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The Policy of Insolvency in the US and the EU: Principal Differences and Recent Developments

Introduction

America is different! This has been the basic impression of Europeans from Alexis de Tocquille until today (Lévy, American Vertigo, 2006). One of these differences concerns bankruptcy policy. Famous cases of insolvency such as Enron show this clearly (Barreveld, 2002; Rapoport/Dharan,2004; Lager/Cornford/Bovin, 2006). Above all, Chapter 11 is both well-known and debated in Europe. In past years, airlines have been the main users of petitions of insolvency as a means to reduce staff costs or even to transfer pension liabilities onto public institutions (Delta, New York Times April 23, 2006, p.22; or Eastern Airlines in 1989). Bankruptcy policy is thus part of a country's economic and legal culture, and it varies between the USA and the EU countries quite considerably.

Writing on bankruptcy policy is like shooting a moving target. The way economic failure is dealt with varies not only from country to country but also with time. Bankruptcy regulations are either a reaction to economic or political changes (such as the crisis of dot.coms at the end of the 1980s) or to the repercussions of the last legal reform. This was especially evident with the Bankruptcy Reform Act of 1978 in the USA. In 1984, there were approximately 62,000 business bankruptcy filings and 286,000 filings by individuals and married couples. By twenty years later in 2004, the number of business bankruptcy filings had fallen by half to 34,000, while the number of filings by individuals and married couples had increased more than five-fold to 1,583,000. Concern about the rising number of individual bankruptcies led Congress to adopt reforms of personal bankruptcy law in 2005 (Weis 2005, p.1).

Differences in bankruptcy policy are therefore historically explicable. This paper deals first with the long-term development of bankruptcy policy in the USA, then it proceeds to compare it with Germany, France and Great Britain. Subsequently, it will discuss the efforts of the European Union to achieve uniformity in this field. Finally, we shall deal with the question of how far the European Union still is from a common policy in comparison with the USA.

The Development of American Insolvency Proceedings

Over the last 200 years the American bankruptcy law has been through three clearly different phases (Skeel, 2001, p. 3-5). In the 18th century, the USA was predominantly still an agrarian country and it was a matter for debate whether a bankruptcy law was necessary or at all sensible. Although the constitution contained a clause according to which the Congress had the right "to establish [...] uniform Laws on the subject of Bankruptcies" (US Constitution, Art. I, Sec.8, clause 4), Washington did not exercise this right for a long time and legislation on insolvency was introduced only with the Federal States. Basically, the Federal States were responsible for property and contract law and the federation simply issued banknotes and was thus fundamentally responsible for bankruptcy law. However, the decentralized regulation made it possible for debtors to change Federal State in the case of bankruptcy, and thus reduced and complicated creditors' options. For this reason, a uniform insolvency law was sensible for the whole of the USA. All the debtor's assets could be assessed no matter where he was. Federalists, on the other hand, feared that a federal bankruptcy law might endanger farmers' property and reduce the influence of the Federal States and benefit the Union.

Republicans held the view that the future of America lay in trade and commerce, and that therefore a bankruptcy law was absolutely necessary in order to guarantee creditors a right of access to a debtor's assets. Farmers and plantation owners in the South feared that the "money men" of the North could force them to pay under the terms of the bankruptcy law and the financial world of the North wanted uniform regulation of the debt collection. This conflict between industrial and agrarian interests went on throughout the 19th century and was essentially a conflict between the Northeast and the Southwest of the USA.

In the years 1800, 1841 and 1867, bankruptcy laws were introduced as a consequence of financial crises; however they were soon repealed. Essentially, these were cases of ad hoc legislation meant to cope with the consequences of an economic crisis and they would appear superfluous at the first economic improvement. Until the law of 1841 the central element of bankruptcy law was still penalty and imprisonment was common. The law of 1841 led to a change of thinking, at least in the kind of approach. This law foresaw for the first time a wilful petition of bankruptcy on the part of the debtor, which the business world regarded with astonishment. It also foresaw for the first time acquittal at the end of bankruptcy proceedings, which ultimately led once again to the repealing of this law. The equally short-lived law of 1867 distinguished for the first time between individuals and enterprises. It was only in 1898 that the Congress issued a lasting federal bankruptcy law which was essentially a triumph for lobbying organisations (board of trades, chambers of commerce) which had been created in the meantime. The continuity of the Republican majority gave the law of 1898 the necessary time to establish the bankruptcy proceedings. With the law, which remained in force for eighty years, the principle of bankruptcy had changed from a crime against the community and an individually punishable act, to an economic condition in which liabilities exceed the assets. This law showed, as Charles Warren, the historian of US bankruptcy observed, an awareness that the continual operation of a firm in trouble is more important for the nation than the closing and selling of a firm for the benefit of the creditors (Warren, 1934, p.144). However, the 1898 law foresaw only the liquidation of the enterprise.

The failure to establish an insolvency law which would be valid for the entire United States, therefore, goes back to an ideological confrontation between the interests of creditors and debtors on the one hand, and the scepticism towards governmental bankruptcy proceedings on the other. The Democrats defended the interests of the debtors and were for the regulation on the part of individual states, whereas the Republicans were in favour of the interests of the creditors and of a federal regulation which would be valid for all the states. The Democrats wanted the voluntary petition of bankruptcy on the part of the debtor as protection against creditors, whereas the Republicans fought for the rights of the creditors and wanted to give the right of petition of bankruptcy only to them. Individual Federal States, including Florida and Texas, had already issued laws for the protection of indebted farmers, to whom they conceded either temporary or permanent remission of debts. The political representatives of these states were thus vehemently against a federal regulation. Only at the end of the century, when the Republican controlled both Houses, could a lasting insolvency law be established.

