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Analysis of basic bankruptcy proceedings (case study of Russia and developed countries)

Abstract
The author examine the basic mechanisms of modern systems of bankruptcy regulations through using instruments and methods of modern institutionalism. The efficiency of voluntary agreements has been proved as a tool for solving crises situations which cause cost reduction. Voluntary agreements help maintain confidentiality and a shorter duration of reorganisation procedures.
The article studies and describes characteristics of the contracting of economic agents in the framework of bankruptcy depending on two parameters: self-interest focus and available information, as well as defines its effect on differentiation of the outcome of crises. The authors have specified the trends in modern bankruptcy systems of business entities in the Russian Federation, France, Germany and the USA, as well as determined their influence on the choice of the priority mechanism for resolving the current crises situation. The effectiveness of bankruptcy institute functioning also depends on the type of bankruptcy regulatory system (either prodebtor or procreditor type). In the first case, there is a big risk of unjustified liquidations of insolvent businesses, in the second case, there can occur an undesirable situation when many businesses will be kept operating, though their dissolution is economically preferable.
Keywords: Financial Insolvency; Liquidation Procedures; Rehabilitation Procedures; Voluntary Agreements
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(на прикладі Росії та розвинених країн)
Анотація
У статті досліджено базові механізми системи регулювання процесів банкрутства з використанням інструментарію та методологічних положень сучасного інституціоналізму. Доведено ефективність добровільних угод як механізму вирішення кризових ситуацій, обумовлену зниженням витрат, що супроводжують їх реалізацію; збереженням конфіденційності; меншою тривалістю реорганізаційних процедур. Вивчено й описано особливості контрактації економічних агентів, що здійснюється в рамках інституту неспроможності залежно від двох параметрів: орієнтації на власний інтерес та наявної інформації, – також досліджено його вплив на диференціацію результату кризовості. Установлено спрямованість сучасних систем банкрутства господарюючих суб'єктів (Російської Федерації, Франції, ФРН, США) та визначено їх вплив на вибір домінуючого механізму виходу з кризової ситуації.
Ключові слова: неспроможність; ліквідаційні процедури; реабілітаційні процедури; позасудові добровільні угоди.

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Аннотация
В статье исследованы базовые механизмы современных систем регулирования процессов банкротства с использованием инструментария и методологических положений современного институционализма. Доказана эффективность добровольных соглашений как механизма разрешения кризисных ситуаций, обусловленная снижением издержек, сопровождающих их реализацию; сохранением конфиденциальности; меньшей продолжительностью реорганизационных процедур. Изучены и описаны особенности контрактации экономических агентов, осуществляемой в рамках института несостоятельности в зависимости от двух параметров: ориентации на собственный интерес и располагаемой информации, – исследовано его воздействие на дифференциацию исхода кризисности. Установлена направленность современных систем банкротства хозяйствующих субъектов (Российской Федерации, Франции, ФРГ, США) и определено их влияние на выбор доминирующего механизма разрешения сложившейся кризисной ситуации.
Ключевые слова: несостоятельность; ликвидационные процедуры; реабилитационные процедуры; внесудебные добровольные соглашения.

1. Introduction

Nowadays, issues of insolvency of business entities are the focus of attention of economists and lawyers [2].

According to the 2014 statistics, court proceedings in Russia included 37,800 bankrupsy cases; in 2015 their number was 49,200 [1]. 64,000 enterprise involvency cases were registered in France in 2015; in 2016, their number was 61,620. In general, the rate of bankruptcy filing grew by 25% in the period from 2007 to 2016 [5]. In Germany, 26,235 involvency cases were registered in 2013 [16]. In 2015, 24,700 enterprises became bankrupt in the United States of America [12].

The statement about positive macro- (economic growth) and micero- (investments and capitalisatipn) consequences of the government regulation of bankruptcy is considered an an axiome. Actually, bankruptcy plays the role of an indicator of the current state of the national economy. Its proper functioning is determined by several key mechanisms such as bankruptcy administration, rehabilitation procedures and extrajuditial voluntary agreements. In each specific case, the choice of a tool is dictated by numerous factors including the current economic situation, government policy objectives, importance of a business for national and regional economies, etc. In this connection, it may be especially interesting to study these basic mechanisms in order to assess their comparative efficiency and understand their restricting conditions.

