creditor protection was twice as high in common law origin than in French law origin countries. German law origin countries ranked in between. The position of secured creditors is strongest in German origin countries, where they are always paid first. The large majority of common law countries also adhered to this principle (except Sri Lanka and New Zealand). Secured creditors were only paid first in two thirds of French origin countries. Secured creditors in France, Greece and a number of Latin American countries are only paid after the state and/or employees are compensated. Legal origin thus makes a difference.

The United States does diverge from the characteristic pattern of common law countries with respect to most creditors' rights as is demonstrated by Table 2. The US has an automatic stay; management does not need creditor consent to petition for reorganization proceedings and management usually stays in reorganizations. The only right upheld is that secured creditors' claims rank first in US bankruptcy proceedings. The US pattern differs from UK and German practices, where all four creditor's rights are upheld. More importantly, only US bankruptcy law knows the construct of the 'debtor in possession', which implies that incumbent management continues to control the firm in reorganization proceedings. This differs from arrangements, where management is not ousted, but in which management has to take instructions from

Table 2 Creditor rights in 5 countries

	No automatic stay	Secured creditors paid first	Creditor consent required for reorganization filing	Management does not stay
US	0	1	0	0
UK	1	1	1	1
France	0	0	0	0
Netherlands	0	1	1	0
Germany	1	1	1	1

Source: LaPorta et al. 1998, p. 1137

a court appointed administrator as happens in European reorganization proceedings (Hahn, 2003). This difference was not captured by the La Porta et al. methodology.

La Porta et al. (1998) concede that measuring the strength of creditors' rights is more complicated than measuring shareholders' rights as the rights of some creditors might prevail at the expense of others. Especially the rights of secured and unsecured creditors might be opposed. Arguably, La Porta et al. approached creditors' rights from an angle that emphasizes the conflicts of interest between managers and creditors at the neglect of conflicting interests amongst creditors. Moreover, the conflict of interest approach overlooks that all parties could benefit from an optimization of the value of the distressed company, if there is more to be distributed.

3. Bankruptcy law

3.1. Goals of bankruptcy law

Bankruptcy law constitutes a way for creditors to sort out their claims collectively by liquidation of the debtor's assets or by reaching agreement in an insolvency or reorganization plan. However, creditors usually are not a homogenous group. Some creditors have more rights than others. Priority creditors' claims rank above those of general creditors. Secured creditors, who have a mortgage or lien, are usually paid before other creditors. Bankruptcy law serves two broad goals. It wants first to achieve an orderly assessment of claims. Managers could withdraw assets from the state (fraudulent conveyance) or illegally advantage one creditor at the expense of another (voidable actions). Bankruptcy law protects creditors by forbidding such actions irrespective of legal origin. The other broad goal involves the maximization of the value of the company and its assets. Looking at bankruptcy law from this perspective, we might doubt, whether some creditors' rights really serve creditors well. Are creditors always better off, if incumbent management is ousted? Does the absence of an automatic stay always benefit the collectivity of creditors? Should secured creditors always be allowed to immediately seize the assets? These creditor rights rule out reorganization of the company and hurt creditors, if firms were more valuable in reorganization than in liquidation. Researchers indeed found that reorganization raises company values above liquidation levels. Reorganized companies in the US lost little pre-bankruptcy value in contrast to liquidated companies. This difference could not be explained by

the greater indebtedness of chapter 7 (liquidation) cases, which were not 'deeper under the water' than chapter 11 (reorganization) cases (Bris, Welch, and Zhu, 2004). Chapter 11 seems especially conducive to the survival of young firms. It allows a larger share of young US quoted firms to survive periods of recession and exchange rate instability than young UK firms (Bhattacharjee et al., 2004, 11).

