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„A Comparison of the Austrian and US Insolvency
Codes”

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Abstract

The paper provides an insight into the design of the Austrian and US insolvency codes. It highlights the importance of a well-functioning bankruptcy procedure that is crucial for an efficient resolution of insolvencies. The first section defines the terms that are commonly used with respect to insolvencies. It also reveals the goals which an efficient code aims to achieve, either by liquidation or reorganization of a distressed business. Over the time, the insolvency regimes have evolved in response to cultural changes and developments in national economies. Due to the fact that the provisions of the insolvency law differ across the countries, we observe variations in the degree of protection that is granted by law to a debtor in default. The paper examines country-specific characteristics that contribute to unequal protection of the interests of creditors and shareholders under different insolvency codes. It compares the features of the Austrian and US insolvency systems. The American code favors restructuring of a financially troubled firm under a strong, debtor-oriented Chapter 11 procedure. The Austrian code is focused more on the protection of the interest of creditors prompting for liquidation of a distressed business under the provisions of KO. Thus, the Austrian and the US insolvency codes create a different environment for a distress firm to deal with the problem of insolvency.

Abstract

Die folgende Arbeit befasst sich mit dem Vergleich der Gestaltung der Österreichischen und Amerikanischen Insolvenzsysteme. Insolvenz kann nur dann effizient und erfolgreich gelöst werden, wenn das Gesetz ein geeignetes Konkursverfahren anbietet. Der erste Teil dieser Arbeit ist eine Erklärung der Begriffe, die zusammen mit dem Thema der Insolvenz vorkommen. Anschließend, werden die Ziele eines Insolvenzverfahrens erläutert. Diese Ziele sind entweder durch Auflösung oder Sanierung von einem insolventen Unternehmen zu erreichen. Im Laufe der Zeit haben die kulturelle Veränderungen und die nationale Wirtschaftsentwicklungen die Gestaltung der Insolvenzsysteme wesentlich beeinflusst. Die Abweichungen unter den nationalen Gesetzen des Insolvenzrechts verursachen, dass der Grad vom Schuldnerschutz beträchtliche Unterschiede aufweist. Die Arbeit untersucht auch gewisse kulturspezifische Eigenschaften, die zu Unterschieden im gesetzlichen Schutz der Rechte von Gläubigern und Aktionären führen sollen. Es werden die wichtigsten Merkmale der Österreichischen und Amerikanischen Insolvenzgesetze miteinander verglichen. Das in den Vereinigten Staaten bevorzugte Insolvenzverfahren nach *Chapter 11* ist mehr zugunsten des Schuldners und der Sanierung gestaltet. Demgegenüber steht das nach den Gläubigern orientierte Österreichische Insolvenzgesetz, das die Liquidation eines insolventen Betriebs vorzieht. Dementsprechend gelten in beiden Ländern unterschiedliche recht wirtschaftliche Rahmenbedingungen, die es einem Unternehmen in Insolvenz mehr oder weniger ermöglichen, das Problem effizient aufzulösen.

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Part I. Introduction

1.1. Basics about the insolvency law

”A well-functioning market economy requires a well-functioning legal system for dealing with insolvencies’”¹

Similarly as after each financial crisis, the recent crisis has once again focused more of our attention on insolvency regimes that still remain very country-specific. A question frequently asked is, which of the insolvency code is the most efficient, effective and fair. An answer to this issue is far away from clear and unambiguous. Historical happenings, market changes, cultural habits, political orientation, innovations, even religion, they all have influenced the development of national laws. For instance, high level of insolvencies due to the recession in Western Europe in the early 90’s has led to determination whether the particular provisions of codes provided correct incentives to liquidate or maintain an insolvent firm as a going concern.² In general, the existing insolvency codes have been a subject to severe criticism, which has resulted in passing a new legislation with the purpose to improve the efficiency of bankruptcy proceedings. Developing countries in the emerging markets that are still in the process of designing their own codes will choose the best components from the most efficient current regimes.

The insolvency law is a broad field that deals not only with legal regulations of distressed businesses, but also takes into account financial issues, social, moral aspects, the well being of the economy as a whole, and touches direct or indirect many market participants.

The term insolvent means that an entity (debtor) that borrowed money from other person or institution (creditor) cannot meet its obligations to pay back debt as initially agreed in a contract (so called cash flow insolvency). It is also a financial situation when a company’s liabilities (debt) exceed the value of the company’s asset (balance sheet insolvency).

¹ Gratzner, Stiefel (2008), p.7

² Franks, Nyborg, and Torous (1996)

How do firms become insolvent? Dun & Bradstreet examined reasons for business failure.³ Their study showed that 37.1% bankruptcy cases occurred due to unfavorable economic factors such as industry weakness and poor business location. Too high leverage ratio and insufficient capital are the main financial factors that in 47.3% cases have contributed to financial distress. In 16% of the cases, the insolvency of the firm was a result of poor management performance and unexpected disaster. A common agency problem is that managers are more interested in gaining private benefits from business operations rather than keeping in focus the prosperity of the firm when making investment decisions.

The term bankruptcy⁴ is frequently used together with insolvency. Bankruptcy, accurately, is a procedure provided by law to resolve insolvency either by liquidation or reorganization.

Liquidation is a bankruptcy procedure that seeks for closing of the insolvent firm under court supervision. It can result in a piecemeal selling of the firm's asset or its sale as a going concern.

Reorganization is also a court supervised bankruptcy procedure. If a firm becomes insolvent, it does not necessary mean that it will go bankrupt. This procedure provides some rehabilitation possibilities for a financially distressed enterprise to survive.⁵ Chapter 11 in the US allows a firm to remain in operation while a plan of reorganization is being worked out with its creditors.

There are several key differences in design of insolvency codes across the world. Such as:

- Solvency requirements
- Who can file for liquidation or reorganization
- Allocation of control rights over the distressed firm (debtor vs. creditor in possession)
- An automatic stay against creditors' claims
- Possibility of raising new funds in reorganization
- Overall cost of bankruptcy proceedings

³ Brigham and Ehrhardt (2008)

⁴ This word comes from medieval age Italian traders that broke their bench (banca rotta) as they defaulted on their debt payments.

⁵ Djankov (2009)

- Renegotiation possibility with firm's creditors
- Court supervised mechanism vs. private work-out procedure

All these differences will impact a final decision, whether the insolvent company should be liquidated or kept alive. Furthermore, when comparing the main differences in bankruptcy procedures, it becomes obvious that a degree of protection creditors and shareholders receive under bankruptcy varies in each country code. Moreover, these dissimilarities in insolvency regimes' features will affect ex-ante financial decisions, thus the firm's capital structure. In addition, variations in insolvency regimes will affect their ex-post efficiency.

1.2. Goals of insolvency codes

Despite the differences in the design of insolvency law systems, the general and the main purpose of each code is to provide the most efficient, adequate, cheap and fair resolution of the financial distress.

A bankruptcy code is efficient if it preserves a firm that is worth more as a going concern than if liquidated. Furthermore, an efficient code should create incentives for optimal investment in reorganization.⁶ In opposite, if a firm is worth more if liquidated, an efficient bankruptcy code should promote liquidation.

