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Agenda

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Bankruptcy codes: how do they affect business?

Julian Franks, Professor of Finance, London Business School, and Oxera Director, explains how recent research into bankruptcy codes reveals significant and sometimes unexpected differences between bankruptcy procedures in the UK and those of other countries

Creditor protection varies considerably across countries. According to one index of protection, the UK has a perfect score of 4, France 0 and the USA a mere 1.[1] Of course, perfection is in the eye of the beholder and these opening remarks make the heroic assumption that more creditor protection is good and less is bad.

Dissatisfaction with country bankruptcy codes is widespread. A committee in France recently made radical recommendations to reform the country's bankruptcy procedures to push it towards a US-style Chapter 11 system. The USA itself has recently passed important bankruptcy legislation restricting the rights of the defaulting company in bankruptcy and strengthening creditors' rights. Under the Enterprise Act 2003, the UK has imposed restrictions on how private procedures can be applied. The interesting observation is that these changes have been made with remarkably little evidence about the comparative efficiency of different bankruptcy codes.

This article describes some research that I have published, with Oren Sussman, which investigates the efficiency of UK bankruptcy procedures.[2] It also makes comparisons, using data from another study, between bankruptcy procedures in France, Germany and the UK.[3]

What makes the UK such an interesting laboratory is that lenders and borrowers resort to bankruptcy procedures rather than to a bankruptcy code—ie, UK procedures are based largely on private contracts that specify what happens when borrowers default. The main involvement by the courts is simply to adjudicate in the wording of contracts and thereby standardise them. The UK procedures are often described as 'contractualist' in nature since what happens in the event of default is laid out in the debt contract; courts only intervene when there is a dispute over the interpretation of the contract or when a matter of legal principle is at stake. In contrast, the US bankruptcy procedures are imposed by statute—for example, Chapter 11 of the 1978 Bankruptcy Code. These statute-driven procedures override clauses in the debt contract. Put simply, in the UK, bankruptcy procedures are devised by the parties to the contract; in the USA, the parties are given the procedures from on high by the judges and Congress.

There are three principal objections raised by sceptical observers to the UK approach to bankruptcy.

- There is no automatic stay against creditors' claims; in other words, payments to lenders are not automatically frozen when a firm is in distress, as they are under Chapter 11. As soon as creditors in the UK smell distress, they often rush for the exit and precipitate the failure of the company. Such coordination failures, rather like the archetypal bank runs, can precipitate the premature liquidation of firms.

- Control rights in bankruptcy largely reside with secured creditors, which, it is often claimed, are interested simply in realising their collateral rather than preserving the going concern. Thus, secured lenders, particularly the banks, are regarded as 'lazy' when it comes to monitoring the going-concern value of the firm. They simply monitor their collateral and when its value gets close to that of the loan, they 'pull the rug' and precipitate bankruptcy. The impression of UK bankruptcy procedures is, therefore, that they are unnecessarily 'tight' and encourage too many liquidations and too few going-concern sales of bankrupt firms.

– Finally, UK procedures are simply 'unfair' to junior (usually unsecured) creditors, which have few control rights in bankruptcy and therefore little influence on how the bankrupt firm is reorganised. As a result, they recover little of the debts owed to them. For these creditors UK bankruptcy procedures do not represent a level playing field.

The Franks and Sussman study provides evidence on all of these issues, and the results are discussed below. There are two important qualifications. First, the Enterprise Act has imposed some changes on procedures; and, second, the study is confined to small and medium-sized companies. There is reason to believe that the restructuring of larger, particularly listed, companies is different.

UK procedures

The main UK procedure used in the study sample of distressed companies is 'administrative receivership'. When the borrower agrees to grant the lender an instrument called 'a floating charge', in the event of default, the lender is able to appoint a receiver (a licensed insolvency practitioner) to take control of the defaulting firm and sell its assets with the purpose of repaying the lender with the floating charge.[4] The receiver owes little duty of care to other creditors—its job is to maximise the proceeds for the creditor that appointed it, although it must respect the collateral rights held by other creditors, and the priority of other claimants when distributing the proceeds from the sale of the bankrupt firm's assets.

The receiver may close the firm down and sell the assets piecemeal, or sell it as a going concern. While trying to sell the bankrupt company, the receiver may continue to run the business, although it will be constrained by any possible losses from administering the going concern. It is not for nothing that, because of these powers, some have referred to the receiver as 'king'.