3.2. Bankruptcy modes

A failed company can either be wound up by selling its assets piece-meal or it may be sold as a going concern at an auction. The firm can also be continued after reorganization proceedings. Several bankruptcy laws contain possibilities to reorganize the firm by giving it a new capital structure. Chapter 11 of the 1978 US Bankruptcy Law is the most well known statute of this sort. A firm should be kept intact, if it is more valuable as a whole than in pieces. Hence, a firm should be sold as a going concern or continued, if it is more valuable than the sum of its individual assets sold apart. This applies particularly to companies whose investments are sunk. 19th century railroads, whose tracks had only value if they were part of a network, are cases in point. Modern investments in physical networks such as electricity and telecom also fit this picture. Sunk assets will only recover scrap value, if they are detached from the network and sold piecemeal. Reorganization could also be the preferred bankruptcy mode, if a firm's human capital is considered especially valuable to the firm. 'High tech' firms are cases in point. Human capital resembles sunk costs if it is not easily retrievable on the job market (Baird and Rasmussen, 2001).

Bankruptcy modes vary distinctly among countries. Reorganization is the preferred bankruptcy mode for US public corporations (Gilson, 2001, 23). About a quarter of all US bankruptcy petitions are reorganization (chapter 11) cases.[1] The confirmation rate of chapter 11 cases is about 20 percent, which would lead to the conclusion that reorganization emerges in about 5 percent of all US bankruptcy cases. The European figures are considerably lower. About 7 percent of all Dutch insolvent firms file for reorganization (surseance van betaling) and 2 percent are actually reorganized (Boot and Ligterink, 2000). A high percentage of reorganization petitions are withdrawn immediately after filing, mainly because the company enters liquidation proceedings.[2] Petitioning for reorganization sends a signal to creditors that the company is in distress. (Secured) creditors will run to retrieve their money, if they become aware of the company's dire financial situation in the absence of an automatic stay. The number of French reorganizations resembles Dutch statistics, as about 2,5 percent of French bankruptcies end in reorganization (Kaiser, 1996, 82). Reorganization was sought in only 0,39 percent of all German bankruptcy cases in the 1985–1992 period (Kaiser, 1996, 73). Reorganization in the UK mainly occurs, if the company falls under a CVA (Company Voluntary Arrangement) following administration. About 75 percent of companies that open a CVA procedure survive. However, CVA procedures are rather rare and constituted about 2 percent of all English bankruptcy procedures

[1] Statistical Abstract of the United States, 2000, no 879, giving data for the 1985–1999 period.

[2] Two thirds of reorganization petitions were withdrawn. Liquidation was the cause of withdrawal in 90 percent of Dutch withdrawal cases. Arnoud Boot and Jeroen Ligterink, 2000.

(Kaiser, 1996, 82). We could, therefore, conclude that less reorganization takes place in EU countries than in the US.

4. The rationale of US bankruptcy law

There are several reasons for the scantiness of European reorganization. Most of them ensue from the different perspectives on bankruptcy that exist at both sides of the Atlantic. EU countries consider bankruptcy the result of preventable failures. The US view, by contrast, could be briefly characterized as recognizing that failure does not need to rule out future successes of incumbent managements.

US bankruptcy law is often considered benign to debtors. The discharge principle in personal bankruptcy, which allows individuals to have a new beginning, illustrates this. The right of discharge was a novelty at the time the first US bankruptcy laws were designed and caused a major shift in the social, moral and economic perception of bankruptcy and credit. It opened the way for voluntary bankruptcy, which has never developed in England (Weisberg, 1986, 30).

Chapter 11 proceedings are usually initiated by management, but can also be initiated by creditors. Petitions filed by management make bankruptcy proceedings voluntary. Involuntary bankruptcy petitions—filed by creditors- are overwhelmingly chapter 7 (liquidation) petitions (Block-Lieb, 1991). We could thus argue that voluntary petitioning favors reorganization, which in turn is triggered by the fact that incumbent management can stay in charge in US reorganization proceedings. Voluntary bankruptcy also stimulates timely bankruptcy petitions; at a point in time where the value of the company has not dwindled to a level, where it is beyond rescue.