A bankruptcy procedure should maximize the total value of the firm's assets. The proceeds will then be split among the creditors according to the absolute priority of their claims. After all creditors' claims are satisfied with the proceeds from liquidation, the remaining assets can be distributed to the shareholders.

The overall cost of insolvency process should be minimized. This cost includes not only the direct cost of bankruptcy such as legal and accounting fees. It also accounts for the indirect cost of the insolvency process: loss of investment opportunities or cost of overinvestment. There are also other costs related to bankruptcy process that should be considered: the costs incurred by the state, employees, suppliers, customers, and other stakeholders of the financially distressed firm. Additionally, White distinguishes between ex ante and ex post bankruptcy costs. When bankruptcy code

⁶ Franks, Nyborg, and Torous (1996)

treats managers of the firm severely, a likelihood of bankruptcy will be low. Since managers want to avoid distress they will manage a firm in an efficient way. However, once a firm becomes distressed, managers will overinvest, what might be costly for a firm.⁷

In general, bankruptcy procedures have one common goal. They are used to resolve clashes arising among investors and management when a firm falls into financial problems. The legal system in each country governs these conflicts in quite different ways. The rights that are given to debtor, creditor, and managers in bankruptcy procedures substantially vary across the world. The provisions of the country's insolvency law depend on how much protection is offered by the system to the particular claimholders' group.

1.3. The history of development of the insolvency law

What came first, a chicken or an egg? This is a common question that is asked, when thinking about the beginning. Let's change it to: what came first, the money or the credit? Kilpi 1998, argues that, *money was introduced because of the need to measure and pay debts*. It should not be a surprise that practices of lending and borrowing money have very deep roots. The term credit comes from the Latin word „*credere*“, which means to believe, to put confidence in someone and credit stands for a person's ability to sell a promise to repay in the future so that one can make a purchase today.⁸ A credit agreement is a contract between debtor and creditor; in which a borrower receives certain amount of money from a lender today, and obligates him to repay this amount in the future under conditions previously specified in the contract. Strict credit terms should secure creditors in the case of debtor's default. It is obvious that creditors stay on a risky site of the credit contract. They face the uncertainty of their future cash flows. But also the debtor cannot foresee what comes next and his promise to repay debt is based on present circumstances. Hence, what if the worst possible scenario happens and the borrower becomes insolvent? What if there is a line of lenders who are waiting for the next payment? How should their claims to debtor's assets be satisfied? Who gets a piece of a pie and who remains with nothing? These

⁷ White, Corporate bankruptcy: A U.S.- European comparison

⁸ Gratzner, Stiefel (2008)

are the issues insolvency law copes with. The bankruptcy codes have been established to regulate such complex situations.

At times, when there were no rules on how to treat insolvent debtor, the involved parties had to come up with some regulations of financial distress. At the beginning, insolvency was seen as the worst evil, which one could encounter. Insolvent debtor was compared to the thief and his fate was put in the hands of his creditor. The creditor had literally the power to decide on the debtor's life. Death penalty, servitude, stigmatizing penalties involving shame, and debtor's prison were still in existence well after Middle Ages.⁹ This harsh treatment of defaulted debtors might be difficult to comprehend by one with today's perception of insolvency. Nevertheless, these kinds of debtor's punishment were commonly used before the first legal bankruptcy procedure was drafted.

In Ancient Roman law, a debtor in default and his family often became slaves of their creditors. Later on, the creditors' rights to debtor's life were limited, however, more focused on his property. The debtor was kept in creditor's prison until he had paid off his debt. As a next step towards bankruptcy procedure, the Roman law gave the debtor a possibility of declaring insolvency voluntarily. At the same time, his remaining assets were taken over by his creditors. There was only one condition for the debtor to be entitled to this privilege, namely, he had to prove that he did not caused his insolvency intentionally but that he defaulted due to unforeseeable circumstances. Any attempt to make a deceitful statement by the debtor resulted in loss of his civil rights and imprisonment.

As the Roman Empire collapsed, Germanic common law system dominated in European states. Insolvent debtor was not treated softened by this regime. His financial failure was further on being seen as a felony for which debtor could be sent to exile or became a creditor's slave. Even if the voluntarily surrounding of property was allowed by the law, it was often abused by debtors. Until the mid sixteenth century, the German law had not developed any formal, legal procedure to resolve insolvencies. Because of the fact that the debtor for such a long period was considered as the only one guilty of his default, the current bankruptcy procedures in the civil law countries act more in the favor of creditors. What has changed is that a defaulted

⁹ Gratzner, Stiefel (2008)

debtor today will not be cut into pieces, but creditors will grab his assets, especially in the case of strong, creditor oriented insolvency codes.

The first formal insolvency code was established in England in 1732, which was influenced by the Middle Age regime.¹⁰ By this fact, in the present British insolvency code, creditors are given much of control rights over an insolvent debtor in the bankruptcy procedure.

The later insolvency laws have developed and changed according to the country's specific needs. The cases of insolvencies have become ordinary and their number has significantly increased. The country's economic and institutional changes, its trade development, financial crisis, all have strongly influenced the structure of the present codes. Insolvency is no longer considered a personal failure but rather as the outcome of adverse market conditions. Corporations are in large degree financed via credit institutions. Funds are borrowed with a promise to be repaid. Whenever it comes to distress, this is resolved in bankruptcy procedures. The existing codes differ a lot and their efficiency is questionable. Current insolvency laws are constantly being reformed and legislators are still looking for the best solution for financial distress. Looking at today's statistics on insolvencies, debtors' imprisonment seems to be unrealistic.

¹⁰ Djankov, (2009)

Part II. The US Insolvency Code

2.1. Development of the US Insolvency Code

The first insolvency law in the US was passed by the Congress in 1800. Its provisions were quite much copied from the British law that existed at that time. Today, these two codes are very different. In fact, the United States have developed a bankruptcy code that is unique to the rest of the world. The code provides more protection to the debtor in default and gives more incentive for a firm in financial distress to remain as a going concern. What has contributed to this specific form of the American code? For centuries, many political, economical, and cultural factors have inspired the legislators to design the insolvency code as it is structured today.

The Federalist desire for commercial growth in the eighteenth and nineteenth century had pushed for the bankruptcy law that would support credit practices since this would build up strong market based economy in the U.S.¹¹. Numerous discussions between the democratic and republican parties resulted in unstable bankruptcy acts in the nineteenth century. Enacted provisions were systematically altered and repealed until the establishment of the first durable Bankruptcy Act from 1898.

2.1.1. Federal bankruptcy law from 1898

Prior to the Act of 1898, the US insolvency law had already introduced the possibility of voluntary filing for bankruptcy by the insolvent debtor and the law distinguished between personal and corporate bankruptcy. The bankruptcy law from 1898 was the first attempt of the US Congress to enact the widespread insolvency law in the country.