The courts are usually not involved in this whole process.

Practitioners, particularly from countries with debtor-friendly codes, are unhappy with the UK system because of its lack of a going-concern bias. One manifestation of this is the inability of the receiver to raise senior, supra-priority debt, which might help the firm to restructure. Moreover, there is considerable pressure on the receiver to sell the assets of the firm quickly, which many believe could lead to lost value. The report of the Department of Trade and Industry/Treasury Committee on Insolvency, of which I was a member, discusses at length how supra-priority finance could be introduced into the UK system.[5] We were defeated because supra-priority inevitably dilutes other creditors' claims, and without judicial oversight (ie, a court-administered system) this was simply a non-runner.

Of course there are bankruptcy procedures in the UK other than receivership. Court-administered procedures allow for collective decisions by creditors. For example, a bankrupt company can ask the court to allow it to go into administration, a procedure introduced by statute in 1986. In this case, the court appoints an administrator to take control of the company. The administrator acts for all creditors, not only the secured creditor. This procedure provides more scope to manage the liabilities of the company, and is frequently used for the larger bankrupt firms. However, and this qualification is crucial, where the lender holds a floating charge, it can always veto administration.

Study data

Data was collected from three UK banks, covering 542 small to medium-sized companies, virtually all of which were private companies. During 1997/98, these companies were placed by the banks in their respective Business Support Unit (BSU), a central unit for managing distressed companies. The companies were either already distressed or it was anticipated that they were likely to become so.

Their average size, as measured by sales turnover, was around £3m. In almost every case, the bank was the prime lender to the distressed company, supplying around 40% of all lending (total lending was calculated as including trade credit). Virtually all the banks' lending is collateralised; the banks in the study sample therefore have most of the control rights in the event of default and are the most senior creditors when it comes to distributing the proceeds from bankruptcy. In the sample, the banks recover, on average, around 75% of the face value of their debt. Other creditors, such as trade creditors, recover very little unless their loans are secured against specific collateral.

Of the 542 companies in the BSU, around one-third went into formal bankruptcy proceedings. The rest recovered and either remained with the bank or repaid their loans and moved to another bank.

Study results

With respect to the three objections described above, the results were as follows.

Are there coordination failures and excessive liquidations?

No evidence of coordination failures was found in the sample; it is almost always the bank that makes the decision to force the firm into bankruptcy. This result is

not surprising given UK bankruptcy procedures and the capital structure of companies. To understand this, we should ask the question, who might cause a creditors' run? The obvious candidates are trade creditors, which are typically small and uncoordinated. They have virtually no control rights in bankruptcy and any attempt to precipitate bankruptcy would simply encourage the bank with the floating charge to exercise its right to appoint a receiver and take control of the company. Since the bank has high levels of collateral, it will also take first bite of the cherry when the firm is sold. To push the point even further, bankruptcy will often mean the end of the supplier's relationship with the firm. Given that only one-third of distressed companies end up in bankruptcy, and a proportion of these are sold as going concerns, the incentives for trade creditors to precipitate bankruptcy are understandably low. It is the concentration of control rights in the hands of the bank and the seniority of their claims that (usually) translate into a very small amount of power for trade creditors.

Is there an excessively high rate of liquidations in the UK economy? It is difficult to define what an excessively high rate would be. We do know from a sample of receiverships that around 44% of companies are sold as going concerns, and the remainder are closed and sold piecemeal. This percentage is based on the opinion of the receivers rather than hard data, and it is very sensitive to the prevailing economic conditions. However, the study on bankruptcy codes (Davydenko and Franks, 2005) indicates that piecemeal liquidations appear to be less frequent in the UK than in France and Germany. This is surprising since France has a much less creditor-friendly bankruptcy code than the UK, and has a specific going-concern bias.

Is there evidence of 'lazy banking'?

The evidence for this proposition is conflicting. On the one hand, banks do not automatically liquidate distressed firms. They have a central distress unit or BSU that has an important objective: to support the rescue of distressed businesses. This does not necessarily reflect good citizenship, although the bankers contacted during the study were sensitive to public opinion. Rather it reflects the painful experience of the recession of the early 1990s: huge losses were made on loans to distressed companies when many were forced into bankruptcy in an uncoordinated fashion by local or regional branches of the banks, weakening the markets in those assets and significantly diminishing recovery rates. The centralisation of distress support activities not only brings much needed expertise into the rescue process, but also allows the bank to understand how aggregate bankruptcies could weaken asset markets. It may be that we will only know how well these procedures are working when the UK experiences another recession.