Management should stay in reorganization, if their human capital adds to the value of the firm. Removing incumbent management and appointing an external trustee could diminish the value of the company. A positive valuation of human capital by investors opens the way for management to get second chances. Small companies whose greatest asset consists of the human capital of the owner/manager can be continued for this reason. US bankruptcy practice is compared with the operations of venture capitalists that also have to decide at several points in time, whether they want to continue to finance start-up firms (Baird, 2001, 194).

Another feature of US reorganization proceedings involves the reversal of the absolute priority rule; stating that senior creditors should be satisfied before junior (unsecured) creditors and their claims- in turn- rank above those of equity holders. The absolute priority rule is distorted, if founders/managers are allowed to preserve their equity in reorganization proceedings. This should happen, if the value of their human capital is estimated to exceed the value of their equity (Baird and Rasmussen, 2001). A reversal of the absolute priority rule can accompany an infusion of new capital by old equity holders, which is often the only possibility for the firm to have a new start (Baird, 2001, 201). Old and new capital providers are identical in many chapter 11 cases, since it is difficult to find new investors for ailing firms. Old equity holders can be allowed to recover some of the pre-petition values of their claims in reorganization, when they provide new capital reversal of absolute priority rule (Beranek, Boehmer and Smith, 1996). New capital always gets priority over old capital in chapter 11 proceedings, since new capital is essential to the survival of the company. The reversal

of the absolute priority rule in a majority of chapter 11 cases is often described as a debtor friendly feature of US bankruptcy laws. However, creditors' interests are safeguarded under chapter 11. All claims and interests are sorted into various classes; secured and unsecured creditors; priority creditors and equity-holders. Classification does not follow strict rules. Each class needs a majority vote, representing two thirds of claim value to accept the reorganization plan. US legislation differentiates between impaired and non-impaired classes. A class is considered non-impaired, if it does not lose any pre-bankruptcy rights in bankruptcy. Creditors whose loans are reinstated under pre-bankruptcy conditions are not considered an impaired class. A reorganization plan is accepted, if all impaired classes accept it. The absolute priority rule is reinstalled, if one impaired class rejects (Baird, 2001, 209). Immediate full payment of high priority pre-bankruptcy claims such as specified obligations to employees and employees benefits is required, if this class does not approve the plan. The tax authority is not considered an impaired class. High priority tax claims are deferred and should be paid within a period of 6 years (Baird, 2001, 201). Taxes that are withheld on employee paychecks need to be negotiated with the tax authority (Baird, 2001, 202). The absolute priority rule can thus only be reversed, if impaired classes either accept the plan or are fully compensated. Secured creditors are deemed to have accepted the reorganization plan, since they are not considered an impaired class, if pre-petition conditions of their loan continue to prevail. Secured creditors can file a motion to lift the automatic stay, which will be granted, if the secured assets are not essential for the company's operations or are in peril. The secured assets are not surrendered to secured creditors, if the court has confirmed the plan. Under-secured creditors' rights are protected by the election clause in US Bankruptcy Law. They can either choose to have their whole claim secured without immediate payment, or choose to be paid the foreclosure value and vote with general creditors for the unsecured part of their claim. The unsecured part of the claim may also constitute a separate class.

The court can decide to confirm a reorganization plan that has been accepted by at least one impaired class (a cram down). But, the court can only confirm the plan, if dissenting impaired classes receive at least as much as they would have gotten under chapter 7 (liquidation). This is called the best interests of creditors test.

We could argue that reorganization preserves more value than liquidation, which benefits creditors. Voting power in US reorganization proceedings lies with impaired classes (mainly unsecured creditors). The importance of unsecured creditors in US reorganization cases is also expressed by the fact that the creditors committee in chapter 11 cases consists of seven large unsecured creditors (Baird, 2001, 199). We might, therefore, argue that the higher incidence of US reorganization cases cannot be attributed to weak creditor rights, since creditors will only accept a reorganization plan, if this serves their interests.