The aim of this Act was to:

- balance the rights of creditor and debtor in bankruptcy process
- reduce the cost of the process and avoid bureaucracy
- improve its administrative structure through court involvement into process

¹¹ Debt's domination: a history of bankruptcy law in America, David A. Skeel

- introduce exempt property rights for insolvent debtors. These are the debtor's assets to which creditors have no claims, which are crucial to start over after bankruptcy. The exemption right was a state law and depended on local courts.

However, the bankruptcy Act from 1898 provided the liquidation of a firm as the only possible solution in bankruptcy. It was foreseen primarily for personal and small-firms' insolvencies. It did not really consider the large corporate bankruptcies and missed provisions for such occurrence. The bankruptcy bar has emerged at that time. Later on, the professionals from this association will design insolvency law.

2.1.2. Crisis in railroad industry and Equity receivership

"In a very real sense, the history of corporate reorganization is the history of nineteenth-century railroad failure".¹² The railroad industry was the most important part of the American economy at that time. As it ran into financial distress, it became obvious that it is even so important that this corporation had to be saved from bankruptcy. The political structure and allocation of jurisdiction responsibilities between States and Congress in the U.S. complicated the uniform solution because the railroads failure has grown to be an interstate dilemma. However, the federal regulations could only be applied to interstate commerce. On the other hand, the state's legislators could only pass law inside its own borders. Finally, this issue was resolved by courts in the equity receivership provision and was used for interstate railroad corporations in financial distress that has issued stocks.

In general, this procedure endorsed the tendency to keep a company running as a going concern instead of its liquidation.

If the company has failed on its debt repayment obligation, then the creditor could file for *creditor's bill* asking the court to appoint a receiver.¹³ The receiver took control over the firm's assets. Similar to today's automatic stay, this bill stayed the creditors' claims on debtor's assets and gave him a time to prepare reorganization plan for the financially distressed firm. The creditor could also file for the foreclosure bill. That bill was used by the court to arrange the sale of the firm assets to the reorganization committee. To protect their interest during receivership process, creditors, typically

¹² Debt's domination: a history of bankruptcy law in America , David A. Skeel

¹³ Debt's domination: a history of bankruptcy law in America , David A. Skeel

investment banks formed the so called creditors' committee. The main purpose of the negotiations between creditors and the firm's management in receivership was to propose a restructuring plan for the insolvent firm. The debt contracts were newly adjusted to the financial situation of the firm, so that the business was kept running and its creditors' obligations were fulfilled. The receivership certificate had guaranteed that the firm's main suppliers get paid and the firm can continue its operations.

The railroad crisis gave a rise for the development of the corporate restructuring in the USA. The equity receivership from nineteenth century provided the basis for further development of the reorganization procedure in America. Although the restructuring offered for the first time an insolvent firm the chance to overcome financial distress, the procedure itself was criticized at that time. The process was seen as unfair, too long, and too expensive. Courts have a little control over the reorganization plan. The Wall Street, banks and lawyers abused their authority to gain private benefits in the receivership process.¹⁴

2.1.3. The Bankruptcy Act from 1938

The Bankruptcy Act, also called the Chandler Act was enacted by the Congress of the U.S. in 1938. The most important chapters of this code are X and XI. The insolvency law distinguished between liquidation and reorganization. Chapter X provided for the appointment of a trustee by the court to oversee the liquidation of the company. Chapter XI allowed a firm to remain in operation while a plan for reorganization was being worked out with its creditors. The position of banks and attorneys was restricted in favour of courts.

The creditors' eligibility requirement for filing for bankruptcy under Chapter X was a minimum value of \$5000 in outstanding claims.¹⁵ The current management could be replaced by new one. Thus, managers did not have the incentive to file voluntarily for bankruptcy because their position was in jeopardy. An independent trustee took over the control of the firm and his main duty was to work out the reorganization plan. The proposed plan had to be first approved by the court and later controlled by the

¹⁴ Debt's domination: a history of bankruptcy law in America , David A. Skeel

¹⁵ Stiefel (2008)

Securities and Exchange Commission. The creditors then voted on the plan. If company was liquidated, the creditors were paid out according to priority of their claims. In order to limit informal resolution of financial distress the out of court restructuring plan had to be confirmed by all of the firm's creditors. Thus, the involvement of the court in the liquidation process under provisions of Chapter X was strengthening.

Chapter XI provided for reorganisation of an insolvent firm. Previously, this option was foreseen for small private companies only. Managers had to prepare a reasonable plan to take the company out of the financial distress. New financing was available and it was senior to the existing claims (debtor in possession). With the time, also larger companies started filing for Chapter XI in order to take advantage of this procedure.

The federal law provisions of 1938 have changed significantly the design of the insolvency code. From the time perspective, this law was still not capable to resolve corporate bankruptcy efficiently. Instead of fast sale of the firm's assets, the creditors complained that their company's value had lost during a long procedure. The well-functioning reorganization procedure for corporations was still missing, which often resulted in an ineffective liquidation of companies.

2.1.4. The bankruptcy code from 1978

*„ Article I, Section 8, of the United States Constitution authorizes Congress to enact "uniform Laws on the subject of Bankruptcies." Under this grant of authority, Congress enacted the "Bankruptcy Code" in 1978. ”*¹⁶

The Bankruptcy Act Reform of 1978 was enacted by the U.S. Congress and became effective on October 1st 1979. The Bankruptcy Act from 1898 was reviewed and considerably replaced by the provisions of the new code. The new legislations of insolvencies were prompted by growing personal bankruptcy cases due to rapid development of credit market. The problem of bankruptcy was closely investigated.

¹⁶ <http://www.uscourts.gov>

Financial distress started to be seen as a social dilemma. The reform had to enhance the existing law and supplement its inefficiencies.

The most important Chapters of the new Code were:

- Chapter 7; liquidation procedure for businesses and individuals
- Chapter 11; reorganization procedure for businesses. This Chapter replaced the former Chapters X, XI, and XII.
- Chapter 13 ; adjustments of debt for individuals with regular income
- Chapter 12; adjustments for farmers and fishermen

From now on, insolvent corporations could file for liquidation under Chapter 7 or for reorganization under Chapter 11. The number of bankruptcy petitions has significantly increased after the new code came in force. Not only has this reform facilitated bankruptcy filing for businesses and individuals, it also allowed wider pallet of possibilities for reorganization. Consumer debt via credits cards became common. But the law was designed much in favor of insolvent debtors and provided them with more protection. In effect, people might have felt less responsible for repayment of their debt obligations. The new regulations have supported the fresh start after filing for bankruptcy. The bankruptcy process was coordinated by qualified personal and courts specialized in insolvency law. „A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts.’’¹⁷ The bankruptcy stigma notably lost on its consequences.