In addition to the debacles in parliament, there was also a second development, which proved to be invaluable for American bankruptcy proceedings: the crisis of the railways. As also in Europe, the companies for the construction of railways were the first large share-based companies in the 19th century. As a result of overexpansion and fluctuation of economic activity, many societies encountered financial difficulties. There was a period in which up to 20% of the railway system was run by insolvent companies. The companies and their creditors, however, did not resort to the state, as happened in Europe, but to the courts. The political structure and the distribution of expertise between the States and Washington prevented a governmental solution for the railways, which stretched over many Federal States. By the end of the 19th century, the courts, therefore, had to develop a reorganization

technique which was called "equity receivership". The courts changed the bankruptcy proceeding—originally meant as a liquidation—to a rehabilitation proceeding. To a larger extent than the Bankruptcy Act of 1898, this legal proceeding was the foundation of the American way in the rehabilitation of firms. This did not emerge from vast considerations, nor on the basis of a master plan, but from the lack of a legal basis with which to deal with enterprise insolvencies which spread over numerous Federal States. Thus, the legal and economic practice created the foundation of insolvency law.

However, this form of rehabilitation of firms turned out to be unsatisfactory. It was both time-consuming and unjust. The courts had little control over the reorganisation plan and the committee, which represented the interests of the shareholders, was mainly composed of insiders in connection with creditors. There was no independent, objective control of the reorganisation plan and as the legal confirmation required the majority of the credit claims, recalcitrant creditors were paid in cash for their support. This led to injustice and delays (Altman, 1971, p.5). Criticism was also levelled against the generous fees of banks and lawyers in certain cases of rehabilitation and against the length of the proceedings.

In the 20th century, new problems emerged. Above all, the world economic crisis, which in the USA lasted throughout the 1930s, brought about the collapse of many a firm. In connection with the New Deal, the State also developed the intention to intervene more strongly in the economy. This led to the "Chandler Act" of 1938, in which the role of banks and lawyers was reduced and—similarly to the English model—bankruptcy proceedings were conducted in a more administrative manner. According to the Chandler Act, the insolvency of all companies was dealt with entirely under Chapter X, and Chapter XI was actually only meant for small private firms. According to Chapter XI, the court can leave to the current management the development of a rehabilitation plan without any supervision on the part of the Securities and Exchange Commission. The firm could take on new loans, which had to be secured in a preferential way. Thanks to the relatively short duration of these proceedings, this method was regarded as successful. There was, however, no clear formal definition for the application of Chapter XI and so it was not surprising that companies began to test this grey area. With the passing of time, larger and larger firms filed for bankruptcy under Chapter XI, which thus became the usual form of the rehabilitation of a firm.

In the 1960s, a renewed discussion on bankruptcy law emerged, concerning, above all, consumer loans. The reform of bankruptcy law had its starting point in the report of the Brookings Institution, *Bankruptcy: Problem, Process, Reform* (Stanley, David T./Grith, Majorie 1971). This was one of the biggest analyses of the bankruptcy problem ever to have been undertaken in the USA. The influence of this study is undisputed; it led, according to point of view, to criticism or praise. The tenor of the study was its emphasis on the social importance of the problem. At its very beginning (p.1) it observed that every fifth American was either directly concerned by a case of bankruptcy—as a debtor or a creditor—, or he knew someone who had gone bankrupt. Every year, thousands of Americans filled in a bankruptcy petition and courts cancelled debts amounting to a total of c. 2 billion. On the other hand, the economic significance of insolvencies was relativised: the 2 billion debts, which were cancelled every year via bankruptcy proceedings, made up only 0.2% of outstanding private debts. This was therefore to be considered as the expenses of the existing loan system. Bankruptcy was therefore not so much an economic problem as a human one (p.40). The focus of this major law reform was the increasing number of private bankruptcy cases. In its shadow, however, the conditions for company insolvencies also changed radically.

The study mentioned above led, after long discussions and some amendments, to the 1978 Bankruptcy Code. This Code brought about a completely new form of bankruptcy law in the USA. Since then the best law firms have dealt with insolvencies and declarations of

bankruptcy by individuals and companies have reached an unexpected number. In the new law, the old chapters X, XI and XII were subsumed under a new Chapter 11. As a consequence there were now only two chapters for companies, namely Chapter 11 for their reorganisation and Chapter 7 for their liquidation. As is customary in the American legal system, the law set guidelines only, its legal and economic application, however, was left to the judicial system in the form of precedence.

US Insolvency Proceedings Today

In the USA, there is a distinction between personal bankruptcy and commercial bankruptcy, although they overlap. The essential element of personal bankruptcy is the "discharge" from all financial liabilities. The creditors can thus no longer prosecute the debtor; he is free from previous financial liabilities. US law, however, foresees exceptions for the possibility of discharge, in the case of fraud or crime this cannot be granted, but also in the case of specific debts such as alimony, tax arrears, student loans, financial obligations which resulted from driving while intoxicated. The discharge is thus granted to the respectable debtor or for respectable debts (Gross, 1997, p.27). An essential advantage of American law for the debtor is that he continues to exercise control over the proceedings. A person who files for bankruptcy, can decide whether to hand over his assets to the court and thus to be immediately free from his obligations, or to keep his assets and make payments within the framework of a 3-5 year rehabilitation plan.

In practice, three quarters of personal bankruptcies are no-asset cases. In a no-asset case, the debtor receives from the court an "immediate discharge" and is freed from his debts without payment. This development is mainly due to the success of credit card companies in the USA. While in the year 1978 only c. 40% of all families owned at least one credit card, by the year 2000 it was over 80%. In 1978, 172,000 Americans filed an application for personal bankruptcy, by 1996 the number had risen above one million, with a tendency to increase further (Skeel 2001, p.188). When a personal bankruptcy petition is filed, the loss essentially concerns the consumer loans on credit card, as the latter are unsecured. Credit card companies include the loss into their total business plans. The receivables which are cancelled in a case of private bankruptcy are finally passed on to the other credit card customers, especially onto the interests, which in the case of an overdraft are substantially higher than bank interests.