2. Brief Literature Review

Bankruptcy issues are studied by different economists both nationally and internationally. A comprehensive economic analysis of the problem can be found in the works by R. Blazy (Blazy, 2000) [3]; J. Combier (Combier, 1998) [6] and Y. Chaput (Chaput, 1990) [4].

Fundamental studies of the costs that are associated with launching bankruptcy procedures and proceeding were conducted by R. A. Haugen (Haugen, 1988) [11]; L. W. Senbet (Senbet, 1988) [11]; L. A. Weiss (Weiss, 1990) [22] and M. White (White, 1983) [21].

Some of the most optimal ways to resolve conditions of financial distress were proposed by J. D. Guigou (Guigou, 1995) [8]; R. Giammarino (Giammarino, 1989) [8]; E. Tashjian (Tashjian, 1996) [20]; R. S. Lease (Lease, 1996) [20] and others.

Today, bankruptcy problems are introduced in the materials presented by M. Lemerle (Lemerle, 2016) [12]; B. Soinne (Soinne, 2014) [18]; Sami Ben Jabeur, Youssef Fahmi, Abdellatif, Hicham Sadok (Jabeur, Fahmi, Taghzouti, & Sadok, 2014) [2]; C. Pietralunga [16].

V. V. Stepanov (Stepanov, 1999) [19] and A. D. Radygin (Radygin, 2005) [17] have studied bankruptcy procedures in the frameworks of Russian and foreign models of insolvency regulations.

Research methods. The authors are using the institutional approach to study bankruptcy processes. It is based on using the theory of the contracting of economic agents and focused on changing a basic one-person economic model into a neo-institutional model. Methods of scientific abstraction, synthesis, induction, deduction, empirical and benchmarking analysis are used in the research work.

3. Purpose

The purpose of the research is to examine basic mechanisms of modern systems of bankruptcy in both the Russian economy and developed economies through using instruments and methods of modern institutionalism and analyse their effeciancy in the terms of ensuring the maintenance of productive capacities.

4. Results

Until early 20th century, bankruptcy proceedings used to be the only tool applied to insolvent businesses. When bankruptcy proceedings were opened, the debtor's top manager was suspended from the duty, while all debtor's assets were aggregated by the competitive manager whom the creditors could lay claims to.

After all creditors' claims had been determined and all assets aggregated, the competitive manager started to distribute them in accordance with specified priority. At the end of the 19th century, such a procedure seemed to be sufficient and appropriate as the economy then was characterised by prevailing small businesses, the bankruptcy of which had no significant negative effect on regional and national economies [17, 14-15].

In the 20th century, there was an emerging trend towards the concentration of production and capital, which gave birth to bankruptcy legal regulation reforms which, in addition to bankruptcy proceedings, foresaw rehabilitation procedures directed to the preservation of an insolvent business and the recovery of its solvency.

The reason is that liquidation of an insolvent debtor is able to cause significant economic damage because in this case:

- not all creditors' claims, especially unsecured ones, can be met;
- the liquidation of an economic entity disintegrates established economic relationships and, as a result, one bankruptcy may be followed by a chain of other bankruptcies, i.e. it causes the knock-on effect;
- the value of an integrated production system is much higher than the value of fragmented equipment pieces [19, 23].

This explains why rehabilitation procedures and extrajuditial voluntary agreements have started to play a very important role in modern systems of bankruptcy control.

If rehabilitation procedures are initiated, the main issue is how this rehabilitation should be run and who is to pay for it [9, 63-66]. It is important that the losses are distributed between all participating parts evenly. Moreover, it should be taken into consideration that governmental bodies, creditors and employees are interested in the fullest and soonest satisfaction of their claims. Best of all it can be accomplished when a business is dissolved through bankruptcy proceedings. If a business entity is retained, the creditors' property rights are impaired, though the creditors will excersise their right to influence the course of rehabilitation procedures. This influence can be different: starting from creditors'complete control over the situation, like in Germany, and finishing with the ban from participating in the rehabilitation procedures, like in France.

