TWO NEW MEASURES OF BANKRUPTCY EFFICIENCY

by
Riccardo Brogi and Paolo Santella

SUERF – The European Money and Finance Forum
Vienna 2004

CIP

TWO NEW MEASURES OF BANKRUPTY EFFICIENCY

by Riccardo Brogi and Paolo Santella

Vienna: SUERF (*SUERF Studies:* 2004/6)

ISBN 3-902109-25-4

Keywords: Bankruptcy, insolvency, corporate governance, banking, regulation efficiency.

JEL Classification Numbers: G33

TWO NEW MEASURES OF BANKRUPTCY EFFICIENCY[1]

By Riccardo Brogi[2] *and Paolo Santella*[3]

Corresponding author:

Riccardo Brogi
Regulatory Impact Assessment Department
Associazione Bancaria Italiana
Piazza del Gesù 49
I-00186 Rome
ITALY

Tel: +39 066767402 (Phone)
Fax: +39 0667678030 (Fax)
E-mail: r.brogi@abi.it

---

[1] The findings, interpretations and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the Associazione Bancaria Italiana, Banca d'Italia or OECD. Riccardo Brogi thanks for the very helpful comments and insights from Pietro Scabellone and Gianfranco Torriero and Cristina Raponi for research assistance with regard to New Basel Capital Accord formulas. Paolo Santella wishes to thank Enrico Baffi, Luigi Cannari, Stefano Cappiello, Salvatore Chiri, Silvia Giacomelli and Massimo Omiccioli for their for help and guidance.

[2] Associazione Bancaria Italiana

[3] European Commission and Banca d'Italia

Abstract

This study is aimed at developing new empirical models for evaluating the efficiency of bankruptcy legislations. The paper is divided in three parts. In the **first part**, we analyze from a conceptual point of view the effects on debtor firms of the lack of creditors' powers in bankruptcy. In the **second part**, we develop a new rating method for bankruptcy legislations according to their degree of creditors' protection and apply it to five European countries. In **the third part**, we introduce a new approach for empirically estimating the efficiency of bankruptcy legislation based on the cost of banking credit and we test it on the Italian case. In particular, the unprecedented tool being used in the third section consists of the New Basel Capital Accord, i.e. the capital adequacy regulatory framework that is about to be put into effect as of the end of 2006.

TABLE OF CONTENTS

1. Some remarks about the lack of creditors' powers in bankruptcy

The purpose of this section is firstly to recapitulate and order the main conclusions reached by economists on the functions of bankruptcy and then to show (taking the Italian legislation as an example) the costs of the inadequacy of bankruptcy on debtor enterprises.

1.1 Credit recovery and corporate governance

The economic function of bankruptcy[4] has been investigated by economists specialized in several fields, such as finance, the theory of the firm, the study of property rights and of corporate governance.[5] Two functions have been singled out as a result:

a) Proper working of the invisible hand mechanism
The first function of bankruptcy is to allow unpaid creditors to seize the insolvent debtor's assets, sell them and invest the proceeds in other venues.

[4] In this paper we use the terms "bankruptcy legislation" and "bankruptcy" for all the procedures of liquidation, financial restructuring, and crisis prevention that are contained in national legislations. In particular, although "insolvency" and "bankruptcy" have not the same meaning in the United States and in the United Kingdom – in the United States insolvency by a firm is described as bankruptcy, whereas in the United Kingdom such a description is used is applied to individuals – in this research they have almost the same meaning.