Some scholars note that continuation of large companies under the same management is becoming increasingly rare (Baird and Rasmussen, 2003). Half of large companies in chapter 11 were sold either as a going concern or piecemeal in 2002. Baird and Rasmussen attribute these changes to the better operation of modern capital markets than in the days of the railroads. The sale of a company at an auction should be preferred to continuation, if it enhances valuation above what old equity is willing to pay.

5. Explaining EU and US reorganization rates

We would expect the economic logic of sunk costs to compel all companies that are more valuable as a going concern to survive intact. There are some indications that this is indeed the case. The number of surviving firms does not differ dramatically between countries; only the method of survival differs. Reorganization is the common method in the US for companies to survive bankruptcy intact, whereas other methods prevail in European countries. Acquisition in liquidation proceedings prevails in England. Sweden has a mandatory auction system for companies in distress. Informal workouts are the most common method for survival in Germany. A firm can also restart, if third parties buy the assets piecemeal. An investigation into Dutch bankruptcy cases brought to light that such cases are not exceptional. Many Dutch firms that were declared bankrupt re-started after an acquainted party had acquired the assets (Couwenberg, 1997).

We could, therefore, conclude that fewer European bankruptcies result in reorganization, because other methods prevail. Reorganization is the most efficient method to resuscitate a company, if it realizes the highest value of the company. A company that is revived in other ways might hurt the competitive process, if the (new) owners got the assets or the company at too low a price.

Successful reorganization requires that no party can seize assets or otherwise prompt a company to close down. The absence of an automatic stay and strong rights of secured and priority creditors in European countries are underlying reasons for the rare occurrence of formal reorganization in these countries. But, the strong position of some claimants may hurt others. Unsecured claims are often worthless in liquidation and can recover more in reorganization. Unsecured creditors' claims in English liquidations are usually completely eliminated (Franks, Nyborg, and Torous, 1996, 95). Suppliers recovered 5 percent of their claims in French insolvency cases (Robert, 1994). Dutch unsecured creditors recovered 1 to 2 percent of their claims in liquidation (Boot and Ligterink, 2000, 26). This contrasts with the 20 percent that US unsecured creditors recovered in chapter 11 cases (Baird, 2001, 82). A study of Arizona and a New York district chapter 11 cases even showed recovery rates of 40 percent for unsecured creditors in emerging reorganizations, whereas they received nothing in 95 percent of liquidation cases (Bris, Welch, and Zhu, 2004, 15).[3] The differences between recovery rates in liquidation and reorganization are also large in Germany. Unsecured creditors received an average of 50 percent in German composition (reorganization) and 4 percent in liquidation cases (Kaiser, 1996, 82). However, the German courts deny most firms entry into reorganization procedures because of a lack of assets. We could conclude from these figures that the scarcity of reorganization in Europe hurts unsecured creditors most. The scant occurrence of reorganization in Europe could be understood as a preference for quick solutions. Legal codes that are geared towards a quick sale of the company lose least time. The English, Swedish and Finnish codes (before 1994) all favored a quick sale of companies that had entered bankruptcy. Thus differs from chapter 11 rules, which allows incumbent management 120 days to prepare a plan. After this period the exclusivity of the debtor can be lifted and creditors can present their own plans. The plan should be accepted within 180 days of filing of the petition.

[3] Bris et al. removed dismissals, pre-packs and subsidiaries from their sample.

However, most reorganization cases are extended beyond this period. Liquidation, however, is usually not quicker than reorganization (Bris, Welch, and Zhu, 2004). Liquidation proceedings took over 3 years in 45 percent of all liquidation cases in the Netherlands to come to a conclusion (Boot and Ligterink, 2000, 24). The average time spent in compulsory liquidation in Germany is 27,5 months (Franks, Nyborg, and Torous, 1996, 90). This exceeds the average time spent in chapter 11 cases, which amounted to 27 months (Franks and Torous, 1994).