2.1.5. The current insolvency law

The insolvency law maintains to evolve in response to political and economical developments as well as in the aftermaths of financial crises. The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) enacted in 2005 substantially altered some of the previous conditions of Chapter 11. The 2005 Bankruptcy Act supports creditors' position, for instance, it limits management bonuses and severance payment and it reduces the management exclusivity period to propose reorganization

¹⁷ <http://www.uscourts.gov>

plan to 18 months. Following are the most important issues that were changed by the Act:¹⁸

- Debtors' exclusive period
- Conversion and dismissal
- Forward, swap, repurchase agreement
- Leases
- Ordinary course of business
- Utilities service
- New administrative priority claims
- Cross-border insolvency
- Prepackaged bankruptcy and meetings
- Wages and salary priority
- Retirement benefits
- Key employee retention plan limitations

Recently, The Bankruptcy Code of 1978 and BAPCPA of 2005 regulate the formal bankruptcy procedures in the United States. Bankruptcy petitions are filed in one of the bankruptcy district courts across the country. The law distinguishes between private and corporate bankruptcy.

2.2. Private bankruptcy

The main purpose of the private liquidation in the US is discharge.

*A bankruptcy discharge releases the debtor from personal liability for certain specified types of debts.*¹⁹

The debtor is legally relieved from debt's obligations and creditors cannot force him to repay any from discharged debt. The discharge cannot be granted to debtors who acted fraudulently. The debtor can be discharged under two chapters of the Bankruptcy Code. Under Chapter 7, a trustee appointed by the court has to gather and sell debtor's nonexempt assets and then use the proceeds to pay creditors accordingly

¹⁸ www.morgenlewis.com

¹⁹ <http://www.uscourts.gov>

to the priority of their claims. In the no-asset-cases, the debtor obtains the immediate discharge. Under Chapter 13, the debtor remains in control over his assets but he has to prepare a repayment plan. Debtor is also obligated to repay part of debt within next three to five years. Therefore, this Chapter is anticipated for self-employed individuals and unincorporated businesses with regular income, the so called wage earner's plan. During the procedure of Chapter 13, creditors are forbidden any other debt collection effort. To be eligible to file under this chapter a person's unsecured debt has to be less than \$360,475 and secured debts less than \$1,081,400.²⁰

The number of private bankruptcies skyrocketed in the twentieth century. The fault for this should mainly be assigned to the credit card companies. In year 2000, 80% of Americans possessed a credit card.²¹ The credit card companies have been very generous in distributing cards, even to the individuals with a very low creditworthiness. Not surprisingly, more and more people failed on their debt. The Fair Credit Rating Act was introduced in 1996 in the U.S. Today, the credit card companies and other institutions can regularly check the credit score based on the credit history. The higher is the score the lower is the interest on your credit card, on your car loan, on your mortgage, on your computeretc.

*The debtor protected insolvency law in the US might be seen as a substitution of weak developed social system. The major reasons for bankruptcies are unemployment and high costs caused through disease.*²²

2.3. Corporate bankruptcy

Currently, in the US, there are two formal bankruptcy procedures for companies, Chapter 7 and Chapter 11.

2.3.1. Chapter 7

In the case of Chapter 7, the liquidation of a firm is performed under the control of a trustee appointed by the court. The trustee has to sell the assets of the firm and

²⁰ <http://www.uscourts.gov>

²¹ Stiefel (2008)

²² Stiefel (2008)

distributes the proceeds from sale to the firm's unsecured creditors. The creditors can file for involuntary liquidation of a firm but this is rare the case. Usually, the management of the insolvent firm will first attempt to resolve the financial distress under Chapter 11. Non-viable companies are liquidated under the provisions of Chapter 7.

2.3.2. Chapter 11

Chapter 11, on the other hand, is drafted with the purpose to keep the firm as a going concern. Provisions of Chapter 11 allow the firm to remain in the control and in operation while a plan for reorganization is being worked out with the creditors. The reason is that the management of the firm has more incentive to work out a plan that will keep the firm as a going concern and if there is a need for liquidation, there will be a greater chance for preservation of the value of the assets to satisfy the claims equity holders. In some cases, a new management is appointed and until this happens, the court appoints a temporary trustee for the purpose to manage the firm. The creditors' committee comprised of the creditors with 7 largest unsecured claims in the firm is appointed by the trustee. It represents and protects the interest of minority claimholders. The firm's management has the exclusive right to propose the reorganization plan within 180 days after filing. The plan is accepted if majority of two-thirds in value of claims or one-half in the number of creditors from each class of claims voted for it.²³ However, if the plan was rejected by some classes of creditors, the court can „cram down’’ the plan. Following, the proposed plan is confirmed by the court as being fair and equal. This means that all claimholders will receive in reorganization at least what they would get if the firm was liquidated. Acceptance of the plan by the court discharges the debtor from his previous debt obligation. The accepted plan replaces the pre-bankruptcy contracts and the debtor is required to obey the conditions of the plan. Chapter 11 provides an automatic stay on asset that forbids creditors to collect their claims. This provision also relieves management from paying interest and principal on debt during the stay. With court's approval, the firm's management may also be eligible for debtor-in-possession (DIP) financing. These kinds of credits receive super priority status, which means that they are senior to all

²³ Chapter 14; Bankruptcy and the resolution of financial distress; Hotchkiss, Kose, Mooradian, Thorburn

other claims. The costs of bankruptcy under Chapter 11 are very high and the process can be very lengthy since the court and the creditors oversee all daily activities of the firm and most of decisions cannot be made without the approval of the court. Therefore, in most of cases, to save on time and cost, firms enter Chapter 11 only after the attempts were made to re-negotiate the conditions of the outstanding debt in private discussions with creditors outside of the bankruptcy process. In fact, the practice of filing of the so called “pre-packaged” bankruptcy petition, where a plan for reorganization has already been arranged for with main creditors prior to filing the petition, has become very common.

2.3.3. Post- Chapter11 Bankruptcy Performance – Avoiding Chapter 22 ²⁴

In his paper, Altman investigates the health of companies as they emerge from Chapter 11. Based on a Z-Score model²⁵ he estimates a probability of the firm’s second (Chapter 22) or even third (Chapter 33) filing for bankruptcy. Concerned with a recent increase in a number of businesses entering Chapter 22,²⁶ Altman emphasizes that careful screening of firms that exit bankruptcy will result in a more effective reorganization procedure. The average time between first emergence from bankruptcy and the firm’s second filing accounts for 4 years and 6 months. In addition, the value of the firm’s assets is usually lower at the time of the second filing.²⁷ In bankruptcy, the capital structure of the firm is altered. However, firms that emerge from bankruptcy have a higher debt ratio than its competitors from the same industry. In general, the higher is the leverage the higher is the likelihood of default on the repayments of debt, thus bankruptcy. In the study, Altman builds up two groups of firms. First group includes firms that successfully emerged from Chapter 11 and did not file for bankruptcy again. The other group consists of firms that have filed for bankruptcy more than once. If Altman’s model is an appropriate device to predict future distress, the first group of firms should have higher Z”-Score²⁸ results than the other group. The study shows, that the average Z”-Score accounts for 4.73 with a bond rating equivalents (BRE) of (B+) for firms in the first group. As expected, this

²⁴ Altman (2009)

²⁵ Z-Score model developed by Altman in 1968 was first used to assess the credit worthiness.

²⁶ From 215 Chapter 22 filings between 1984 and 2009; 19 occurred in 2008 and 18 in 2009. These numbers are higher than in previous years.