[5] See for instance Ronald Coase, *The Nature of the Firm*, Economica, vol. 4, p. 386–405, 1937; F. A. Hayek, *Individualism and Economic Order,* Chicago, The University of Chicago Press, 1949; Ronald Coase, *The Problem of Social Cost*, Journal of law and Economics, vol. 3, 1960; Harold Demsetz, *The Exchange and Enforcement of Property Rights*, Journal of Law and Economics, ott. 1964, reprinted in Harold Demsetz, Ownership, Control, and the Firm, The Organization of Economic Activity, vol. I, Oxford, Basil Blackwell 1988; Armen A. Alchian, *Some Economics of Property Rights*, Il Politico, vol. 30, p. 816–29, 1965, reprinted in A. A. Alchian, Economic Forces at Work, Indianapolis, Liberty Press, 1977; Harold Demsetz, *Toward a Theory of Property Rights*, American Economic Review, May 1967, reprinted in Harold Demsetz, Ownership, Control, and the Firm, The Organization of Economic Activity, vol. I, Oxford, Basil Blackwell 1988; F. A. Hayek, *Studies in Philosophy, Politics and Economics*, Chicago, The University of Chicago Press, 1967; M.C. Jensen et W. H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, Journal of Financial Economics, vol. 3, p. 305–60, 1976; Franco Romani, *L'analisi economica del diritto di propriet/*, proceedings of the workshop held by the Acton Society, All Souls College, Oxford, June 1978; S.N.S. Cheung, *The Contractual Nature of the Firm*, Journal of Law and Economics, April 1983; Franco Romani, *Some Notes on the Economic Analysis of Contract Law*, in European University Institute, Series A: Law Contract and Organization: legal analysis in the light of economic and social theory, 1986; Michael C. Jensen, *Active Investors, LBOs, and the Privatization of Bankruptcy,* Continental Bank Journal of Applied Corporate Finance, vol. 2, p. 35–44, 1989.

On the one hand, in western economic systems decentralized decisions are coordinated through the price system (the so called invisible hand), through which economic agents decide which economic initiatives to encourage. The juridical basis of the price system is given by two fundamental features of western systems, to give owners exclusive control on scarce goods[6] and to allow transfer of ownership by way of contract.[7] The result is that goods end up in the hands of those who use them most efficiently.

On the other hand, the modern enterprise (but more generally the enterprise *tout court*, if we think about the *accomandita* in the middle ages and the forms of enterprise in the ancient Rome[8]) is founded on the separation of ownership and control, which allows to take advantage of the benefits of specialization between the entrepreneur and the financial investor.

In this context the role of the law is to mediate (or, as an economist would say, to reduce transaction costs) between the exclusivity of control over goods and the necessity to delegate their use. Bankruptcy's pivotal role is due to the fact that it allows creditors to redeem their resources from insolvent enterprises so as to lend them to more profitable venues.

b) Control on the debtor's management

Bankruptcy legislation coordinates exclusivity of ownership of scarce goods and delegation of their use in a second and not less important way, that is by allowing creditors to monitor the management of the debtor enterprise. While in the former case the function of bankruptcy is to give creditors the right to disinvest from the insolvent enterprise, ensuring the functioning of the exclusivity clause; in this case the *threat* of bankruptcy, being the main tool creditors have to monitor the debtor enterprise, takes care of the working of the delegation clause.[9] From this point of view, corporate law and bankruptcy law can be seen as the two complementary legal preconditions which allow

[6] A more correct definition should refer not to ownership of goods but to ownership of rights which insist on goods.

[7] See also Anthony de Jasay (1991), *Choice, Contract, Consent: A Restatement of Liberalism*, London, The Institute of Economic Affairs, and Stig Strömholm (2002), *L'Europe et le droit*, Paris, Presses Universitaires de France.

[8] On which see for instance H. Hansmann, R. Kraakman and R. Squire (2002), *Legal Entities, Asset Partitioning, and the Evolution of Organizations*, mimeo.

[9] See M. C. Jensen and W. S. Smith jr. (1984), *The Modern Theory of Corporate Finance*, New York, McGraw Hill Inc., p. 14: "Some of [the bankruptcy costs] arise because the bankruptcy trustee is an agent of the court and thus has limited incentives to make value-maximizing investment or financing decisions. Good estimates of these costs do not yet exist; but in general, they are unlikely to be trivial." See also Rasmussen and Skeel (1995), p. 93: "Because→

the financial contributors to the enterprise (shareholders and creditors) to monitor its management.[10]

The efficiency of these instruments is above all in the interest of the debtors themselves: if corporate law allows shareholders to monitor managers this reduces the cost of capital; likewise, if bankruptcy legislation makes the threat of bankruptcy credible, this reduces the cost of credit. Efficient protection of the contributors to the enterprise (shareholders and creditors) makes the former buy the stock of the enterprise at a higher price and the latter give loans at a lower rate of interest.