The second possibility for personal bankruptcy is the presentation of a Rehabilitation Plan according to Chapter 13. Here the debtor maintains control over his assets and commits himself to pay back a certain part of his debts over a period of three to five years. This form is meant for persons with a regular income and dates back to the 1930s. This procedure is therefore an option in view of the possible future income of the debtor, but the creditors must be able to expect at least the same financial result as that of the liquidation of the current assets. Chapter 13 is advantageous if the debtor wants to keep the value of his assets, and it also enables to preserve his social image. The debtor can always choose. Even in Chapter 13 the creditors' claims cannot be fully satisfied, because the purpose of the proceedings is the economic continuation and not the financial ruin of the debtor. It is, however, problematic that this chapter can be applied only within certain limits of debts: in the case of secured debts, the sum must be lower than $750,000 and in the case of unsecured ones, lower than $250,000. These limits appear arbitrary (Warren, 1997, p. 29/30). Most debtors, however, do not complete the proceeding described in Chapter 13, which requires a lot of rigour. An unexpected expense is enough to ruin everything, and the debtor finds himself using Chapter 7.

In addition to the three principles of personal bankruptcy, namely liquidation, rehabilitation

plan and discharge, there is also that of liquidated assets. That is, such essentials as house furniture, cars, and tools for one's profession up to a certain sum cannot be used to satisfy the creditors. US federal law regulates the extent of discharge, but allows the individual states to issue their own provisions. This has indeed been done by 35 states. What is inaccessible to the creditors varies greatly in the USA. The assessment of what is necessary for personal survival and well-being in the present and future is dependent on various estimates. The bankruptcy system protects automobiles, televisions and hi-fi equipments, but not works of art. It protects domestic property: more than half of the people in private bankruptcy are, and in fact remain, house owners (Sullivan/Warren,/Westbrook, 1989, p. 328), but in New York only up to a value of 10.000 $, whereas in Florida (the debtor's haven), Texas and five more states it is unlimited, which arouses criticism in the USA. Thus, a debtor can escape bankruptcy even with assets in the region of millions, as long as this is a domestic property. One certainly cannot speak of an egalitarian treatment.

In a certain sense, bankruptcy law in the USA is a substitute for a weakly constructed social system. The health care system and unemployment support are rather limited, and so the only replacement available for families whose survival is threatened is the bankruptcy system. Unemployment represents two thirds of the grounds for bankruptcy, while the high costs of living resulting from disease make up 20%. In the USA the bankruptcy system is a protective measure against the pressure of the market economy and the state has here drawn a socio-political line to guard against the dangers of credit companies. The Bankruptcy Court is therefore comparable to a hospital for patients in financial troubles (Sullivan/Warren/Westbrook, 1989, p. 328). There are, however, also voices which assert that one should not regard the bankruptcy system as a panacea for all social problems (Gross, 1997, p. 131).

The number of personal (non-business) bankruptcy filings increased from 241,000 in 1980 to more than 1.6 million in 2003—more than six- fold. During the 6-year period from 1980 to 1985, a total of 1.8 million personal bankruptcy filings occurred; while during the 6- year period from 1998 to 2003, there were 8.6 million filings. Since the same individual cannot file for bankruptcy under Chapter 7 more often than once every six years, this means that the proportion of households that filed for bankruptcy rose from 2.2% in 1980-85 to 8.2% in 1998-2003. One of the important issues in personal bankruptcy is to explain the large increase in the number of filings.Because Chapter 7 is so favorable to debtors, 70% of personal bankruptcy filing occurunder Chapter 7. 95% of debtors who file under Chapter 7 have no non-exempt assets and repay nothing to creditors. Thus, a new bankruptcy law was adopted in 2005 (Bankruptcy Abuse Prevention and Consumer Protection Act), of which the main changes are in the area of personal bankruptcy. Individual debtors must take a financial counseling course before filing for bankruptcy. Also, they must pass a series of means tests in order to file for bankruptcy under Chapter 7. If debtors' household income is greater than the median level in their state and if their disposable income over a five year period exceeds either $10,000 or 25% of their unsecured debt, then they must file for bankruptcy under Chapter 13 rather than Chapter 7. In addition, the homestead exemption is limited to $125,000 unless debtors have owned their homes for 3.3 years at the time they file for bankruptcy. These changes are expected to reduce the number of personal bankruptcy filings by debtors who have relatively high earnings and they will also prevent millionaire debtors (O.J. Simpson is a recent example) from moving to high exemption states such as Texas and Florida to shelter their millions from creditors. But the reform seems unlikely to substantially reduce the overall number of bankruptcy filings, since most debtors who file for personal bankruptcy are in the lower half of the household income distribution in their states. (White 2005, p 45-6)

The management of firms are also free to decide whether to file a petition for bankruptcy

either for liquidation or for reorganization. As in the case of personal bankruptcy, Chapter 7 foresees that the firm hand over all of its assets to a Trustee who is appointed by the authority unless at least 20% of the creditors' unsecured claims request that the trustee be appointed by the creditors. The function of the trustee is the liquidation of the firm and the realisation of all assets. The proceeds are then distributed according to the order of precedence of the creditors. Here, bankruptcy is a mechanism to settle a no longer solvable debt situation. Chapter 7 is rarely the first choice; in most cases, it is the second option after chapter 11; however, c. 80% fail and are consigned to chapter 7 (Warren 1993, p.31).