²⁷ Due to fire sale of firm’s assets in bankruptcy, this provides liquidity.

²⁸ Z”-Score model is a modified version of previous Z-Score model that is used to predict firms’ performance after Chapter 11 bankruptcy procedure.

score is higher from the other group, which average Z"-Score was 2.67 and had a BRE of CCC. The results confirm that firms entering second bankruptcy filing have substantially worse performance after they emerged from the first bankruptcy than a firm that did not file again. Furthermore, firms from the second group were characterized by significantly higher leverage ratio, three times higher than the firms from the first group. In addition, the second group firms were less liquid and less profitable after emerging from Chapter 11 than the first group.²⁹ This model may be a proper indicator to assess the post-bankruptcy performance of a firm. As Altman suggests, the model may be used by bankruptcy judges for the evaluation of a reorganization plan.

2.3.4. Continental Airlines in Chapter 11

Chapter 11 takes care of the insolvent debtor and his firm. However, this procedure is a subject to severe criticism. The complaining parties are the creditors, stockholders, and competitors of the filing company. The distressed firm is being rescued at the costs of other market participants. The case of Continental Airlines can serve here as a good example. The Airlines with its 53 subsidiaries and \$3.96 billion heavy debt filed for the second time under Chapter 11 in 1990.³⁰ Under the court's protection, the firm's management was able to restructure the distressed business. In order to protect the jobs, the labor union agreed on lowering wages for Continental workers. In addition, the firm's creditors could not collect their claims and the rehabilitating firm was excused from interest payments. All these have substantially decreased the expenses of the Continental. However, the creditors received new stock in the firm. In addition, in exchange for DIP financing, the investors group got 55% of the Continental equity, leaving the original stockholders with nothing.³¹ In end effect, the firm could offer competitive prices for its services. Chapter 11 firm make the operations of its rivals thorny. When a firm emerged from Chapter 11 the competitive firms expect a decrease in their future cash flows. Thus, we will observe a negative stock market reaction of the rival firms. There is a significant relation between the negative stock price reaction for the portfolio of rival firms and downward revisions

²⁹ Based on retained earnings and working capital to total assets measures.

³⁰ Brigham and Ehrhardt (2008)

³¹ Brigham and Ehrhardt (2008)

in analysts' earnings forecast.³² Continental has successfully emerged from bankruptcy in 1993 and today is ranked among the world largest airline companies.

2.3.5. Informal reorganization - Private workouts

The U.S. companies in financial distress have two alternatives of reorganization: private workouts and formal bankruptcy. The formal procedures, as mentioned before are supervised by the court. The workouts are informal and court is not involved in this kind of restructuring. In either case, new financial claims are exchanged for the firm's outstanding debt contracts on terms firms find more affordable.³³ The private renegotiation can be difficult because of:

- a different interests of debt holders and equity holders,
- an asymmetric information between firm's management and outside claimholders
- a holdout problem in the presence of multiple dispersed creditors
- a private benefits of management in control,
- an incompleteness of the debt contracts,

These problems can increase potential costs of private restructuring. Therefore, the management has to determine, if the private re-contracting is more beneficiary for the firm than formal bankruptcy. The workouts can be advantageous for the firm in resolving the distress because:

- Private restructuring takes less time³⁴
- The costs of private restructuring are generally lower
- Private restructuring avoids a loss of investment opportunities
- Often, shareholders are better off in private restructuring

A financially distressed firm will usually try „to repair” its capital structure. The debt restructuring will require a reduction in the interest or principal payments, an

³² Caton, Donaldson, and Goh (2008)

³³ Gilson (1991)

³⁴ According to Gilson the private workouts take on average 15 months (vs. 20 months in the Chapter 11). They are also cheaper 0.3% (vs. 2.8% in Chapter 11) on average of the firm's book value.

extension in the existing debt maturities, or to substitute the distressed debt for firm's equity.³⁵

Firms that try out-of-court negotiations with their creditors are usually in a better shape than firms entering Chapter 11 bankruptcy. The firm will decide to reorganize in private workouts when the debt holders of the firm are not dispersed among different debt classes. In this case, the private renegotiation can be focused on particular claimholders and are easier to control. In addition, the management will have an interest in out-of-court restructuring when a firm has more bank debt rather than public debt and when the portion of the intangible assets in the firm value is large.³⁶ Because the private restructuring plan requires an endorsement of all creditors, the less creditors the uncomplicated is the process. Private workouts can significantly reduce the costs of reorganization when compared to the formal procedure. Moreover, the equity holders can preserve more of the firm's value in the out-of-court re-contracting. The stock market reaction to the workout is less negative than to Chapter 11.³⁷ The senior creditors are more generous to other claimants in the workouts. They give up on average 9% from the reorganized firm value in favor to equity holders and junior creditors. In Chapter 11, these are only 2%.³⁸

The tax reform from 1986 made the workouts less attractive and has pushed the firm more toward the formal procedure. Nevertheless, the companies in U.S have strong incentives to reorganize out-of-court.

At the same time, there is also a number of firms filing for Chapter 11 instead of going private. Why should a firm consider court supervised reorganization? Analogically, in Chapter 11 we should observe high leveraged firms with a high portion of public and secured debt. The main advantages of the formal procedure in resolution of financial distress are:

- the holdout problem is formally resolved
- procedure is more debtor oriented, focusing on the firm surviving
- automatic stay allows a firm to remain in operations
- debtor- in-possession financing is provided

³⁵ Hotchkiss, Kose, Mooradian, Thorburn (2008)

³⁶ S. Gilson (1991)

³⁷ S. Gilson (1991)

³⁸ Franks and Torous (1994) from Hotchkiss, Kose, Mooradian, Thorburn (2008)

- interests on the default debt payments stop accruing while a firm is in bankruptcy
- less restrictive voting on reorganization plan

All these benefits of Chapter 11 reorganization have to offset at least the part of the costs arising from this procedure. The overall costs can be split into direct and indirect costs of the bankruptcy process. The direct costs are most of all court administrative expenses, legal and professional fees. Attorneys' compensation will depend on the length of the process and their worked hours. Instead of concentrating on the firm well being, they will work on their private benefits from the process. A tempting solution of this issue would be to pay lawyers and investment bankers using the same securities distributed to shareholders and creditors as currency, thus giving them an interest in preserving the value of the reorganized firm and an incentive to shorten the Chapter 11 procedure.³⁹

The prepackaged bankruptcy procedure was developed in the U.S to combine the best features of both forms of restructuring. In a prepackaged bankruptcy, the managements of the distressed firm file for Chapter 11, after they have already reached an agreement with the creditors on the reorganization plan. Thus, the *prepacks* substantially shorten the negotiation time and significantly reduce the costs of the formal procedure. Moreover, the debtor gains the tax benefits and the holdout problem is overcome by less strict voting rules, as in the case of workouts. Therefore, the court will approve the reorganization plan much faster. Baird and Rasmussen estimated that one quarter of 93 large-firms Chapter 11 bankruptcies in 2002 were prepackaged bankruptcies.⁴⁰ However, Altman assumes that we should observe more Chapter 22 cases after prepackaged bankruptcy filings, which in his opinion, just briefly fix a capital structure of a distressed firm.⁴¹