6. European bankruptcy law

Bankruptcy law would be superfluous, if each creditor would be fully informed on the future financial situation of the debtor at the time the contract was signed. Creditors would not sign a debt contract, if they could foresee the debtor's bankruptcy in the near future. However, uncertainty about future states makes bankruptcy a desirable action to prevent a further deterioration of the company's value.

Optimal bankruptcy law would allow the realization of the maximum value of the company at the lowest possible costs. Reorganization would occur in all cases in which sunk costs and firm specific human capital are pivotal. An optimal bankruptcy regime would start bankruptcy at the appropriate time and conduct the process without undue delays. A bankruptcy petition comes too late, if the value of the company's assets has largely dissipated. Timely initiation and execution of either liquidation or reorganization procedures is, therefore, paramount.

Creditors may not have a clear picture of the actual financial situation of a company, if there are many creditors that all operate at arms' length from the company. It could, therefore, be preferable, if the debtor, who knows the company best, would initiate bankruptcy in order to save as much of the company's value as possible.

Involuntary bankruptcy (initiated by the creditor) is the norm in Europe. This contrasts sharply with US practices, where over 90 percent of corporate bankruptcies are voluntary (initiated by the debtor) (Baird, 1991). Involuntary bankruptcy may come too late. The debtor might want to continue the company as long as possible for his own sake or that of his employees and hide the real financial situation of the company from creditors. This applies particularly, if managers expect to be ousted in bankruptcy proceedings.

Most European bankruptcy statutes stipulate that only the debtor can file reorganization petitions. But, European management is often not allowed to stay in reorganization in contrast to the US, where incumbent management remains in control in about half of reorganization cases (Franks, Nyborg, and Torous, 1996, 89). The US debtor in possession also has the right to compose a (first) reorganization plan. European management, by contrast, is usually not allowed to propose a rescue plan, which is assigned to a court appointed curator or a trustee appointed by the main creditor. It seems, therefore, questionable, whether European management will be as eager to file for reorganization as its US counterpart.

Another difference between the US and Europe involves that many European codes—in contrast to the US-lack an automatic stay. Secured creditors can, therefore, exercise their rights in both liquidation and reorganization procedures. Another difference involves the acquittal of labor contracts, which is not allowed under some European reorganization codes. France and the Netherlands are cases in point.

Reorganization requires new capital to get priority over old capital, which was also not allowed in many EU codes.

7. The Evolution of European Bankruptcy law

Many European Bankruptcy Codes have been amended in the past decades in order to encourage reorganization and preserve value. However, European practice still differs from US practices, due to the absence of the debtor in possession construct. Management responsibility is handed over to an administrator or trustee in most European reorganization cases. A practitioner remarked that European legislation is still aimed at protecting creditors' interests ahead of preserving enterprise value. Restructuring through negotiation or as a consensual process is not the norm in Europe (Tilley, 2005). As a consequence post petition finance is largely absent in European reorganization cases. Companies have to rely on cash flow funding and are forced to corporate downsizing in order to generate cash in bankruptcy (Tilley, 2005). We will discuss the amendments to bankruptcy legislation in 4 European countries below.

7.1. The Netherlands

Creditors depositing liquidation petitions when the debtor does not meet his obligations usually initiate Dutch bankruptcy proceedings. Reorganization (surseance van betaling) has figured for long in Dutch bankruptcy law. The Dutch bankruptcy law of 1893, however, did not provide for an automatic stay in reorganization. Secured and priority creditors kept their rights in reorganization cases. Management had to transmit control of the company to a court-appointed curator, who could compose a reorganization plan in collaboration with management. Reorganization petitions needed to be accepted by three fourths of creditor votes present at the meeting, representing at least two thirds of debt. Dutch banks often attempt to reach an informal workout, when the company gets into dire straits. However, the time for informal workouts can be cut short, if the tax authorities use their rights to confiscate some assets to satisfy their claims. A race for the assets could ensue, if the bank expects a seizure by the tax authorities. Moreover, creditors seek contract forms that evade the tax authorities' claims on assets. But, these rental constructions entail the immediate close down of the company in bankruptcy proceedings. Another impediment to successful reorganization under Dutch law is the impossibility to end employment contracts in reorganization, while they are automatically ended in liquidation.

