EFFECTIVENESS OF THEROMANIAN BANKRUPTCY PROCEDURE: AN EVIDENCE-BASED LEGAL ANALYSIS

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Abstract: The Romanian legal forums have generated much debate over the recent reform of the Insolvency Law (2014), generally focused on the legislative changes which were put in place in order to ensure the efficiency of the procedure. As there is little insight into the workings of the actual insolvency procedure, the present analysis aims to tackle a new perspective on the Romanian insolvency paradigm in the European and even global context. Thus we have conducted a file-based study of the bankruptcy procedures of 200 Romanian companies, between 2010 and 2013 by which we consider the application of the Romanian Insolvency provisions and their effectiveness in the national context. While, theoretically, the legal provisions strive to ensure primally the protection and safeguard of the debtors, our analysis shows that, in reality, the insolvency system is focused on the liquidation of the company. Our study offers an insightful look at an insolvency system in which the state, through its agencies, is the main creditor, therefore the possibility of a fresh start is (almost) inexistent and the main purpose of the liquidator's actions is related to capital maximization without consideration to the continuation of the activity of the company. We conclude our study with a series of suggestions for the improvement of the efficiency of the insolvency procedure, based on our empirical findings.

Key words*: efficiency, recovery rate, empirical study, reorganization, liquidation*

INTRODUCTION

An efficient insolvency procedure represents the aim that brings together both debtors and creditors, although "efficiency" has different meanings for the two categories of participants.

Efficiency is the concept that covers the ability to create a mechanism able to produce the desired result[1].

This paper follows a dual approach (debtor and creditors respective perspectives) so that one could have a broader picture of the insolvency procedure efficiency.

Thus we have conducted a file-based study of the bankruptcy procedures of 200 Romanian companies, between 2010 and 2013 by which we consider the application of the Romanian Insolvency provisions and their effectiveness in the national context.

I. THE DEBTOR'S SAGA

In the process of analyzing insolvency procedure, in the legal literature there were outlined two types of errors to be avoided: error type I and error type II[2].

Error type I allows inefficient companies go through the process of reorganization, although from the outset, the chances of recovery are minimal. Beyond optimism and indulgence, failure to

[1] Brogi, R., Santella, P., *Two New Measures of Bankruptcy Efficiency*, available at http://www.suerf.org/download/studies/study20046.pdf[20.12.2014].

[2] Gutierrez, C.P.; Olalla, M.G.; Olmo, B.T.: Economic Valuation of the Efficiency of Bankruptcy Systems, the paper is available at http://ssrn.com/abstract=917784 sau http://dx.doi.org/10.2139/ssrn.917784[12.11.2014].

take appropriate action involves significant costs and therefore proportionally reduced chances of debt recovery for creditors.

Error type II is generated by the liquidation of viable companies. This type of action is peculiar to more severe legal frameworks.

The efficiency of the procedure should focus, first, on a key moment: the correct diagnosis of the debtor so as to avoid error type I and II. A second milestone is a personalized treatment and the correct implementation. If after diagnosis there were awarded recovery opportunities, these opportunities have to be exploited in the most productive way possible.

Analyzing Romanian insolvency procedure from a debtor approach, we chose to focus on several indicators as following: the most used insolvency procedure, main participants, their role and responsibilities, recovery rate and duration.

1. No hope for reorganization

Randomly analyzing 200 case law over 3 years (2010-2013) concerning SMEs there are very few chances one can find a reorganization. The result of our study revealed that the insolvency procedure consists of 100% simplified procedures ending dramatically and, however, predictably in bankruptcy. At a national level (including all enterprises, not only SMEs), the results for the same period of time, confirm the percentage with a slight difference: 61517 bankruptcy procedures, 2309 reorganization procedures and 33 successful reorganization procedures[3].

Which are the causes of such disappointing results?