³⁹ Gilson (1991)

⁴⁰ From Hotchkiss, Kose, Mooradian, Thorburn (2008)

⁴¹ Altman (2009)

Part III. The Austrian Insolvency Code

3.1. Development of the Austria Insolvency Code

The origins of the Austrian insolvency code go back to the time of Habsburg Monarchy. The insolvency law (*Konkursrecht*), established in 1868 was in force until the 1914. However, its regulations were subject to many appeals. The law was criticized heavily by creditors. They were unsatisfied with the outcome of bankruptcies, especially with the proceeds. In the year 1909, creditors received only 13% of their claims in the bankruptcy processes.⁴² The law distinguished four groups of creditors (*Massegläubiger*, *Rückforderungsberechtigten*, *Realgläubiger*, *Konkursgläubiger*). They were paid out according to the priority of their claims. Public duties, like taxes, were also given a priority. The law had already offered a form of reorganization of the insolvent business through the compulsory settlement (*Zwangsausgleich*). Because of poor regulation, the procedure at that time did not fulfill its purpose.

In the year 1915, two new regulations of the liquidation (*Konkurs*) and compensatory settlement (*Ausgleich*) were passed. The insolvent debtor could choose between the liquidation of his business, regulated in *Konkursordnung* (KO) or he could try to restructure his business in out of court *Ausgleichordnung* (AO). Austria has as first developed the rehabilitation procedure for a bankrupt firm.⁴³ The reorganization procedure was preferred by both, the debtors and creditors. As next, in the year 1934, the new law provisions have complicated the filling for the compensatory settlement. The minimum of the creditors' claims that had to be satisfied by the debtor in reorganization has grown from 35% to 40%. Therefore, the number of reorganizations has significantly fallen. After the annexation to Germany, the Austrian insolvency law introduced the concept of the protection of employees. In addition, the creditors' unions have emerged. In 1982, the Austrian insolvency law has been significantly altered. Again, the legislators sought to improve the position of the debtor so that he could easier reorganize the insolvent firm. Formerly, the debtor had often delayed filing for liquidation. Consequently, the number of no assets (*mangels Masse*) bankruptcy cases has increased. Moreover, the new law provided for the equal

⁴² Stiefel (2008)

⁴³ Djankov (2009)

treatment of all creditors. As a result, the creditors' groups disappeared. New was also the 60-day period throughout which the debtor was given a chance to prepare a plan for reorganization of his business. The next reform of insolvency law in Austria took place in 1994. The intention of the reform was that the potential for insolvency should be recognized as soon as possible by the system and resolved in the most efficient way.

3.2. Liquidation - *Konkurs*

The Austrian insolvency law knows two main bankruptcy procedures to resolve financial distress. The first one is liquidation, which is regulated in the KO (*Konkursordnung*). The assets of the insolvent firm (*Konkursmasse*) are sold and the proceeds are used to repay the firm's creditors. The requirements for bankruptcy filing are not only the over-indebtedness of the debtor firm but also the illiquidity. Moreover, the illiquidity has to be deemed permanent. In addition, the distressed firm's assets value has to cover the expenses of the process. The debtor or creditor, who files for liquidation, has to deposit in advance the amount of 4000 Euro.⁴⁴ Otherwise, if the value of firm's assets is not sufficient to cover the costs of the process, the liquidation petition is rejected by the court leading to the so called no-asset case. The insolvent debtor is obligated to file a petition. He has to submit a petition for liquidation or reorganization within 60 days from the time of recognition of the firm's insolvency. Each of the unpaid creditors can file a petition for liquidation as well. However, if the petition is applied by the creditor, its credibility has to be first verified by the court. Fraudulent applications are immediately abandoned.⁴⁵ The insolvency liquidator (*Masseverwalter*), appointed by the court, takes control over the firm's assets from the management. He coordinates the liquidation process and much of the efficiency of its outcome is dependent on him. The unsecured creditors (*Konkursgläubiger*) are satisfied equally from the liquidation proceeds based on the bankruptcy quota. They cannot demand their individual securities in the process. They just have to register their claims. On the other site, the

⁴⁴ Stiefel (2008)

⁴⁵ Fröhlich (2001)

secured creditors⁴⁶ in the liquidation have direct right to their securities, for instance, to liens or collaterals. However, there is a possibility of 90-day stay on secured claims that are crucial for the firm's operations.⁴⁷ „*Masseforderungen*“ such as administrative expenses, taxes, process fees, social security dues, and wages, have to be fully satisfied from the liquidation proceeds before other creditors' claims. *Berichtstagsatzung* is a meeting that takes place no later than 90 days after filling. At this convention, the trustee has to decide wheatear to close or to rehabilitate the business. At the meeting, the creditors have a right to a hearing. They also vote on the compulsory settlement. The creditors' committee can but does not have to be appointed by the court. This decision will depend on the size of the company. The committee's duty is to protect the interest of the firm's creditors, employees, and other stakeholders.

3.3. The compulsory settlement - *Zwangsausgleich*

During the liquidation process the debtor has a right to propose the compulsory settlement. This is a kind of court supervised reorganization procedure. Only a debtor can apply for this procedure and his proposal has to be accepted by the majority of creditors.⁴⁸ In this procedure, the management of the firm remains in control and the firm continues to operate. The secured creditors preserve the rights to the assets they have the lien on. The debtor is obligated to pay at least 20% of the claims to the unsecured creditors in the next two years. In compensatory settlement (*Ausgleich*), 40% of the creditors' claims have to be satisfied. This lower rate in compulsory settlement is the reason why this procedure has dominated in the recent years the *Ausgleich* procedure. Finally, the court has to approve the plan. Most of all, the court will asses the current financial position of the insolvent debtor to his planned obligations. The plan is only approved if there is a realistic chance that the requirements will be satisfied by the debtor.

⁴⁶ Aussonderungsgläubiger und Absonderungsgläubiger

⁴⁷ The so called „*Zwangsstundung*“. It has to be requested by insolvency liquidator or bankruptcy court.

⁴⁸ Accepted by two-thirds in value of the claims and by one-half in number of the creditors

3.4. The compensatory settlement – *Ausgleich*

The purpose of the compensatory settlement is to prevent the liquidation of the firm in financial distress. The right to file for this bankruptcy procedure is granted only to the debtors. The requirements are not only over-indebtedness or the illiquidity, but also the imminent illiquidity. Within 90 days from filing, the debtor has to propose a plan for reorganization of the business. In the plan, he obligates himself to make certain repayments to the creditors in the pre-specified time. The creditors have to vote on the proposed plan.⁴⁹ Following, the accepted plan is confirmed by the bankruptcy court. The settlement has to be accomplished within 90 days from the beginning of the process. During this process, the management retains the control of the business and its assets. The insolvency administrator (*Ausgleichsverwalter*) appointed by the court, supervises the management of the firm during the reorganization process. The firm continues to operate. Similar to KO, there is a stay on the secured claims for 90 days (§ 11 AO). The debtor is obligated to pay 40% of the unsecured creditors' claims during the next two years. The compensatory settlement needs to be announced publicly. The debtor needs to achieve the goals of the reorganization plan and repay the required rate of the claims to the creditors. After that, he is discharged from the rest of his debt.