A 1992 revision of the Dutch bankruptcy law allowed for a 'cool down' period of a month for all creditors in both liquidation and reorganization proceedings. However, the Dutch tax authority kept its special right of recourse on all moveable assets that are required in the profession of the debtor. The assets stay in the company during the 'cool down' period. New capital gets priority over old capital in reorganization proceedings under the 1992 Code.

Further amendments of the code were proposed to Parliament in 2000 and 2001, but have not been accepted yet. The proposed amendments involve a lengthening of the cool down period to a maximum of four months. Collective lay-off plans of employees should become possible. Each reorganization petition should be accompanied by a reorganization plan or a plan needs to be delivered within 21 days after petitioning. The

bankruptcy court has to decide within 28 days on the acceptance of a petition. The court should only accept reorganization petitions, if it deems the reorganization feasible; meaning that the firm can survive after reorganization. The suggested procedures differ from existing practices, where the courts automatically grant a reorganization petition, if a qualified majority of general creditors accepts the petition.

Amendments have also been proposed with respect to the special recourse rights and rights of attachment of the Dutch tax authorities. It was suggested that eliminating these rights could stimulate reorganization. It was suggested that the tax authority should waive her priority rights and vote with the general creditors on acceptance of the petition and the reorganization plan. Other creditors with priority rights would also lose their rights, if they voted with general creditors. Management can stay under the revised code, but has to accept instructions from a court-appointed administrator. It is also suggested that public utilities such as electricity companies could be forced to continue supply in reorganization. The same suggestion was made with respect to other suppliers, whose cooperation was deemed essential to the survival of the company. Their claims should be paid in cash, or be secured. The proposed amendments also involve the acceptance of a reorganization plan by a common majority of the members of a committee of general creditors present at the meeting. This differs from the two third majority that is now required. The possibility of a cram down was also mentioned in the amendments to Dutch bankruptcy law. The court should only enforce a cram down, if creditors that voted against the plan would not be worse off than in liquidation.

We could conclude that the (proposed) amendments to Dutch bankruptcy law would make it more similar to US chapter 11 in some respects. This applies to the longer cool-down period. However, a period of four months is still far below the US norm. But, other suggested amendments would make it less similar. The introduction of a preliminary feasibility test of the reorganization plan by the courts deviates from US practices. Dutch legislators wanted to weed out non-viable reorganization attempts by this amendment. We could, however, doubt whether judges or their hired experts can easily identify potential reorganization successes. Moreover, there is no obvious party in Dutch reorganization proceedings with an incentive to pay more than the liquidation value of their claims. Equity-holders are not mentioned in the suggested amendments; neither is an infusion of new equity or a reversal of the absolute priority rule. This can be explained by the dearth of outside equity finance, especially in small Dutch firms. New capital could come from bank loans. But, the banks opposed the suggested lengthening of the cooling down period. Secured creditors would prefer liquidation to reorganization, if they can quickly recapture the full value of their claim by selling the assets. Banks do indeed recover the larger part of their claims in Dutch bankruptcies as loans are usually based on collateral value. This applies with the greatest force to small firms. We could argue that only the infusion of new finance by old equity or debt holders would force investors to reveal their perceived worth of the company and let unsecured creditors share in the valuation.

7.2. Germany

The old German Code already distinguished between liquidation (Konkursordnung) and reorganization proceedings (Vergleichsordnung). However, reorganizations were extremely rare under the old law. The extremely low occurrence of formal reorgani-

zations in Germany (<1 percent) could be attributed to the stringent conditions that German firms had to meet before they could file composition (reorganization) petitions. Debtors had to repay at least 35 percent on unsecured claims in reorganization. The courts rejected most reorganization petitions. Three fourths of all cases were not allowed to enter bankruptcy due to insufficiency of assets in the 1980–1992 period. Secured and priority creditors maintained their rights in composition proceedings and could repossess their assets and so precipitate the closure of the firm. German directors are personally liable for late filing (later than 21 days before the company becomes insolvent). Insolvency can ensue, when a company is over-indebted; a situation which is not clearly defined and on which the courts decide (Tilley, 2005). The scarcity of composition proceedings can also be attributed to the preponderance of out of court workouts between German banks and distressed companies.