***

To sum up, bankruptcy may be seen as a sanctioning device at the hands of creditors in a double sense, either as a right to disinvest from an insolvent enterprise and as a tool to monitor the debtor enterprise's management all along the credit relationship. The conclusion is that every legislator should give directive powers to creditors in bankruptcy.

1.2. Bankruptcy and creditors coordination

In this context must be evaluated what *further* characteristics bankruptcy should have. The debate has been opened twenty years ago by Thomas Jackson,[11] who provided an argument in favor of the automatic stay of creditors' individual claims. Jackson wrote that the multiplicity of creditors and their alternance in time which normally characterizes the financial structure of enterprises at the moment of their insolvency may induce its ordinary creditors to anticipate one another in a costly zero-sum game. A collective bankruptcy would allow to coordinate ordinary creditors' claims by distributing the debtor's unencumbered assets in proportion to the amount due to each ordinary creditor.

---

market participants are penalized by the markets if they make bad decisions (they lose money), and rewarded for making good decisions (they make money), a market player has a strong incentive to make wise business decisions. By contrast, since a bankruptcy judge does not have a personal stake in the firm, she does not bear the consequences of any business decision made in the bankruptcy context."

[10] See also Harold Demsetz (1995), *The Economics of the Business Firm*, Cambridge University Press, p. 43–4 and Richard Posner, *Economic Analysis of Law, 5th , Aspen Law & Business, 1998*, p. 439 who aver that the risk of bankruptcy is an incentive for managers to follow shareholders' will.

[11] Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, Yale Law Journal, vol. 91, pp. 857–907, 1982

Jackson's argument has elicited several proposals aimed at singling out mechanisms to distribute debtors' assets without any waste of resources. These proposals are all aimed at distributing automatically, although in different ways, the insolvent debtors' assets to creditors, for instance through auction selling (which entails dissolving the insolvent enterprise's juridical identity) or by turning creditors into shareholders (which allows to cancel debt thereby maintaining the enterprise juridical identity).[12]

Other authors have contrasted Jackson's vision arguing that creditors and debtors are able to efficiently coordinate their interests by way of contract.[13]

Anyway, the different points of view in both camps share the necessity to recognize directive powers to creditors in bankruptcy and to give public authorities (judiciary and administrative) the role to ascertain the regularity of the procedures but not to direct them.

1.3. The inadequacy of Italian legislation

European legislations deal with the role of creditors in bankruptcy in very different ways. Nonetheless, in several cases creditors are given directive powers: among the solution chosen there are countries where the collective principle is rigidly applied (Sweden) and other countries who do not recognize the automatic stay of creditors (United Kingdom and Germany).[14]

---

[12] See for instance Douglas Baird, *The Uneasy Case for Corporate Reorganization*, Journal of Legal Studies, vol. 15, p. 127ff., 1986; L. Bebchuk, *A New Approach to Corporate Reorganization*, Harvard Law Review, p. 775–804, 1988; P. Aghion, O. Hart and J. Moore, *The Economics of Bankruptcy Reform,* Journal of Law, Economics and Organization, vol. 8, p. 523–46, 1992; M. Bradley and M. Rosenzweig, *The Untenable Case for Chapter 11*, Yale Law Journal vol. 101, p. 1043 ss., 1992; Barry Adler, *Financial and Political Theories of American Corporate Bankruptcy*, Stanford Law Review, vol. 45, p. 311 ss., 1993; Oliver Hart, *Different Approaches to Bankruptcy,* 2000, http://www.nber.org/papers/w7921.