The alternative to this procedure is chapter 11. This contains the regulation of American bankruptcy which is most cited and most criticised in the media. Numerous big firms made use of Chapter 11 in order to reorganize themselves financially and to exercise pressure on their creditors, suppliers and employees. Chapter 11 foresees a reorganisation of the firm on the recommendation of the management. The management remain—at least temporarily—in position and continue to run the firm. This is the main reason for the popularity of this procedure. The management thus not only preserve their influence on the administration of the firm, but also on the company surveys which would have been carried out independently if a trustee had been appointed. The management get some breathing time, an "exclusivity period" of at least four months (120 days). In the case of large firms, however, the Court prolongs this period for as long as it is necessary. The continuation of the firm's activity by the management makes the option of bankruptcy considerably more attractive than it would otherwise be. "No other bankruptcy system in the world gives the managers of a troubled firm so much influence" (Skeel, 2001, p. 9). The management do not have to liquidate the firm, even if this would be more advantageous to the creditors than the continuation of the firm's activity. Of course, it is criticised in the USA, too, that the people who remain in the leading positions are those who led the firm to its ruin. The counterargument is that only the current management really know the firm and any new management would need precious time to become acquainted with it. However, in real insolvency cases, that is, those which are not entered into for other business goals, at least part of the management is replaced, in order to make a better impression on the creditors. Despite this, studies show that only in smaller firms the management remain in their position, whereas in bigger ones the insolvency proceedings, even when they come under chapter 11, are accompanied by some fluctuation. Elisabeth Warren mentions that in the biggest 'Chapter 11 cases' in the 1980s, in the 18 months prior to and after the declaration of insolvency, 91% of CEOs were replaced. Other investigations into approximately the same period of time show a 71% to 91% turnover rate of the top management within two years after the declaration of bankruptcy (Warren 1993, p.66).

The reorganisation now takes place through the negotiations with the creditors about the reorganisation plan. The reorganisation divides the creditors into classes with similar claims and presents a plan to every class of creditor. Shareholders and creditors hold a vote on this plan. If the plan is rejected, the management and/or the creditors can present a new plan. When every class of creditors has accepted the plan, the latter is confirmed by the Court and the firm begins to operate again. A typical reorganisation plan foresees a quota of 25% to 50% for unsecured loans (White, Michel, in: Bhandari, Jagdeep S./Weiss, Lawrence A., p. 475). These losses are eligible for tax depreciation.

This is the normal case for big firms, although the procedure can usually last up to two years or more (Franks/Torous in: Bhandari, Jagdeep S./Weiss, Lawrence A., 1996). Therefore, Chapter 11 is, as a rule, considerably more costly than Chapter 13, not only because it lasts longer, but also because one must resort to a whole series of costly services, above all those of lawyers, trustees, accountants and investment bankers. Firms in trouble generally file for bankruptcy under Chapter 11. This must often, however, be revised towards chapter 13. A study discovered that only one fourth to one third of firms are actually reorganized according

to chapter 13. The percentage of big firms is c. 60% (White, Michel, in: Bhandari, Jagdeep S./Weiss, Lawrence A., p. 478).

If the plan is rejected by one or more classes of creditors and an agreement cannot be reached, the plan can nonetheless be confirmed by the Court. This is called "cram down" because the reorganisation is, as it were, crammed down the creditor's throat. The liquidation value of the firm is assessed and the reluctant class of creditors receives its part according to the priority rule, i.e. preferential creditors must be entirely satisfied before the next class of creditors can be considered. It has been repeatedly observed, however, that the priority rule is often broken. This is because the creditors with high guarantees always agree to a reduction of their receivables in favour of less secure receivables and even of the share holders in order to obtain their approval of the reorganisation plan. Thus, in a bankruptcy proceeding even share holders can obtain a part, albeit usually small, of the bankruptcy proceeds (Bhandari, Jagdeep S./Weiss, Lawrence A., 1996, p.109). A study has recorded such infringement in about two thirds of the cases analysed; the disadvantaged creditors, however, were usually granted a higher interest rate for their receivables (Weiss, Lawrence, A., in. Bhandari, Jagdeep S./Weiss, Lawrence A., 1996, p. 260).

The immediate advantage of this proceeding is the "automatic stay", that is an automatic moratorium, as a consequence of which the firm does not have to pay back its previous debts during the proceeding. This advantage can hardly be overstated. Firms in financial troubles are in most cases under creditors' pressure. Chapter 11 temporarily frees the firm from its creditors and affords the necessary breathing time to restructure its finances and to reach a solution. Preferential payments are also excluded, all payments to unsecured creditors are invalid from 90 days before a bankruptcy petition; if the creditor is an insider, then this period is extended to one year. The regulation of the debt problem thus takes place in an orderly manner.

In American law, the management and the owners/shareholders are not personally liable for the debts of a firm which according to corporate law has limited liability (shares etc). The management run the firm without exposing themselves to risks and in the case of bankruptcy can continue their activity in another firm without being burdened by the mistakes of the past. The different treatment of personal bankruptcy and commercial bankruptcy is seen as peculiar in the USA, too. Whereas an individual person is liable for his financial blunders, bankruptcy affects the firm but the people who caused its financial ruin leave all their obligations behind (Gross, 1997, p. 29). The purpose of this generosity towards the management is ultimately to permit the timely commencement of the bankruptcy proceeding and to prevent the management from continuing running the insolvent firm at high costs in the attempt to avoid bankruptcy by all means (White, Michelle J. in: Bhandari, Jagdeep S./Weiss, Lawrence A.,1996, p.207).

The stigma of bankruptcy has considerably weakened in the USA in the last decades and the costs of a bankruptcy petition for the firm have clearly abated. With Chapter 11, the emphasis has shifted towards the debtor. It is difficult for the creditor to replace the management in a proceeding, the deadline for the reorganisation is often postponed and the rather peculiar situation emerges in which creditors who lend sums of money to the firm which has already filed for insolvency are put first in the list of preferences. Some firms, therefore, file for bankruptcy under Chapter 11, in order to obtain further loans. The declaration of bankruptcy no longer necessarily means that a firm is finished; rather than a last resort for the weak and for failures, it can be an instrument of the rich and powerful. Because of the costs and the length of the proceeding, Chapter 11 is for large firms or, in the words of a New York lawyer: "Bankruptcy is not for bankrupts." Chapter 11 is an insider business; one needs a large amount of financial means, knowledge and experience in order to be able to play this game

appointment of a liquidator, which would make the receiver superfluous. The lack of a court and the possibilities of the secured creditor lead to a quick resolution of the financial liabilities. If there are no secured creditors, no receiver can be appointed. The only alternative until 1986 was the liquidator.