The new German Insolvency Code of 1994, which went into effect in 1999 opens up more possibilities for reorganization. The new legislation allows for a three months moratorium, in which time a court appointed administrator could propose a reorganization plan to the creditors' committee, which can decide whether they prefer reorganization to liquidation. Both secured and unsecured claims can be stayed for 3 months under the new law. New finance receives priority to pre-petitioning debts. The threshold recovery rates that had to be repaid before a reorganization plan was accepted by the court were lifted under the new law. The works council needs to agree on a reorganization plan involving plant modification (Ins.O, section 121). The administrator must negotiate both the lay-offs and social plan with the employees' representatives. However, the court may replace their approval by a judicial decision (Pochet, 2002, 351). Some authors argue that the new German Code is a rather flexible piece of legislation that largely resembles chapter 11 of the US Code (Franks, Nyborg, and Torous, 1996, 90). But, a main difference with the US is that management loses control in German composition proceedings in contrast to the US. There is also no reversal of the absolute priority rule. Another aspect of new German bankruptcy legislation involves the preponderant role of higher ranked creditors in reorganization proceedings. The creditors committee is composed of secured and higher ranked creditors only. Secured creditors can vote on the reorganization plan, if the debtor is personally liable to them; if they waive their rights, or if they are not fully compensated (Ins O, section 237). Lower ranked creditors have no voting rights (Ins.O, section 77), which contrasts with practices in other nations, where general creditors dominate decision making in reorganization proceedings. Claims of lower ranking creditors are deemed waived unless the insolvency plan provides otherwise (Ins.O, section 225). Another element of the Insolvency Code involves a ceiling for new debt, which cannot exceed the value of the value of property listed in the survey of assets (Ins.O. 264). This section demonstrates clearly that new finance is not related to investors' valuation of the company as a going concern, but to the value of the assets only.

7.3. France

The 1985 French bankruptcy code opened possibilities for a negotiated settlement (reglément amiable); the French form of voluntary bankruptcy. A firm that wants to renegotiate her debt contracts can invoke this procedure. Each creditor can refuse to participate in such a settlement procedure. The negotiations are kept secret from non-

participating creditors. The settlement regime does not know an automatic stay. These factors could explain why the negotiated settlement is seldom used (Kaiser, 1996, 71). The judicial arrangement (redressement judiciaire) that was also introduced by the 1985 Bankruptcy Law, knows an automatic stay (observation period) that can take a maximum of 18 months. New capital gets a super priority status. However, reorganization or acquisition under the judicial arrangement is hampered by the fact that the (new) owner needs to assume all employment contracts (Kaiser, 1996, 72). These preconditions make the sale of an intact company rather rare. Only 3 percent of French bankruptcies ended in the sale of the company in the 1987–93 period. French creditors (both secured and unsecured) lost almost all their rights in company sales that were conducted under the 1985 French law. They are not allowed to vote on the reorganization plan. The 1994 revision intended to repair this shortcoming of the 1985 code (Kaiser, 1996, 72). The courts play a preponderant role in French bankruptcy cases. Out of court settlements are rare in France, in contrast to Germany, where they are common (Pochet, 2002, 368). Whether a firm is insolvent is determined by the courts and does not follow from a precise accounting definition (Tilley, 2005). Bankruptcy mainly involves small and medium-sized family firms, since listed firms are protected by the state from failure (Pochet, 2002).