Romanian insolvency procedure proves to be a mechanism meant to clean the market and remove enterprises that are not anymore economically viable. One cannot deny the positive effect of this phenomenon, but which is the role of the reorganization procedure, when does it find its applicability? Reorganization is not for micro and small companies, only companies which cross over the thresholds of the indicators specific to SMEs (number of employees, net asset value, and annual turnover) have the privilege to taste the chance of reinsertion in the market. Our survey showed that SMEs are often entering the insolvency procedure with no or very few resources in order to support a revival process. The inefficiency of applying a treatment like insolvency procedure to an economically exhausted enterprises is caused by two main factors: on one hand, there are the directors who lack of the diligence to treat the financial distress at an early stage in order to increase the chances of recovery; on the other hand, the legal provisions are lacking in incentives for both the debtor and creditors to initiate the procedures and maximize the debts recovery. Establishing an invariable threshold of 40000 lei (in the former law) or 45000 lei (Law no. 85/2014), required as an admissibility condition to enter the insolvency procedure, is not the best solution as this amount is not reflecting the same impact for a SME or a big company. A debt of 45000 may prove a severe distress for a limited liability enterprise and may mean nothing to a big company. Consequently, a one-size-fits-all model is not an efficient approach.

In addition, another explanation for the impressive number of bankruptcy procedure lays in the role of the participants. In order to achieve the scope of the procedure (as set in article 2 of Law no 85/2014): recovery of debts and reinsertion of the debtor in the business, it is necessary to apply adequate solutions and a customized treatment. The judicial administrator may not be a specialist in all fields of activity. The law requires him to be a lawyer or/and an economist. In this context, can

[3] ONRC, The National trade Register Office, http://www.onrc.ro/index.php/ro/ [07.05.2015].

he be aware of the needs of distressed debtor activating in the chemical, agricultural, hi-tech field? The survey proves that not the creditors show more involvement in designing a customized treatment for the debtor as there are 2% of cases in which creditors contests against official receiver acts.

Consequently, behind the facts that seemed to be a constructive destruction[4] (elimination of unviable enterprises) there is a lack of efficiency of the insolvency procedure instruments.

2. Two administrators to carry out the debtor's activity during the procedure

Romanian insolvency law provides for the debtor's prerogatives and interests during the procedure to be represented by a special administrator designated by the debtor's shareholders, while the creditors' collective interest for the maximization of the debtor's assets and the recovery of its liabilities is represented by the judicial administrator, an authorized insolvency practitioner. These two interveners are carrying out both alternatively (i.e. when debtor in possession of its business) and simultaneously their tasks set in the law. The survey revealed the fact that there is a rule (with few exceptions) establishing that the special administrator is the former statutory director of the debtor company, and the interim judicial administrator (appointed by the judge) is confirmed in the position of permanent official receiver by the creditors. So the predictability characterizes these aspects too, along with the above mentioned ones.

A high percentage (80% of the law cases) is reached in creditors' request to replace the special administrator's right to manage the affairs of the debtor by that of the judicial administrator (article 85 of Law no. 85/2014).

The associates/shareholders of the debtor trust the former statutory director of the debtor company and appoint her to represent their and debtor's interest during the procedure; on the contrary, the creditors' lack of confidence in his capability to make right decisions and they opt for giving the right of management to the official receiver. This conduct proves that creditors apriori blame the statutory directors for the debtor's financial distress, removing this right from his responsibilities. By confirming the interim official receiver appointed by the judge, creditors agree and trust judge's option. The survey emphasizes that the relationship between creditor, on one hand, and official receiver, on the other hand, is more likely to be cooperative as there are few contests filed by creditors against judicial administrator's acts.

In conclusion, it seems that even if the law offers instruments to share the control over the procedure, the participants adopt quite a passive role, their conduct being almost uniform and predictable, relying maybe on the other predictable elements and stages of the procedure.

3. Statutory director's responsibility

One should not consider the predictable and sometimes passive role of creditors' and judicial administrator as a total lack of involvement in the procedure. For instance, an important legal institution of the insolvency procedure is the engagement of the debtor company' statutory directors' responsibility for financially distressing the debtor, grounded on the actual article 169 of Law no.85/2014. In 68% of the 200 cases, creditors and judicial administrator used this instrument in order to sanction the directors and moreover to recover a part of the debts. If the director is found responsible for the debtor's financial distress, he may be liable for paying a part or even the whole

[4] Schumpeter, J, Capitalism, Socialism and Democracy, Harperperrenial Modernthought, 2008, New York, 2008.

debts of the insolvent debtor. It is important to note that not all requests filled by creditors or judicial administrator against the directors are accepted, but the 68% represents the accepted requests ending up in directors'

Analyzing more deeply the results and the legal provisions, one can note that where the law sets specific interests for a participant it is by far more likely for him to act accordingly than in other situations where the result of participants' conduct is indirect or improbable to happen. The fast and sure recovery of debts is a strong incentive for creditors, even if, in most cases, it is not an accompanied by more chances for the recovery of the debtor. At least, one part of Romanian insolvency law's scope is reached (the recovery of debts). The other part of the scope, the reinsertion of the debtor in the business, needs more resources and in order to be accomplished.