Bankruptcy administrators are independent professionals also known as licensed insolvency practitioners. They are usually professional accountants whose reputation is of paramount importance as only a small group of banks deal with a large part of the appointments of receivers. The receiver decides whether a firm will continue to operate. If the cash flow is positive, then this is easily the case. If it is negative, new financial means must be taken up. The receiver is personally liable for all the liabilities incurred after his appointment and will be very careful in taking up new loans. His main aim will be to reach the highest possible satisfaction of the creditor by whom he was appointed. Whatever else he can obtain is distributed among the remaining creditors according to the order of preference of their receivables. There are some regulations which should protect the remaining creditors; however, the receivership is in general regarded as a proceeding in which the remaining creditors are damaged while the only benefits are destined to the floating charge holders, and the continual operating of the firm is sacrificed to the interests of this creditor. Receivership, therefore, encourages liquidation, all the more so because this can be requested at any time by the other creditors.

The decision as to whether the firm should continue operating is mostly taken under time pressure and with insufficient information, therefore liquidation is a frequent solution. The management are not involved in the proceedings and are under remarkable pressure to avoid insolvency whenever possible. The debtor, therefore, no longer has control over the firm. If a firm can be sold in its entirety, it often happens that the current management take the lead, since their knowledge of the firm allows them to submit the best offer and to take decisions more quickly than anyone else.

The Insolvency Act of 1986 foresees a third possibility, that of an administrative receivership, through which the proceeding can become more debtor-friendly and premature liquidations are supposed to be avoided. An administrative receiver is appointed at the request of the firm or of creditors via the court. The appointment of an administrator by the court is the fundamental difference from the US law (Chapter 11), in which the operations of the firm are conducted by the current management. The management in Great Britain, however, lose their control over the firm in all cases. The accompanying role of lawyers and management consultants is also lacking, whereas it is essential in the USA. The British bankruptcy administrator is a licensed profession. He represents the claims of all creditors and thus an area of conflict which existed with the receiver now disappears. The administrator has a much stronger position than the receiver: he can suspend existing loans, interest rates or leasing payment, take up new loans and cannot be replaced by a liquidator. Also, he is not personally liable for the financial commitments which are made after his appointment. The appointment of the administrator brings about an automatic three-month stay during which a rehabilitation plan must be developed, which must be accepted by more than 50% of the creditors (value of receivables). The court, too, can impose a rehabilitation plan on the creditors. The administrator is regarded as an English way of approaching Chapter 11 and to find a more debtor-friendly and reorganisation-friendly solution (Franks/Torous, in:Bhandari/Weiss 1996, p. 456). The difference, however, is that the rehabilitation plan is prepared by the administrator and not by the management, which during this phase have only a limited role. In addition, creditors with a fixed or floating charge can block the appointment of the administrator by appointing their own receiver or liquidator. Therefore, the option of an administrator is possible only when the majority of the creditors agree with this proceedings from the outset. In addition, these proceedings are costly and only larger firms can afford

them. During the first ten years after the appointment of the administrators, of 202,000 firm insolvencies 78% resulted in liquidation, 20% in bankruptcy trusteeship, and less then 1% in the appointment of administrators (Hoshi 1998, p.26/7). The proceedings work, therefore, almost only for very large firms, in which the preservation of the assets is of utmost importance.

British law gives the firm the opportunity to solve its problems with its most important creditors in the form of a legal workout. The court confirms the voluntary arrangement with a "scheme of agreement"; this is conditional on 75% of each class of creditors giving their consent. This procedure is mainly chosen for complex reorganisations, because a voluntary arrangement with the mediation of the court becomes binding for all creditors. In the ten years after the introduction of this regulation, this procedure, too, represented around one percent of insolvencies.

Considerably more successful are informal workouts in which the firm itself—or more often its bank— appoints a consultant and an accountant before opting for a formal workout. In two thirds of the cases, this method allows a solution to be found for the continuation of the firm's activity (Hil 1998, p.37). As a consequence of the strictness of British insolvency law, only real insolvency cases are considered for formal proceedings, otherwise there is a tendency towards an extrajudicial resolution.

British insolvency law is rapid and therefore relatively inexpensive. Creditors obtain control of the firm and thus a higher reliability of the original credit agreement. However, this can lead to premature insolvency petitions and underinvestment, as the management's personal liability advises extreme caution. (Franks/Torous, in:Bhandari/Weiss 1996, p. 464). In principle and in spite of all reforms, however, British law still assumes that it is the creditors' money at stake, and that it is therefore their concern to control the proceeding. Most rehabilitations and liquidations occur without involving the courts or with only minor involvement in order to secure legal certainty. The market must regulate its own errors, because "companies are not rescued in courtrooms, but in the market-place" (Hil 1993, p.47). In Great Britain there is no "rescue culture": the rehabilitation is not regarded as a first possibility but as a last resort. What becomes obvious here is the conviction that a firm's failure should be punished and that insolvency proceedings should not be an opportunity to redress aberrant developments. Continental European practice, like in Britain, foresees the appointment of a bankruptcy administrator or trustee in order to continue the activity of the firm during the insolvency proceeding. Here, however, the courts are much more strongly involved in the proceedings. There is no equivalent of the administrative receivership and of a secured creditor's influence. Bankruptcy legislation is more debtor-friendly and reorganisation generally lasts longer. Regulations for private bankruptcy are very far from the strictness characterising company insolvencies. Although in this case, too, a debtor's assets and income are realised to mere subsistence level for the benefit of the creditors, this phase lasts only two years in the case of debts of up to £20,000, and three years for higher debts. After this relatively short time, the person concerned is free from its previous obligations.

France

French insolvency law belongs to the tradition of Roman law and was first laid down in the Napoleonic Code in 1807. All later laws were based on these principles. It provided for the equal treatment of all creditors, the appointment of a bankruptcy administrator by the courts and the creation of a committee of creditors. The regulations focused on creditors' interests and regarded insolvency as an offence on the part of the debtor and thus entailing penal consequences (Lafont 1994, p.15). The 20th century brought about a series of legislative

amendments, the most important of which were in 1984, 1985 and 1994. In the economic crisis of the 1980s, with increasing unemployment and bankruptcies, the structure of the insolvency proceeding changed profoundly. In France, its essential aim is to save the firm and maintain working places. The law of 1985 revoked the necessity to create a creditors' committee, in order to accelerate the proceeding and to reach the following aims:

- reintegration of the firm into the economy
- strengthening of employment
- satisfaction of the creditors' receivables.