7.4. The United Kingdom

Most UK companies that have filed for bankruptcy go into liquidation. Only 22 percent go in receivership, which is the main alternative to immediate liquidation. A creditor whose security is backed by a floating charge can initiate administrative receivership. Administrative receivership is not a collective procedure and mainly serves the interests of the creditor secured by a floating charge. Reorganization is discouraged, because new finance does not get priority over antecedent debts. The receiver is personally liable for all post-commencement financing (Kaiser, 1996, 75). Employment contracts are usually terminated upon the installment of receivership and the company or its assets are sold within days or weeks after receivership has been installed. Unsecured creditors usually do not recover anything on their claims.

The UK 1986 Insolvency Act introduced the administration proceeding to facilitate reorganization. Administration is a collective procedure and allows for an automatic stay. Creditors with a floating charge could, however, frustrate the appointment of an administrator by installing a receiver instead. The 2002 Enterprise Act remedied this shortcoming. The administrator has the power to negotiate deals. He can terminate contracts with suppliers and contractors. However, he does not have the power to postpone interest and capital repayments. Unsecured creditors are the main beneficiaries of administration proceedings, which occurred in 2 percent of bankruptcy cases in 1998 (UK Department of Trade and industry, 1999)

The 1985 UK Companies Act introduced the Company Voluntary Arrangement (CVA), which is aimed at reorganization. It was installed to create more possibilities for reorganization, but depends on the willingness of all parties to cooperate. The CVA does neither allow for an automatic stay nor for priority of new financing (Kaiser, 1996, 75). Management has to hand over control of the company to a bankruptcy professional. Managers are reluctant to start CVA proceedings, because they fear these professionals to be more interested in a burial of the company than to seek its restoration to health

(UK Department of Trade and Industry, 1999). The 2000 amendment to the Insolvency Act allowed for a mandatory moratorium and a debtor in possession regime for small companies (<50 employees). We may conclude that secured creditors' rights still prevail in UK bankruptcy law, although some amendments have been made lately to stimulate reorganization of small companies.

8. Discussion

Reorganization is more rare in European bankruptcy cases than in the US, which has spurred reform in a number of EU countries. The reforms, however, have not raised the share of reorganizations substantially. We can explain this by pointing out that management, who is a main beneficiary of US reorganizations is either ousted or subject to the orders of an administrator in European bankruptcies. Hence, we cannot expect European managers to be as willing to initiate reorganization proceedings as their US counterparts. Another impediment to reorganization in Europe involves the protection of secured creditors' rights and those of the tax authorities and employees.

The differences between countries' bankruptcy legislation cannot be primarily contributed to the difference between common and civil law regimes. More important than legal origin is the attitude adopted towards bankruptcy. Most European countries see bankruptcy as management's personal failure and are not willing to allow them second chances, in contrast to the US. But, reorganization is efficient, if it enhances the valuation of the company above the value of its assets. Such surplus value can be realized, if either old or new investors can bid up to this value by infusing new capital into the company. A reversal of the absolute priority rule can assist in obtaining new finance, but is not considered in European amendments to bankruptcy statutes. This can be explained by the fact that new (equity) finance is not sought in most European reorganization cases. A related difference involves the greater use that is made of court decisions to decide on insolvency and on a firm's chances of survival in continental Europe. Courts decide on the feasibility of a reorganization petition in the Netherlands. German and French courts decide, whether a firm is considered insolvent. German courts can reject insolvency procedures due to lack of assets, thereby denying that the firm's value may exceed the value of its assets. Courts thus have a major say in estimating the viability of a company in these countries. This contrasts with the US (and the UK), where investors' valuations decide on the fate of a company in reorganization proceedings. The notion that civil law judges have less discretion than their common law counterparts thus does not seem to apply to estimations of a company's value. The preponderance of the state in French civil law countries is confirmed by Dutch and French statutes, which give either tax authorities or employees priority over other claimants.

Continuation seems more likely with an infusion of new equity than of debt finance, since fully secured creditors do not benefit from reorganization and would prefer liquidation. The heavy reliance on debt finance in civil law countries thus might impede a surge of successful reorganization proceedings.

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