As an improvement compared to the previous law, Law no. 85/2014 provides a more severe legal framework for the directors' responsibility. Thus, in addition to the obligation to pay a part or the whole debts, there are now more situations that may engage directors' responsibility and there is also one more sanction added: the directors may not keep their position and may not be appointed as directors in any other enterprise for ten years (article 169 of Law no. 85/2014)[5].

4. Duration of the procedure

Duration of the procedure is an extremely relevant indicator of insolvency procedure's efficiency.

The survey reveals that even if is about the simplified procedure of bankruptcy, the duration varies from several months (6 months) to over a year. We appreciate that this period of time is too long compared to the activities developed; not to mention the fact that the creditors are depending in many cases on considerable debts that have to be recovered. Business partner's insolvency combined with a reduced level of debts recovery is frequently mentioned in the judicial administrator's report as one of the main causes of insolvency.

A long duration implies more effort for the creditors, insecurity and distrust in the market. So, the duration of the insolvency procedure is a tacit, but harmful component. It is imperiously necessary that the Romanian legislator pays more attention to this aspect which undermines not only an insolvent debtor's chance to recover, but jeopardizes other enterprises existence too.

Doing Business Report 2015 (Resolving Insolvency)[6] mentions that the Romanian insolvency procedures has a 3.3 years medium duration. The above mentioned note (that the duration is unreasonably long) is valid for this results as well. The shortest period of time covered by insolvency procedure characterizes the Japanese procedure (0.6 years), while the longest is specific to the African countries (over 5 years). Comparing these extremes, Romania is somewhere in between, but this is not convenient, as the majority of European countries are offering shorter procedures (less than 3 years).

II. THE CREDITORS' SAGA

This part of our study focuses on the identity of and issues faced by creditors in the bankruptcy procedure. There is a common perception in the insolvency-related academic literature

[5] I. Turcu, *The Insolvency Code, Law no. 85/2014. Commentary on articles*, 5th edition, C.H. Beck, Bucharest, 2015, p. 464-497.
[6] Available at http://www.doingbusiness.org/data/exploretopics/resolving-insolvency [07.05.2015].

whereabouts, in a conventional scenario, in any insolvency undertaking, the following types of creditors are visible: the employees, the State, the secured (usually the banks or other entities analogous to credit institutions) and the unsecured creditors. If the first three categories suffer little variation, the unsecured creditors are a melting pot for various types of parties which have interacted in one way or another with the company. Both the Law no. 85/2006 and the new Insolvency Law no. 85/2014 validated this approach, through the definitions of the types of debts a company can incur (secured, unsecured, employee-related etc. - art. 3, no. 9, 10, 11, 13 of Law no. 85/2006; art. 5, no. 14, 15, 21, 22 of Law no. 85/2014), by defining the types of creditors that vote for the approval of a reorganization plan (art. 100, para. 3 of Law no. 85/2006; art. 138, no. 3 of the Law no. 85/2014) or the order in which the different types of debt are to recovered in case of liquidation (art. 123 of Law no. 85/2006, art. 161 of Law no. 85/2014). The relevant legislation paints an image of the active shareholders trying to recover their costs following the downfall of the debtor as well as trying to salvage the company through collective collaboration with the other creditors and the debtor itself. Based on this perceptions, the insolvency procedures offer both safeguards and control measures at the disposal of the creditors through the Creditors' Meeting (or the Creditors' Committee, if applicable).

1. A peculiar structure of the debtors liabilities: the prevalence of unsecured creditors

Whereas the image described above is validated in the case of debtors with significant equity and with a relevant market share, it is important to investigate what is the reality of the smaller companies who, considering recent Coface analysis[7], are the most common debtors in bankruptcy procedures.

The study showed that in almost 80% of cases no secured creditors were part of the bankruptcy procedures. In those cases where they present, they were not the majority creditor in the procedure. This position was held, in almost all cases, by the State through its subsidiaries, the largest of which was the National Authority for the Administration of Finance (ANAF). This is an interesting position considering that secured creditors are usually the banks (although not always) and one would assume that private loans (which are often secured debts) are a significant part of any company's financing strategy.