3.4.1. Out-of-court negotiations – *Außergerichtlicher „stiller“ Ausgleich*

An Austrian debtor is allowed to restructure a distressed firm in an out-of-court settlement. The managers bargain directly with the firm's creditors, which significantly lowers the administrative expenses of the process. The informal negotiations have to take place within 60 days from the recognition of insolvency.⁵⁰ Afterwards, the debtor is obligated to file either for liquidation or formal reorganization of the firm. The debtor will decide to go for informal procedure only if there is a reasonable chance that the firm will effectively resolve the financial distress. The efficiency of out-of-court settlement will depend on the number of creditors and on the nature of their claims. One obstacle is that the informal restructuring plan has to be approved by all creditors. Commonly, creditors will voluntarily forego a part of

⁴⁹ The required majority: two-thirds in value of the claims and one-half in number of the creditors

⁵⁰ Fink (2009)

their claims, however, they will not prefer to settle informally if they would get more in case of liquidation or formal restructuring. No specific quota of claims needs to be satisfied. In addition, the informal restructuring of the firm does not have to be announced publicly. However, the firm cannot be extensively distressed in order to meet the desirable expectations. In addition, some public creditors like social security (*Sozialversicherung*) are usually prohibited to participate in the informal process. These factors can substantially obstruct the informal settlement.

3.4.2. The bankruptcy case of Cosmos GmbH & Co KG

The case of Cosmos GmbH illustrates an example of one unsuccessful attempt of reorganization due to the lack of the new capital required to sustain the operations.

In February 2010, Cosmos GmbH & Co KG, an electronics retailer, filed for bankruptcy at the Vienna Commercial Court (*Handelsgericht*). First, the firm's managers filed for a compensatory settlement. However, the financial situation of the distressed business turned out to be too serious for reorganization. The firm has not realized substantial positive cash flows since November 2009. The liabilities of the Cosmos have reached almost €40Mio until the day of filing.⁵¹ The firm's suppliers refused to deliver. The distressed company has not obtained new financing in order to remain in operation. Following that, the managers were not in position to propose a reasonable plan for restructuring of Cosmos. The lack of any investor willing to support the firm was the main reason why the attempts for restructuring have failed. In effect, the investors forced for liquidation of the firm. A trustee (*Masseverwalter*) took over the rest of the firm's assets. The remaining inventory from the shelves was sold at a significant discount. Any coupons lost their value and could only be claimed in liquidation process. Finally, only two main competitors remained at the electronics market in Austria, Saturn and Media Markt.⁵²

⁵¹ http://www.ksv.at/KSV/1870/de/5presse/2medienarchiv/1insolvenzerstfaelle/2010-02/COSMOS_Elektrohandels_GmbH__Co/index.html

⁵² <http://wien.orf.at/stories/423710/>

3.5. IRÄG⁵³ 1997

The reorganization procedure from 1997 does not require the firm to be insolvent in order to qualify to file for rehabilitation. The main purpose of this reform was to avoid bankruptcy by filing the petition timely. The debtor can file for this method of rehabilitation, when there is a potential risk of the firm's bankruptcy. Financial ratios are proper indicators to appraise the firm's financial condition. In order to avoid financial distress, the management should in advance undertake the steps necessary to improve the financial position of the firm. Once again, the debtor stays in control of the firm and he has 60 days to propose reorganization plan that needs to be approved by the court. The plan needs to be realized within the next two years. This procedure was barely used.

3.6. IRÄG 2010⁵⁴

The recent reform of the insolvency system in Austria aims to overcome its inefficiencies. Above all, the new regulations will provide insolvent debtor with more rehabilitation oriented procedure. So far, the insolvency regime in Austria prompts for a liquidation of distressed firm. The rehabilitation procedures are barely usable.⁵⁵ The reason for that is the lack of legal protection and institutional support available to a debtor, while a firm is facing financial troubles. Thus, the despaired managers try to inefficiently rescue their businesses from bankruptcy, which results in petitions filed too late. When the majority of the firm's assets are lost, the rehabilitation of the firm makes less sense. The 2008 crisis resulted in further increased of liquidations in Austria, especially with respect to the no-assets cases. The Austrian lawmakers were forced to come up with a reform that will substantially increase the chances for reorganization of insolvent companies.

The 2010 reform will considerably change the design of the insolvency law in Austria. Both procedures, KO and AO will be replaced by the insolvency procedure regulated by articles of the IO (*Insolvenzordnung*). This reform comes in force in June

⁵³ Insolvenzrechtsänderungsgesetz

⁵⁴ http://www.parlament.gv.at/PG/DE/XXIV/I/I_00612/pmh.shtml

⁵⁵ In 2008, 34% insolvent firms ended up in Zwangsausgleich. Only 1.3% from reorganizations have not lead to firms liquidation.

2010. From this point, *Ausgleich* will be called *Sanierung*. The main purpose of the reform is to combine the best features of the *Ausgleich* and *Zwangsausgleich* with the goal to create the most efficient rehabilitation procedure for insolvent businesses, thus to reduce the number of liquidation cases. The requirements to open a bankruptcy process will stay the same, except that the start-up costs of the process, €4000, can as well be raised by the shareholder holding a majority of company's shares. Had a creditor decided to pay this fee, he can charge it back as a bankruptcy claim in the process. As a result, the likelihood of no-assets bankruptcy cases should be lowered. The debtor is eligible to file for the firm's reorganization when his rehabilitation plan satisfies at least 30% of the unsecured creditors claims⁵⁶ within the next two years from the date of confirmation. He also has to provide a detailed list of the firm's assets and propose a financing plan for his business during the process. In general, the managers stay in control of the firm.⁵⁷ However, they are supervised by the insolvency administrator (*Sanierungsverwalter*). The reorganization plan (*Sanierungsplan*) proposed by the debtor within 90 days from filing needs to be first accepted by the creditors. A simple majority in number of creditors and simple majority in value of the creditors' claims are required for the plan to be accepted. Following, the plan has to be approved by the administrator and finally confirmed by the court as well. If the debtor does not propose a plan within 90 days from filing, or if his plan makes the creditors worse off in the reorganization procedure than the required rate anticipates, the administrator takes the control over the distressed firm. Under his supervision another reorganization plan can be drafted. The first step in the new insolvency procedure is the attempt to reorganize the troubled firm. A liquidation procedure should only be implemented if there is no chance for an efficient and sensible rehabilitation.

In the new insolvency system, the management of the distressed firm is obviously empowered. Thus, the managers should have an incentive to early file for bankruptcy procedure. The creditors' rights to repossess their assets are limited, so that a firm can continue its operations. A stay on assets that are vital for the firm's operation was extended from 90 days to a six-month period.⁵⁸ These changes should provide a

⁵⁶ The average from 20% in *Zwangsausgleich* and 40% from *Ausgleich* Quote

⁵⁷ A new system offers three alternatives of reorganization. They differ with respect to who stays in control of firm during the restructuring process.