[13] See J. W. Bowers, *Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure*, Michigan Law Review, vol. 88, p. 2097–2150, 1990; R. K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy,* Texas Law Review, vol. 71, p. 51–121, 1992; R. K. Rasmussen and D. A. Skeel, *The Economic Analysis of Corporate Bankruptcy Law,* American Bankruptcy Institute Law Review, vol. 3, p. 85–115, 1995; Alan Schwartz, *The Law and Economics Approach to Corporate Bankruptcy,* in "Faillite et concordat judiciaire: un droit aux contours incertains et aux interférences multiples", proceedings of the conference held in Louvain-la-Neuve (Belgium) on 25 and 26 avril 2002, Bruxelles, Bruylant, p. 243–73, 2002. Schwartz also demonstrates that it is possible for creditors to "bribe" debtor companies' administrators not to prevent its liquidation in case of insolvency.

[14] See Paolo Santella, *Le procedure fallimentari in Italia e in Europa e il costo dei rimedi giuridici del credito bancario*, Bancaria, December 2002.

It is open to debate which of these systems is preferable in ensuring the best coordination of creditors' interests, as well as whether and to what extent the law might integrate the contractual activity of creditors and debtors in order to facilitate the financial restructuring of ailing enterprises.[15] Anyway, since the characteristic of the Italian system is to deny any directive role for creditors (who may, under the provisions of the liquidation procedure introduced by 1942 bankruptcy act and the financial restructuring procedure introduce by the 1999 extraordinary administration act, just express non-binding opinions),[16] the main goal of a bankruptcy reform in Italy should be, before solving the problem of their coordination, to guarantee creditors credible powers of deterrence vis-à-vis insolvent debtors.

1.4. The costs of the inefficiency of bankruptcy legislation

In the end, the debtor enterprises ultimately bear the cost of an inefficient bankruptcy legislation, at least from two points of view.

In the first place, it is logic to assume that the subordination of creditors be reflected on the working of the credit system, since banking creditors have the interest and the possibility to transfer to the debtors the costs of bankruptcy legislation, first of all in the form of higher interest rates but presumably also through other forms of self protection such as credit rationing, multiple creditors, lower average credit length or amount.

In the second place, the price inflicted by the inefficiencies of bankruptcy legislation on debtor enterprises may translate itself not just in a higher cost of credit, but also in a deficient monitoring on debtor enterprises on the part of creditors. According to not just Berle and Means[17] and Galbraith[18], but also Schumpeter in his *Capitalism, Socialism and Democracy*,[19] an inefficient monitoring of managers by shareholders represents a very serious danger for

[15] The reference on this point is of course the American *Chapter 11* procedure, for a first introduction to which see L. A. Bebchuk, *Chapter 11*, in The New Palgrave Dictionary of Economics and the Law, vol. I, London, Macmillan, 1998 p. 219–24.

[16] See Paolo Santella, *Alcune considerazioni su soluzioni alternative in tema di fallimento*, La rivista del diritto commerciale, n. 3-4/5-6, 2002. It is important to signal that in Italy these problems are made even more serious by the extraordinary length of bankruptcy procedures and by the obstacles that bankruptcy legislation poses to the negotiating activity of creditors and debtors aimed at preventing insolvency.

[17] Berle, A., and G. Means (1933)

[18] J. K. Galbraith (1967), *The New Industrial State*, Boston, Houghton Mifflin

[19] Joseph A. Schumpeter (1942), *Capitalism, Socialism and Democracy*, Harper & Brothers.

the western economic system, whose enterprises could run the risk of being managed by managers-bureaucrats irresponsible to their shareholders. On this point, even though further researches have showed the efficiency of company law to allow shareholders to monitor management,[20] the prompt reactions which take place periodically following episodes of corporate mismanagement are proof of the full conscience in western countries of the importance that managers be faithful executors of the shareholders' will.[21]

More recently, the growing importance of debt capital on the total assets of modern business enterprises has brought to attention the other part of corporate governance, that is monitoring by creditors on debtor companies' management. In this case the debate focuses on whether bankruptcy legislation allows creditors to sanction those debtors who do not respect credit contracts. Due to the poor credibility of sanctioning instruments, enterprises might suffer from lack of control on management proportional to their recourse to credit.[22]

For these reasons it should be recognized that, in countries where creditors do not have directive powers in bankruptcy, the reform of bankruptcy legislation is one of the most important structural reforms.