The aims of this legislative amendment were therefore primarily of a social and politico-economic nature; creditors' interests, which until then had been of primary importance, became secondary. The law was therefore thought of as a socio-economic instrument that now bore little resemblance to the regulations of the Napoleonic Code.

In France, a bankruptcy petition can be made by the firm, the creditors, the state attorney or the courts. The management are obliged to file a petition for insolvency within 15 days. However, these sanctions are not strict, which is why, as a rule, the firm itself rarely completes the petition (Hoshi 1998, p.30). Petitions for insolvency are therefore more often filed by a creditor who needs only to prove that the firm has not honoured its payments.

If a firm becomes the object of a bankruptcy petition, a vast administrative process starts. Courts examine the insolvency application and issue a decree of reconstruction. An automatic stay ensues, which means that debts can no longer be demanded or paid individually. This decree envisages the appointment of an administrator, who supervises the management, and a period of observation that is initially of six months but can be extended twice. The bankruptcy administrator represents the state and not creditors. He is chosen from a list of administrators authorised by the court and is responsible, personally and without limitation, for this activity and must be therefore appropriately insured. His authority is set down by the court. During the period of observation, he must examine the company's economic and social conditions and assess the viability of rehabilitation. If his examination gives positive results, he develops a reorganisation plan. This plan refers not only to the financial aspect of creditors' claims, but also to the firm's organisation, cuts in the number of employees, replacement of management. How high the restructuring rate must be is not explicitly stated; in most cases, instalments are paid over a period of seven or eight years.

If the administrator's examination gives negative results, a liquidation plan is developed whose aim is to sell the firm either in its entirety or in parts. The firm is then liquidated and the new owner is released from previous liabilities. Either plan—reorganisation and liquidation—is subject to court approval. The French model is clearly even more interventionistic than Chapter 10 of the Chandler Act (Bolton 2002, p. 19). It leaves hardly any space for negotiations between creditors and debtors. Decisions on a reorganisation or liquidation plan as well as its development are taken exclusively by the administrator and the court. Of course, an administrator will consult all persons concerned and therefore also creditors, but it is a court that has the last word without the participation of creditors. A 1994 amendment strengthened the position of creditors further by eliminating the automatic period of observation and by leaving this to a court's discretion. This is meant to permit a more rapid treatment of hopeless cases. For firms with temporary liquidation difficulties, the law of 1984 introduced another proceeding in which the court appoints a "conciliator" whose task is to develop a financial plan and submit it to the creditors for approval. This method, however, has been rarely applied, as it requires the voluntary approval of creditors. Only in Paris was it reactivated for the rehabilitation of real estate firms at the beginning of the 1990s. Another, rather flexible, proceeding allows a company to designate a "guardian", normally a trustee

firm, which is authorised by the court for insolvency proceedings and acts as a sort of consultant to supervise the company's reconstruction before it becomes truly insolvent. This proceeding has permitted some spectacular cases of rehabilitation.

Germany

In Germany, too, bankruptcy proceedings are an administrative model, in spite of the fact that there was no uniform law until 1999. The legal fundamentals were the bankruptcy law, the 1935 restructuring law and the law of 1990 that regulated insolvency proceedings in East Germany after the reunification. In addition to these, there were several civil and criminal regulations that also referred to bankruptcy proceedings. German bankruptcy proceedings are predominantly applied to the liquidation of a debtor's assets, in order to satisfy creditors' claims. Restructuring, that is to say a voluntary agreement with a creditor, played a minor role. Both debtors and creditors can file a bankruptcy petition. Creditors must prove their business partner's inability to pay, while debtors must submit a record of their assets and liabilities as well as a list of their creditors. Debtors must file a bankruptcy petition no later than three weeks after their inability to pay or over-indebtedness has become apparent. The management are personally liable for any damage that may result from a belated insolvency petition (Fialski 1994, p.26). German insolvency law, therefore, stresses creditors' interests to a high degree. However, the importance of a company's survival for the employment market has become increasingly clear in Germany, too.

If formal conditions are met and the assets are enough to cover court expenses, the insolvency judge will institute the proceeding and appoint an expert for the examination of the reasons for insolvency. At the same time, a debtor's assets are confiscated in order to prevent disposals. If the proceeding is confirmed, a bankruptcy administrator is appointed from a list of authorised lawyers and trustees and the date for the creditors' meeting is decided. Normally, the administrator later becomes the trustee of the insolvent firm. The previous management are replaced. The bankruptcy administrator liquidates the debtor's assets and continues operating the firm only if this can secure receivables. Courts can also elect a committee of creditors for the support and control of the bankruptcy administrator. During the first creditors' meeting, the provisional trustee submits a report on the causes of insolvency and the assembly normally confirms the trustee for the ensuing procedure. In the second creditors' meeting, which often takes place immediately after the first, creditors' receivables are examined and approved. In a third and last meeting, creditors hold a vote on the final report of the trustee.

Creditors with solid guarantees do not take part in insolvency proceedings, as they can enforce their receivables independently thanks to their right of preferential treatment. Most of the loans given to firms are provided with preferential, securitised guarantees. In practice, this means that after the satisfaction of creditors' claims with specific guarantees, there no longer are assets for the bankruptcy proceeding. In three quarters of cases, the proceeding is therefore rejected on the grounds of unavailable funds. The debtor's assets are distributed according to priorities: first to those obligations incurred by the bankruptcy administrator in order to continue operating the firm, then to court expenses, employees' claims up to six months earlier, taxes and public dues, and finally to the unsecured creditors.