Another essential issue within the framework of rehabilitation procedures is to determine the person who will manage the insolvent business. For example, when bankruptcy administration is used in Russia, the business is put under complete control of the court-appointed administrator. In France and in the USA, there are two possible options: either the top manager continues to perform all administrative functions or the business is totally managed by the third-party (external administrator) who is appointed by court [18].

A different way to preserve a business is to make a voluntary agreement between the debtor and the creditors. Such agreements make provisions for the debt restructuring or for the financial support of the debtor, while the creditors have to agree with the latter, because otherwise they take the risk to remain without any revenue at all. Voluntary agreements have following advantages:

- lower cost as compared with the cost of initiating and running bankruptcy procedures [11; 22];
- ensured confidentiality (an open declaration of insolvency may cause credibility gap and affect the business detrimentally);
- shorter reorganisation period [21];
- higher percentage of debt redemption (80% in case of a voluntary agreement compared with 51% in bankruptcy) [7].

In the above context, it is evident that an insolvent business has more chances to recover without initiating bankruptcy procedures. However, in practice, the number of initiated bankruptcy procedures significantly exceeds the number of voluntary agreements. It is related to the fact that in bankruptcy proceedings individual suits against the debtor are prohibited, creditors' information asymentry is eliminated, measures are taken to keep the debtor's assets and should the decision be taken about the replacement of the business top manager, its new administrator is carefully selected, etc. [8; 13]. As a result, many insolvent businesses prefer formal bankruptcy procedures to making voluntary agreements.

A relatively recent way to resolve the condition of financial distress is «a prepackaged bankruptcy» («prepacks»),

which is a hybrid reorganisation form combining some features of formal procedures and voluntary agreements. Like in a voluntary agreement, the reorganisation period is determined arbitrarily by the creditors and business management without court mediation. Concurrently, the bankruptcy procedure is initiated; the rehabilitation program is developed, approved and brought to a vote. The goal of a prepack is to overcome disadvantages of existing formal bankruptcy procedures and voluntary agreements, so that to reduce costs and involve all creditors into reorganisation measures. The research has demonstrated that nearly all businesses reorganised as prepacks have successfully got over financial difficulties, which shows sufficient effectiveness of the abovementioned procedure [20].

The decision about which procedure fits better in each specific case - to make an extrajuditial agreement, to initiate liquidation or rehabilitation procedures - should be made taking into consideration multiple factors. However, the chosen procedure should ensure the maximisation of the value of economic entity assets. In each specific situation the choice of the procedure type should be based on the following postulates:

1. It is advisable to keep the business that does not need any new loans to continue its operation, provided that its confirmation value (V_c) is bigger than its realisable value (V_l) and vice versa.
2. If a business is not able to operate without new borrowings, its preservation is expedient only if V_c - V_l is bigger than the new loan value (Table 1).

Tab. 1: **Business preservation or liquidation decision-making criteria**

	Period 1	Period 2	Period 3
Revenues of the economic entity	9	9	9
Creditors' debt in t period *	14	14	14
In case of continued operation			
Debt repayment in t+1 period **	–	5	5
Debt repayment in t period	9	4	4
In case of business liquidation (V_l=0)			
Debt repayment in t period	9	0	0

Notes: * - period before the debtor's bankruptcy adjudication;
** - period after the initiation of bankruptcy proceedings.

Source: [6]

Thus, the chosen way to resolve financial distress should ensure the maximisation of the economic entity value and, consequently, of social wealth.

However, in economic practice there are certain barriers that may hinder an optimal decision regarding the insolvent business and, first of all, there are conflicting interests of economic agents involved in bankruptcy procedures and the character of national system of bankruptcy regulation. Let us discuss both factors.

Conflicting interests of economic agents involved in bankruptcy procedures.