---

[20] See the proceedings of the conference "Corporations and Private Property" published by the Journal of Law and Economics, June 1983, with contributions by George Stigler, Douglass North, Eugene Fama and Michael Jensen, Oliver Williamson and Harold Demsetz; See also the comparative study by La Porta R., F. Lopez-de Silans, A. Shleifer and R. Vishny, *Law and Finance*, Journal of Political Economy, vol. 106, m. 6, p. 1113–55, 1998 in which the authors show that US and other Anglo-Saxon legal system allow for efficient management monitoring even in fragmented ownership structures.

[21] This of course does not mean that there are no changes to be made in corporate law. For surveys on the main issues on discussion, see for instance A. Shleifer and R. Vishny, *A Survey of Corporate Governance*, Journal of Finance, vol. 52, n. 2, 1997; D. K. Denis and J. J. McConnell, International Corporate Governance, 2003, mimeo.

[22] There have been in the last years several studies on the characteristics of bankruptcy around the world, see for instance Lopez-de-Silanes, F., A. Shleifer and R. Vishny, *Legal Determinants of External Finance*, Journal of Finance, vol. 52, n. 2, 1997; La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny, *Law and Finance*, Journal of Political Economy, December 1998. Waiting for systematic studies on the relationship between economic growth and bankruptcy, Bergoeing, R., P. J. Kehoe, T. J. Kehoe and R. Soto, *Decades Lost and Found: Mexico and Chile Since 1980*, Federal Reserve Bank of Minneapolis Quarterly Review, vol. 26, n. 1, p. 3–30, 2002, single out the introduction of directive powers for creditors (together with privatization of state-owned assets) as the reason for the high rate of economic growth in Chile in the period 1980-2000.

1.5. Conclusion

Whenever bankruptcy legislation cannot guarantee the possibility for creditors to recover their credits from insolvent debtors, the working of an economic system based on private property may be impaired.

Furthermore, whenever the threat of bankruptcy does not exert credible deterrence on debtors, the possibility for creditors to monitor the management of debtor enterprises may be impaired. In proportion to the importance of debt on total assets, enterprises are at risk of being managed inefficiently by managers who have power without responsibility.

In countries where bankruptcy legislation already gives directive powers to creditors, the attention should be focused on singling out procedures to coordinate their action; on the other hand, where, as in Italy, creditors have no directive powers in bankruptcy, that debate should wait for the introduction of such powers.

2. A rating method for bankruptcy legislations

In this chapter, with reference to five European countries (Sweden, United Kingdom, Germany, France and Italy), we examine the cost for banking creditors of bankruptcy procedures (2.1) according either to the powers banking creditors and the time of recovery of credits. As for the former, Italy and France do not recognize any directive role to creditors, just the authority to deliver non-binding opinions to the court. Furthermore, especially in countries where creditors do not have directive powers in bankruptcy, an accessory interpretative tool is represented by the length of the procedures, which contributes to make the threat of bankruptcy less credible.

The chapter then goes on to examine (2.2) the other forms of recovery of banking credit, that is free covenants (made more difficult in Italy and France by certain provisions of bankruptcy legislation) and enforcement proceedings, whose length is significantly different among the considered countries.