In German law, a debtor is not freed from his obligations. An individual remains liable for his remaining debts for 30 years, that is to say for the rest of his life. The management of a firm can also be liable for their personal assets, if creditors can accuse them of negligence. If a penal proceeding ends with a conviction, it is always a minor one (c. 14 days probatory), but it lays the basis for a civil prosecution for material compensation. Managers who receive a

criminal conviction as a result of an insolvency proceeding are barred from holding high office in the firm for five years.

German insolvency law also provides for enforced restructuring. A debtor offers his creditors a specific quota and presents a plan of how he intends to render these services. The creditors' assembly holds a vote on it and if 50 % of the creditors present with a share of 75% of the total amount outstanding agrees with it, restructuring is accepted. This is binding for both the creditors who were absent and for those who voted against it and relieves the debtor from any other liability. Nonetheless, this insolvency proceeding with a reorganisation aim is only of minor importance, because during the proceeding there is no debt moratorium for secured receivables and because a quota of 35% is required (40% if the payments of instalments exceed one year). The cases of insolvency that can be solved with restructuring are comparatively rare: they make up only 1% of the total, as low as that of Great Britain. Hence, it is perfectly common—in an estimated 20% of cases—to reach a workout outside the court proceeding .

In Germany, the 1999 insolvency decree introduced a new codification of insolvency law that put an end to the traditional dichotomy of bankruptcy and restructuring. The new insolvency law combines all regulations on insolvency and, with its stronger emphasis on company rehabilitation, has brought German regulations closer to Chapter 11, thus following the international trend. The new law revokes secured creditors' privileges to make use of their guarantees even during the insolvency proceeding. It introduces an automatic three-month stay, creates classes of creditors and allows creditors to present their own reorganisation plan. The main aim of this law, however, remains the best possible satisfaction of creditors. In addition to liquidation, the new law foresees an insolvency plan that replaces restructuring and enforced restructuring. The legal context for this is extremely flexible. It is usually the bankruptcy administrator who presents such plan to the creditors. He can also continue operating the firm in order to satisfy creditors with future proceeds. The plan, however, can also recommend the selling of the firm or its liquidation. The new law allows the current management to continue operating the firm, albeit under a trustee's supervision, and endeavours to promote reorganisation by means of a debt moratorium and agreements below 35%.

Methods of dealing with bankruptcy and insolvency have raised discussions both in the USA and in Europe and have led to amendments to the law. Criticism has been levelled against excessive privileging of creditors' interests in Great Britain and Germany, and against the infringing of creditors' rights in order to reach rehabilitation in the USA and in France. The regulatory changes of 1986 in Great Britain and of 1999 in Germany attempted to redress this imbalance, as the amendments of 1994 had done in France and in the USA. Whilst insolvency policy seems to grow more uniform, at least with regard to individual regulations, the different political principles remain unchanged. The question as to which direction is economically more efficient depends on the success of the reorganisation, its costs and above all the individual who bears the expenses, since any macroeconomic advantage is hard to demonstrate.

A frequent argument maintains that managers who have nothing or little to lose in a case of insolvency are more ready to take risks than those for whom it can be life-threatening. There are numerous studies that confirm this 'experience' (Hoshi 1998, p.33). Few figures are available for the triumphs of rehabilitation in insolvency proceedings. Most statistics do not follow the development of a firm after an insolvency proceeding has been completed; only for individual cases do we know how successful the rehabilitation was, that is how long the firm continued to exist, whether for a couple of years at the expenses of creditors or whether a new structure was found which could put the company firmly on its feet again.

It has also been also argued that an overly lax insolvency legislation subverts the payment behaviour of the firm. However, one of the most crucial innovations of the 19th century was the introduction of a limited responsibility for companies in the form of joint-stock companies and limited liability. This permitted the flow of outside capital into firms that represented the driving force of the emerging credit services sector. Firms constantly operate with limited liability for their financial obligations; insolvency legislation is only a part of liability limitations.

European Union

On May 31st 2002, the European Insolvency Regulation (EIR) came into force. The EIR has a long history that is typical of the European integration process and is mainly due to extremely different economic and legal cultures in member states. But the USA, too, had to wait over a hundred years for the emergence of a uniform insolvency law in all Federal States.

Whilst the Brussels agreement of 1968 regulated the jurisdiction and the recognition and enforcement of judgments, the field of insolvency remained—with the exception of few bilateral conventions—simply unregulated. In a note of 1959, the EEC points out disturbances and difficulties in the economies of member states when courts are unable to assess or support legal claims in the European economic area. "Legal protection of rights and legal security on the European market depend essentially on a satisfactory regulation of recognition and enforcement of judgements between member states" (Morscher 2002). In 1960, a commission of experts attempted to reach a uniform agreement which would regulate all these matters. The year 1970 saw the preliminary drafts of an agreement on bankruptcy, restructuring and related proceedings. The bill, however, could not develop. In 1980 the commission worked on a new bill, which was only marginally revised in 1984. All of these bills were ultimately rejected. Criticism was levelled against their impractical nature, their overly complex regulations and their marked French influence. In addition to the efforts of the EU Commission and of the EU Council, the Council of Europe had worked on the international protection of creditors' rights since 1979. This led to the European Convention on Certain International Aspects of Bankruptcy, aka Istanbul Bankruptcy Agreement, in 1990. The bill limited itself to the mutual recognition of bankruptcy proceedings and to assert the administrator's cross-national competencies, but it left many other questions open. Although the Istanbul agreement was not ratified by all member states and therefore never came into force, it was an essential preparation for a later one. During a meeting of the EU ministers of justice in 1989, it was once again observed that the lack of an insolvency agreement for the whole Community must be regarded as a grave flaw in the home market. It was considered unacceptable that the activity of companies be increasingly regulated with Community law, whereas in the case of insolvencies only national law was applied. The Council created a work group for "bankruptcy agreement" which operated from 1991 until 1995. By 1992 a bill was presented which the Council passed without major changes as European agreement on insolvency proceedings in 1995. However, this agreement never came into force either, because Great Britain refused to ratify it. In 1999 the Committee on Legal Affairs and Citizens' Rights observed that the Community was at the same point as 20 years before. A resolution of the European Parliament invited the Commission to develop a regulation on the basis of the 1995 bill. On the initiative of Germany and Finland, the transformation of the insolvency agreement of 1995 into a regulation of the Council was finally proposed, which ultimately prevailed as the European Insolvency Regulation (EIR) of May 2000 (Morscher 2002).