Economic entities that are interacting within the institutional frameworks form their own behaviuoral patterns according to their targets that are determined by the revenue pattern [14, 41-49] and specifically:

- the shareholders and management are likely to be interested in keeping the business. Otherwise, the management will loose control powers, while the shareholders, whose claims are met after all others, will get nothing;
- those creditors whose claims are not satisfied in the first place will prefer to have the business operating even under the conditions when its liquidation is economically appropriate. Such a decision will be taken if the realisable value is not sufficient to satisfy all claims;
- on the contrary, the prefrencial creditors will prefer liquidation, even if the business is viable, though experiencing temporary financial difficulties.

Thus, when economic agents are considering bankruptcy procedures, first of all they are governed by their specific interests. As a rule, the criterion of economic expediency is not taken into consideration.

The character of national system of bankruptcy regulation.

Modern systems of bankruptcy regulation can be divided into two opposed groups: there are debtor biased systems in the first one, or prodebtor regulatory systems (USA, France), threre are creditor biased systems in the other, or procreditor regulatory systems (Great Britain, Germany).

Procreditor procedures usually presuppose the placement of an insolvent business's assets under the control of a person who is appointed by court. Acting in creditors' interests, this person liquidates the business quickly (often by one-time sale). In this case, bankruptcy petition usually is filed later than it would be optimal from economic point of view [15, 82-86].

It is worth noting that the liquidation of a company is inevitably accompanied by an increase of transaction costs (suppliers' loses, investment reduction, reduced fiscal revenues, customer-related costs, etc.) [3, 72].

France is a good example of expressed prodebtor regulatory system, i.e. the primary goal here is to keep an economic entity that may be in a temporary financial distress situation. First of all, this trend is demonstrated in the will to offer the insolvent business different ways of solvency recovery. Though the French system gives preference to keeping crisis businesses, it infringes upon the creditors' interests, including secured creditors at the same time [4].

Economic effectiveness also conflicts with the main criterion that is applied when choosing a new owner of an insolvent business, and that is to maintain employees. In this case the specified value may be less than the fair market value [10]. All buy-out proposals are examined by a judge who makes a personal decision on the candidacy of the new owner. In this way, the creditors are completely barred from establishing the buy-out price, though their revenues depend on it largely.

Indulgent attitude towards debtors seems to be a very serious disadvantage of the French bankruptcy, because it does not give any incentives that can stimulate top management to make a voluntary agreement with the creditors or to look for any other ways to resolve financial distress. On the other hand, in the search for the finance that will be sufficient to overcome critical conditions the CEO of an insolvent business may decide on taking risky investment projects thus jeopardising the creditors' interests.

In order to surmount the abovementioned limitations, there is a need to determine an economically appropriate regulatory «leniency» in respect of the top manager of an insolvent business.

Thus, the diverging motivators of the persons who exercise certain rights concerning the distressed business, on the one hand, and the orientation of the existing bankruptcy regulation system towards the interests of either the debtor or the creditors, on the other hand, are the main factors that prevent applying the most efficient bankruptcy tools in each specific case. It might be worthwhile to aim further economic research at the ways to eliminate the conflict of interests and the dilemma between prodebtor and procreditor bankruptcy regulatory systems in order to ensure bankruptcy functioning in full compliance with the maximisation public wealth.

5. Conclusions

Basic tools of modern bankruptcy regulation systems are extrajudicial voluntary agreements, rehabilitation procedures and bankruptcy administration.

A modern tenency is to keep a financially distressed business operating. In this case, the main criterion is the maximisation public wealth. If the final decision about the future of an insolvent business is made by a certain stakeholder category (such as shareholders, creditors or management), this decision is usually far from being optimal. In other words, the decision is made considering the interests of only one interested group without taking into account the interests of national economic system.

The effectiveness of bankruptcy institute functioning also depends on the type of bankruptcy regulatory system (either prodebtor or procreditor type). In the first case, there is a big

risk of unjustified liquidations of insolvent businesses, in the second case, there can occur an undesirable situation when many businesses will be kept operating, though their dissolution is economically preferable.

Theoretically, the bankruptcy should conciliate the interests of all stakeholders by means of resolving existing distribution conflicts in accordance with the Pareto-optimal condition criterion when the conditions for maximisation of the objective function of one group of economic agents coincide with the conditions under which an increase in the wealth of this group is not possible without a decrease in the wealth of the other group.

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