2.1. Bankruptcy procedures according to creditors' protection and length

In this section we examine bankruptcy procedures according to the degree of creditors' protection and the length of the procedures.

a) Sweden

According to the main bankruptcy procedure (*Konkurslagen*)[23] from the declaration of bankruptcy[24] ensues that the management of the debtor's assets is entrusted to the trustee, who must take all the measures necessary to achieve a favourable and rapid winding-up so as to distribute its proceedings

[23] The other existing procedure (*Ackordslagen*) is rarely applied (50 cases out of 9000 every year according to Mimeo 1999, p. 31), and it is aimed at preventing insolvency. See on this point Strömberg 2000, p. 2645, who attributes the causes of its inefficiency to (i) the necessity that the restructuring plan provide an entire reimbursement for preferential creditors and at least 25% to ordinary creditors; (ii) the impossibility to give new creditors precedence over preferential creditors; (iii) the impossibility to apply to this procedure some provisions concerning state-funded employee protection measures which apply in case of insolvency.

[24] Creditors who wish to request the opening of the procedure must prove the state of insolvency (the Swedish legislation defines insolvency as the temporary inability for the debtor to pay its debts).

to the creditors according to their priority.[25] The trustee must not necessarily liquidate the debtor's assets piecemeal: when it is in the creditors' interest, he may sell all the assets as a going concern. It is what happens in the majority of cases, thing which guarantees a particular celerity to the entire procedure.[26] From the declaration of bankruptcy ensues the impossibility for preferential and non-preferential creditors[27] to make recourse to individual legal proceedings against the debtor's estate. Only the trustee is allowed to sell the debtor's assets.[28] On the other hand, creditors have an important role in bankruptcy processes, particularly as regards monitoring the trustee. Although the trustee is nominated by the court, she is monitored by an inspector nominated by the creditors who, in the case they are not satisfied with the trustee's administration, may ask the court to appoint a new trustee. Besides, the trustee needs the consent of creditors holding security in real property and personal property before selling such property.[29]

Several provisions make sure bankruptcy proceedings are short, in particular creditors' monitoring powers on the trustee, the low degree of bureaucracy of the procedure[30] and, as we have seen, the wide range of solutions to which the trustee may make recourse so as to liquidate the bankrupt enterprise's assets. Furthermore, the trustee has an interest in closing the procedure in a short time, since he is the sole responsible for the management of the bankrupt's assets[31] so that he is responsible to the creditors in case of negligence.

---

[25] The trustee must obtain the consent of creditors holding security in real property before selling such property (see Swarting (2002))

[26] Strömberg (2000), p. 2647, reports for these cases an average length of the procedure of 2–3 months. Strömberg and Thornburn (1996) estimate the average cost of insolvency procedures in Sweden at 19.4% of the debtor's assets.

[27] With the exception of the retention of title and leasing. The Swedish law considers among preferential creditors also those creditors entitled with a *floating charge*. The *floating charge* is a security interest in the changing assets of a business enterprise. Different from the situation in the UK, the creditor entitled with a floating charge may not appoint a receiver, who under the Swedish law must act in the interest of all creditors. See Galanti (2000).

[28] See Åbjörnsson (2002), p. 116.

[29] Swarting (2002), p. 261.

[30] For instance, only in a minority of cases do the creditors need to file proofs of debt with the court. In the majority of cases the trustee alone administers the winding up of the estate (cf. Swarting (2002), p. 261).

[31] The role of the court is limited to approving the distribution to creditors of the proceedings of the liquidation of the debtor's estate.

b) The United Kingdom

Bankruptcy legislation in the UK traditionally gives a directive role to creditors either in the liquidation procedures[32] and in the main reorganization procedure, *Receivership*.[33]

In Receivership floating-charge creditors are entitled[34] to nominate a trustee (receiver) to manage the insolvent debtor enterprise. The task of the receiver is to manage the debtor company so as to satisfy the floating charge creditors. The receiver may choose between liquidating the debtor's estate piecemeal and selling the entire business to a third part. In the performance of these duties he may not violate the rights of legal priority creditors and fixed-charge creditors. Receivership does not prevent other creditors (non-preferential creditors) to apply for the liquidation of the company. In that case, they may appoint a trustee to monitor the receiver and to manage the debtor's assets left after floating-charge creditors have been satisfied.[35]

The characteristic of the Receivership is to allow to safeguard viable assets in financially troubled companies without necessarily guaranteeing the survival of the enterprise in its legal identity. Since the receiver's task is to liquidate at the best possible terms some or all the debtor's assets, normally the extinction of the debtor company ensues.[36] Because of the fixed costs required, the receivership procedure is used to deal with the insolvency of sizable companies.[37]

[32] They are the *Creditors Voluntary Liquidation* and the *Compulsory Liquidation*.