If that is the case, why has the secured creditor disappeared from the insolvency paradigm? Possible explanations for this phenomenon can be brought forth if we consider the banks positions to their clients - companies. One possibility we can consider is that the debtors chose a different pattern of financing, avoiding the possibility of applying for a private loans. Since Romania become part of the European Union in 2007, companies in particular have had access, in theory, to various European-founded opportunities, like structural or development funds. However statistics issued by the National Bank of Romania[8] has shown that the number of non-governmental loans has maintained an albeit small level and Romania is still seen has a country which is at least partly dependent on private loans. If we thus infer from this that the debtors did apply for private loans, two options emerge: either the loans issued by the banks were not secured or the Bank already recovered its loan-related costs prior to the commencement of the bankruptcy procedure and/or chose not to be part of the procedure at all.

[7] Coface, Panorma Romania Insolvente (Study), January 2015, p. 4.
[8] NBR, The National Bank of Romania, http://www.bnr.ro/Statistica-monetara-si-financiara-6380.aspx [07.05.2015].

In the first case scenario, the credit institutions might still be part of the procedure but simply registered as unsecured creditors. However, in less than 25% of the cases we have studied were banks registered in the bankruptcy procedure as unsecured creditors. This can be corroborated with the fact that banks in Romania seem to offer unsecured loans in similar conditions[9]: a high credit score (no past delays in payment of other credits, no issued reported in regard to the use of credit instruments or demand guarantees), a strong financial situation; and the loans themselves are short-termed (between 1 and 5 years) and of small to medium value. It is thus possible that, either the debtors did not qualify for the loans, or, by the point of bankruptcy, the Bank may have recovered the short-termed loans through other means.

This leads us to the second scenario, where the bank may have issued secured or unsecured loans and recovered these sums prior to the commencement of the bankruptcy procedure. This would be in line with a bank's cost recovery policy. Considering that, although in 2014 84% of total sums recovered in insolvency procedures were distributed to secured creditors, a bank actually recovers only about 30% of its debts through a bankruptcy procedure, sometimes even less. Thusly banks are discouraged from any cost recovery attempts via liquidation procedure and opt for other non-bankruptcy related measures. In this regard, a bank will only start a client's bankruptcy procedure: if a credit workout procedure cannot be put in place, if the bank's guarantees are not enforceable or are undervalued or if there is no other viable option by which the bank can recover its costs. If the bankruptcy procedure is approved, a bank will evaluate its position carefully, taking into consideration the sums it needs to recover, the costs it can incur from this undertaking as well as other available means of recovery of the initial sums (demand guarantees, personal guarantees, legal provisions etc.). If the disadvantages are too great or the unrecovered sums small enough, the bank will to opt to not participate in the procedure. This might explain why the secured creditor is so little involved with the procedure and why almost no banks have voluntarily started a bankruptcy procedure against a client in the cases we have analyzed.

This phenomenon is unfortunate considering that the lack of secured creditors is felt strongly in the development of the procedure. The secured creditor and the State hold the majority of the debts which need to be recovered via insolvency. Therefore these types of creditors are the voice of the whole creditor mass since all decisions in the Creditors' Meeting are taken through a majority and they ensure a control system between the two which can temperate any abusive attempt by one of the majority groups. Moreover, in the academic literature, a ride along principle has been underlined where the decisions of the secured creditor promotes the recovery of the company while favoring a private interest, thus protecting the unsecured creditors as well[10]. As it stands, the State holds a monopoly over the decisions of the Creditors' Meeting and is interested with the recovery of its own public costs, as it should be. Our results show that unsecured creditors recover less than 10% of their debts, in some cases just under 1%.

2. The State as majority creditor

[9] Authors' analysis of the relevant offers of the three largest banks in Romania: Banca Comercială Română (BCR), Banca Română de Dezvoltare (BRD) and Banca Transilvania (BT), [07.05.2015].

[10] Rizoiu, R., *Garanțiile reale mobiliare. O abordare funcțională*, Ed. Universul Juridic, Bucharest, 2011, pp. 145-150; Schmidt, K., *The Economics of covenants as a means of efficient creditor protection, in Eidenmuller, H. (ed.): The Law and Economics of Creditor Protection*, TMC Asser Press, 2008, pp. 89-92.