The EIR is meant to regulate reorganisation and liquidation where they concern more than one EU member state. It is valid for all EU member states with the exception of Denmark. In principle, EU law is valid for all member states, but Denmark, Great Britain and Ireland are allowed to reject it under the terms of their accession treaties. Of the three, only Denmark has so far rejected this convention. The convention is valid between EU countries but not for insolvencies that concern other states, too. The EU avoided a uniform definition of the notion of 'insolvency'; instead, it has listed the various national insolvency laws. The convention governs a whole series of law cases. The regulation does not concern pre-insolvency proceedings or insolvencies of banks, insurance companies and financial institutions. The EU convention invalidated other agreements between states, such as the Nordic Convention and nine bilateral treaties between EU member states.

The EU feared that insolvent debtors might go 'shopping' in EU countries and take advantage from it. As national legislation could not prevent this, the EU opted for a compromise between universal and territorial approach. Special consideration was given to the different property rights and to the rights of the persons involved. This led to the conclusion that a uniform EU insolvency law could not be reached. In order to obtain an efficient collaboration, the EU convention focuses on the following fields:

1. In what country and under which law must an insolvency petition be filed and a proceeding be initiated. The EU convention allows two proceedings, a primary and a secondary one. The primary proceeding must be initiated in an EU country that represents the debtor's "centre of interests." Every conflict that concerns this centre of interests is dealt with by the court where the insolvency petition was filed. The bankruptcy legislation of the country hosting the centre of interests is valid for the whole proceeding, and this also applies to the other EU countries. However, creditors' rights for preferential and secured receivables depend on the country in which the business was concluded, because the law of that country was the basis on which the business was done and business partners must be able to rely on it. In addition to a primary proceeding, the trustee or, according to national laws, a party concerned, institute a secondary proceeding that is valid only for this specific country. A debtor must have an establishment in this country as a basis for regular business transactions; a loose connection such as banknotes is not enough. A secondary proceeding concerns only assets and receivables declared in this country, and follows the insolvency law of the country in which it takes place and not that of the primary proceeding. This is one of the main reasons for choosing this proceeding, along with the ease of work in very complex cases. The primary proceeding is universal, whereas the secondary one is limited to the state in which it was instituted. If a primary insolvency proceeding is instituted in a EU country, there is a strict priority policy. Every subsequent proceeding in another member state can only be a secondary proceeding. Secondary proceedings are only valid for branches of companies and the like, whereas legally independent subsidiaries do not fall under these regulations and are dealt with in separate proceedings. The EIR, however, does not exclude all conflicts of jurisdiction if, for example, a primary proceeding had been instituted but a court in another country noticed flaws in the proceeding and instituted a new primary proceeding itself. Generally speaking, creditors will have to consider more than one legal system in the future. A German limited company (GmbH), for instance, may be partly subject to German insolvency law, but its assets can also be realised according to the principles of any other insolvency law within the European Union (Bert/Schlegel 2003).

2. The recognition of this country's legal system. The petition of insolvency in a EU country is automatically recognised by all other member states. If the automatic stay is valid in this country, then it must be recognised as a legally regulated debt cancellation even in those EU countries that do not have it. There is, of course, a possibility of objection if this procedure is in conflict with constitutional laws or fundamental freedom rights in this country. The

liquidator or trustee can carry out his functions in all EU countries but he must also take into consideration local insolvency legislation.

Trustees taking part in proceedings are expected to collaborate and submit reports and have the right to take part at every proceeding, even those in other countries. Although the overall aim of a primary proceeding is a fair distribution, secured creditors in particular can be treated differently as a result of a different legal situation in the various EU countries. The European proceeding cannot be regarded as European insolvency law; it only creates a relatively comfortable possibility to approach the ideal of the best possible creditor satisfaction on the basis of different national insolvency systems. At EU level, much still needs to be done.

Generally speaking, there is certainly a worldwide convergence towards a more debtor-friendly insolvency policy. Differences between the USA and the EU are first of all in the degree of involvement of courts, administrators or trustees in the management of an insolvent company. In this respect, the USA and Great Britain are diametrically opposed cases. Whilst in the USA rehabilitation proceedings take place with a minimal participation of courts, anywhere else courts are much more present in both proceedings and supervision. A further difference is the restructuring of interests between creditors and debtor. On the other hand, creditors' interests are nowhere as strongly represented as in Great Britain. Germany abandoned the strong emphasis on creditors' interests with the 1999 law. There are also differences in the consideration given to stakeholders' interests, such as those of employees. Especially in France, large firms protect employees' interests. Finally, there are differences in the personal responsibility of the debtor or of the management and in the extent of the debt moratorium.

In the USA, it is usually debtors who file insolvency petitions, whereas in Europe it is mostly their creditors. The insolvency petition should be neither premature nor belated. It is assumed that the stricter the insolvency law towards the management, the bigger the danger of a belated insolvency petition. The early filing of a petition is meant to help minimise losses and increase the chance to save the company. Europeans do this with strict, personal sanctions on management, whereas the US system assumes that a milder treatment of the previous management can lead to earlier filed insolvency petitions. American managers are induced to early filing by the 'carrot' represented by Chapter 11, whereas European ones by the 'stick' of their legal sanctions (White, Michel, in: Bhandari, Jagdeep S./Weiss, Lawrence A., p. 478).

The most important difference, however, is that in the USA there are largely uniform insolvency proceedings, from which the EU, in spite of all its efforts, is still no small distance. This article has described only three EU countries; if it had considered all 25, the picture would have been confusing. Not only is the legal tradition different, but so is legal certainty. (La Porta/Lopez-de-Silanes; Claessens/Klapper).

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