[33] See Citron et al. (2002), p. 3, who report that, in the period 1992–1998, 85% of the insolvency procedures were liquidation procedures (compulsory liquidation or creditor voluntary liquidation) and 12% Receivership.

[34] Without asking for the authorization from the court or from other creditors.

[35] This explains why creditors entitled with floating charge usually request also fixed charges. See in this respect Citron et al. (2002), p. 3: "In practice, creditors usually ensure they hold both floating and fixed charges, the former to give the right of appointment of administrative receiver and the latter to gain priority over certain assets realisations."

[36] The Receivership constitutes the bulk of the restructuring procedures commonly used. Scarcely applied is the other restructuring procedure, the *Company Voluntary Arrangement*, which consists of the approval by the majority of creditors of a reorganisation plan submitted by the trustee in charge of the Administration. The latter procedure has been introduced by the 1986 Insolvency Act, which gives the court the power to appoint a trustee who must take care of the rights of all creditors, not just of the creditors entitled with the floating charge. At least until 2002 the Administration was severely limited by the Receivership: on the one hand, the Administration could not be initiated during Receivership; on the other hand, creditors entitled with *Floating Charge* could initiate the Administration even after the opening of the *Receivership*. On 9 November 2002 the new Enterprise Act obtained the Royal Assent. It provides, among other things, several limitations to the possibility for creditors entitled with Floating Charge to nominate an administrative receiver. For an introduction to the new Enterprise Act see Shandro (2002) and Rajak (2003).

[37] See Franks and Sussman (2000), p. 19.

In the case of liquidation procedures, the court appoints a trustee to liquidate the insolvent enterprise. The trustee represents all the creditors, not just the preferential ones. On the other hand, even though liquidation takes places formally under the court's supervision, the procedure is influenced by creditors as well, who take into consideration its lesser administrative costs. Since floating-charge creditors may in fact decide whether to allow the liquidation procedure to take place or to start receivership, they decide on their course upon balancing the possible higher recovery rate guaranteed by receivership with liquidation's lower administrative costs.[38]

c) Germany

According to bankruptcy legislation in force until 1999 there was a radical difference between preferential and non-preferential creditors. While the former could make recourse to individual legal proceedings against the debtor's estate even after the declaration of bankruptcy, for the duration of insolvency proceedings (*Konkursordnung*) the latter could not enforce their claims. Following the opening of the procedure the management of the insolvency estate passed to a court-appointed trustee (*Konkursverwalter*), upon whom creditors had monitoring powers. Even though the task of the trustee was to liquidate the bankruptcy estate and to distribute its proceedings to non-preferential creditors, she could temporarily continue to run the debtor's business waiting for better market conditions. On the other hand, in the majority of cases the collective procedure was made impossible by the selling by the preferential creditors of the secured goods and the consequent closing of the procedure due to lack of assets left.[39]

The reform of bankruptcy legislation which became effective as of 1st January 1999 introduced measures aimed at keeping in business ailing enterprises by means of partially and temporarily preventing preferential creditors to enforce their claims. The new legislation now requires that preferential creditors' right to seize the debtor's assets is suspended for three months so as to promote a reorganization of the insolvent business. It is now possible for a trustee (who can be nominated by the creditors) to present a reorganization plan which must be approved by each class of creditors. A class of creditors accepts the plan if a majority in number and amount in

[38] See Franks and Sussman (2000), p. 19.

[39] Franks, Nyborg and Torous (1996), p. 92–3, who report that in 1992 this happened in 92% of cases