In most insolvency cases of micro and small companies, the State has a position of majority creditor, especially through its tax and social insurance agencies. This especially brought a major concern in regard to its behavior related to the voting procedure for the reorganization plan. Our research has shown that none of the bankruptcy cases have generated a reorganization procedure and, in the few cases were such a procedure was suggested (less than 10%), the State has rejected such an attempt. Even in cases (other then those studied) where the reorganization plan of the debtor was approved, the State as creditor voted against. The reasoning behind this is based on an economical and a legal concern: (i) the State wishes to take advantage of its preferential position in the sums distribution procedure via liquidation and (ii) legally, any approval of a reorganization procedure would imply a restructuring of the state's debt, which is seen as state aid. Such state aid can only be given under very strict legal conditions. Law no.85/2014 has tried to tackle this issue by introducing the private creditor test. Applying the European Frukona Kosice case (C-73/11P), the legislator introduced a new evaluation of the debts a state could recover via reorganization (compared to a diligent private creditor) as opposed to the recovery rate in liquidation[11]. If the former is higher, the State's decision to support the reorganization will not be considered state aid. These provisions came into force in 2014 and it is yet unsure what their impact will be in improving the disappointing reorganization rate which has been plaguing Romania. The reasons for this doubt are based on the lack of enforceability of the positive test: the law does not oblige the state to vote for the restructuring plan even in the case the private creditor test shows it would recover more of its claim if the plan would be approved. The courts have no clear legal ground to enforce the effects of a positive test, which therefore remains just an incentive for the State to consider the reorganization of debtors.

3. The absenteeism of creditors

A major concern brought forth by the results of our analysis was the significant passivity of the creditor groups. The State, in its position of majority creditor (with over 50% of the total debts), has the legal power to decide on issues which fall within the prerogatives of the Creditors' Meeting without the necessity to convene such a meeting. In none of the cases we have studied has such a creditor protection measure been utilized. The unsecured debtors show similar absenteeism. There is little creditor participation in the Creditors' Meeting; in 80% of cases the meetings members were not present but simply sent their written votes, thus diminishing any type of dialogue with the insolvency practitioner in regard to the development of the procedures. In none of the cases was there a legal action brought by the Creditors' Meeting against the directors of the company for mismanagement for the company, the judicial administrator for mismanagement of the procedure or was there a reorganization procedure suggested by one of the creditors. The actual activity of the creditors revolved around pecuniary matters: the registration of their debt and the opposition to the alleged incorrect registration of their debt (in 80% of cases, at least one opposition was filled). These results paint a bleak picture: the state-owned creditors are dedicated to the swift recovery of their debts while the unsecured creditors, discouraged by their precarious position in the procedure, offer a weak and almost non-existent voice.

4. The decline of the recovery rates

[11] Țăndăreanu, N., *Codul Insolvenței Adnotat*, Universul Juridic, Bucharest, 2014, pp. 53-54.

Arguably one of the most important concerns of the bankruptcy procedure, cost recovery issues continue to affect and determine the perception of this particular undertaking. While statistics[12] place the Romanian recovery rate between 20% and 30% (2008-2012), in regard to our smaller companies, the recovery rate is much lower. State-owned creditor have recovered 100% of their debt in a very small number of cases but the average is around 30% of their registered costs. Unsecured creditors recover less than 10% of their debts, in some cases just under 1%. The results might help explain why unsecured creditors have little incentive to incur further cost by engaging in the procedures and why secured creditors have opted to recover their debts via means that completely avoid the bankruptcy procedure, as stated above. Considering that, according to official statistics, the recovery rates in recent years have stagnated while procedure costs have increased by 1%[13], perhaps it is time to reevaluate the efficiency of the bankruptcy procedure, take into account the pitfalls mentioned above.

CONCLUSIONS

From a debtor's perspective, the Romanian insolvency procedure, as shown through our case study, outlined several predictable aspects due to the high number of liquidation procedure and lack of incentives to avoid insolvency and to recover debts. From the creditors' vantage point, the results outlined a procedure were the secured creditors are all but lacking, the majority state-owned creditor is focused solely on swift cost recovery (with no interest towards the reorganization of the debtor) while the unsecured creditor is passive towards any type of measure taken by the other participants. All of these creditor-related patterns are further exacerbated by the small, almost insignificant recovery rates determined.

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