However, evidence of high recovery rates for the banks, and low recovery rates for unsecured and preferential creditors, suggests that banks time bankruptcy close to the point at which the value of the firm is similar to the value of collateral. This means that, because the bank is the most senior creditor, there is unlikely to be much left for other creditors. Moreover, the bank is very tough in its bargaining with borrowers—the study found only one case of debt forgiveness by the bank. Banks very rarely expand credit during the distress period; on the contrary, the lending from the bank contracts. This contraction appears to coincide with an expansion in trade credit, which increases by 50p for every pound by which bank lending contracts.

Are UK bankruptcy procedures fair?

While the bank is busily forcing the firm to repay bank debt, the trade creditors are busily supplying more on credit. Are the trade creditors badly informed, or are they taking a calculated decision that the bankruptcy of the firm is very costly to them and a two-thirds rescue rate makes good business sense? The answer is likely to be the former—they are often ill-informed about the impending bankruptcy. In this respect, UK procedures appear 'unfair'. Whereas trade creditors recover around 3p in the pound in our sample, they fare much better in the USA under Chapter 11, where they recover closer to 27 cents in the dollar (although the US statistics are based on much larger companies than those in this sample).

There are some signs of change in the UK. Trade creditors are frequently selling or insuring their trade credit with trade insurers, which can collateralise trade credit through 'retention of title clauses'. In the event of receivership, they can threaten to cut off further trade credit to a receiver that wishes to sell the firm as a going concern. Moreover, the size of their book of trade credit influences their ability to enforce retention of title clauses by threatening court action. This provides a case where markets can adjust to a more level playing field.

Conclusion

It is not possible to answer the question of whether UK bankruptcy procedures are optimal. However, we can say that a contractual system like that of the UK is feasible. It is very creditor-friendly, but predictions about obvious market failures are not borne out by the study evidence. The international study of France, Germany and the UK reinforces this view—France, with its less creditor-friendly system, has higher piecemeal liquidations than the UK, and a lower level of workouts. The explanation we believe goes far beyond differences in bankruptcy codes, but also includes differences in institutions such as credit markets and banking arrangements. For example, the concentration of lending

among UK banks may have increased the cost of lending. Also, as described above, the centralisation of support for distressed companies by UK banks may have mitigated the problem of uncoordinated distressed selling of the assets of defaulted companies (ie, reduced the incidence of fire sales).

The issue of harmonisation often arises in discussions about the comparative efficiency of different countries' bankruptcy procedures. This is an important question for the EU, given the large differences in bankruptcy codes. EU legislation currently allows bankruptcy proceedings to take place where the company's decisions are made. We could envisage very different legislation whereby a lender and borrower could incorporate into the loan agreement the country or jurisdiction where the bankruptcy petition would be heard. In this way there would be competition between jurisdictions. This is not dissimilar to US practice in commercial law where companies can choose the state in which to incorporate.

Julian Franks

[1] La Porta, R., Lopes-de-Silanes, F., Shleifer, A. and Vishny, R. (1998), 'Law and Finance', *Journal of Political Economy*, **106**: 1,113–55.
[2] Franks, J. and Sussman, O. (2005), 'Financial Distress and Bank Restructuring of Small to Medium Size UK Companies', *The Review of Finance*, **9**: 65–96
[3] Davydenko, S. and Franks, J. (2005), 'Do Bankruptcy Codes Matter? A Study of France, Germany and the UK', working paper, London Business School.
[4] Whereas a fixed charge is a security on a specific asset such as real estate, a floating charge is a security that may be extended to cover the entire pool of the company's assets, including intangibles or circulating capital (ie, cash, receivables and future cash flows). The Enterprise Act 2003 curbs the powers of the floating charge holder. An interesting question would be how this has affected outcomes, although this is beyond the scope of this article.
[5] Department of Trade and Industry and HM Treasury (2002),'Review of Company Rescue Mechanisms: A Review of Company Rescue and Business Reconstruction Mechanisms'.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.co.uk

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