⁵⁸ § 11 IO

troubled business with better environment for rehabilitation. The managers should not be disturbed by the claimholders during the process. The new provisions also allow managers to terminate such labor contracts that can jeopardize the restructuring of the business.⁵⁹ The reform of the Austrian insolvency regime aims to keep a firm in the market as a going concern. The liquidation should be avoided. Once the reorganization plan is achieved by the debtor firm, any signs of its insolvency should disappear from public register.

The German legislators have also recognized a need to reform their insolvency system. The new German insolvency law came in force in 1999. It substantially alerted the old code. The court composition (*Vergleichordnung*) and compulsory liquidation (*Konkursordnung*) were replaced by one insolvency procedure (*Insolvenzordnung*). The new system aimed to increase the chances for the survival of a firm and prevent its premature liquidation, which is often forced by the secured creditors.

3.7. Private Bankruptcy - *Schuldenregulierungsverfahren*

In the amendment from the year 1993, the Austrian insolvency law regulates private bankruptcy. With the new provisions the law gave an insolvent individual the right to restructure private debt. In the liquidation process, an individual person can also be discharged of the residual debt. The debtor is not required to cover the cost of the process. The insolvency administrator is not assigned and the process is supervised by the district court. Other than in the case of the legal entity process, the creditors have no voting rights. They just acknowledge the court's holding. The debtor stays in control of his assets. The repayment plan is worked out with creditors and must be endorsed by the court. For the maximum period of the following seven years, the debtor is obligated to make the repayment in full to creditors. There is no fix rate that must be repaid as it is in the case of corporate bankruptcy. The amount of installments is proportional to the outstanding debt and prospective future cash inflows of the insolvent person. If the installment plan is rejected by creditors, the debtor can get a discharge from the court in an absorption process.⁶⁰ During the period of seven years

⁵⁹ § 25(1c) IO

⁶⁰ http://www.uibk.ac.at/zivilrecht/buch/kap19_0.xml?section-view=true;section=8

to follow, the debtor should be employed so that a part of his earnings could be attachable (*pfändbar*) to his creditors. In the year 2000, the total of 3.465 individual persons filed a bankruptcy petition, which accounted for €520 Millions in liabilities.⁶¹

⁶¹ Stiefel (2008)

Part IV. Bankruptcy Statistics

4.1. Bankruptcy Statistics

Following data represent the statistics on bankruptcies in the US and Austria. The analysis of the statistical data emphasizes the difference in occurrence of bankruptcy types (business vs. private) and different, country specific, approaches to resolve them.

4.1.1. Austria⁶²

As can be derived from the bankruptcy data on insolvency in Austria shown in the table below, the tendency of filing for insolvency is growing. In general, during the year 2008 the number of bankruptcy cases grew by 7.2% as compared to the previous year. Above all, the number of private bankruptcies in 2008 was 11% higher than in the proceeding year. Private filings accounted for almost 60% of opened insolvencies. Another 40% of all bankruptcies were filed by businesses. In 2008, an increase of 2.2% in corporate bankruptcies was observed. Out of all 6,500 business insolvency filings in 2008, close to 50% (3,239) were classified as non-asset cases. Out of the remaining 50% opened bankruptcy cases, only 2% of companies resolved their financial distress in course of the reorganization (*Ausgleich*). This means, that about 98% of businesses had to be liquidated.

Insolvenzstatistik 2008

	2008	2007	Veränderung absolut	Veränderung in %	Insolvenzquote
Gesamtinsolvenzen	16.061	14.978	1.083	+7,2	
Unternehmensinsolvenzen	6.500	6.362	138	+2,2	17,7
Privatinsolvenzen	9.561	8.616	945	+11,0	14,2

Definition Insolvenzquote: Verhältnis der Anzahl an Insolvenzen je 1.000 Unternehmen bzw. je 10.000 Privatpersonen älter 18 Jahre

Austria 2008, Business and Non business Bankruptcy cases in comparison to 2007

Source: http://www.creditreform.at/home/downloads/Insolvenzstatistik_Creditreform/index.html

⁶² http://www.creditreform.at/home/downloads/Insolvenzstatistik_Creditreform/index.html

Unternehmensinsolvenzen 2008

	2008	2007	Veränderung absolut	Veränderung in %
Unternehmensinsolvenzen	6.500	6.362	138	+2,2
davon Ausgleiche	73	49	24	+49,0
davon Konkurse und Anschlusskonkurse	6.427	6.313	114	+1,8
Eröffnete Insolvenzen	3.261	2.971	290	+9,8
Mangels Masse abgewiesene Konkursanträge	3.239	3.391	-152	-4,5

Austria 2008, Business Bankruptcy cases in comparison to 2007

Source: http://www.creditreform.at/home/downloads/Insolvenzstatistik_Creditreform/index.html

In conclusion, a high number of non-asset bankruptcy cases in Austria suggest that the managers file for insolvency too late. On average, in 50% cases, the company's assets are not even sufficient to cover the €4,000 of the initial administrative proceeding's costs. Following that, an Austrian company has to be in a very bad financial position already prior to the time of filing for bankruptcy. This can explain such astonishingly low percentage (2%) of firms' reorganization cases. Restructuring of such financially overwhelmed company is just rarely possible.

4.1.2. The United States⁶³

The number of overall bankruptcy filings in 2008, as calculated based on the data shown in the tables below, increased by almost 32%, as compared to the previous year. In 2008, the number of corporate bankruptcies increased by 53%. The non-business filings accounted for almost 96% of opened bankruptcy cases in 2008, which is similar to the result in 2007. Out of 43,546 business filings, approximate 21% were reorganized under Chapter 11 and 68% were liquidated under Chapter 7.

⁶³ <http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm>

TABLE F-2 U.S. BANKRUPTCY COURTS
BUSINESS AND NONBUSINESS BANKRUPTCY CASES COMMENCED, BY CHAPTER OF THE BANKRUPTCY CODE,
DURING THE TWELVE MONTH PERIOD ENDED DEC. 31, 2008

CIRCUIT AND DISTRICT	TOTAL FILINGS	PREDOMINANT NATURE OF DEBT(1)					PREDOMINANT NATURE OF DEBT(1)					TOTAL NON-		
		CHAP. 7	CHAP. 11	CHAP. 12	CHAP. 13	TOTAL BUSINESS FILINGS	CHAP. 7	CHAP. 11	CHAP. 12	CHAP. 13	TOTAL NON- BUSINESS FILINGS	CHAP. 7	CHAP. 11	CHAP. 13
TOTAL...	1.117.771	744.424	10.160	345	362.762	43.546	30.035	9.272	345	3.815	1.074.225	714.389	888	358.947

2008 Bankruptcy Statistics USA,

Source: <http://www.uscourts.gov/bkprctstats/statistics.htm#calendar>

TABLE F-2 U.S. BANKRUPTCY COURTS
BUSINESS AND NONBUSINESS BANKRUPTCY CASES COMMENCED, BY CHAPTER OF THE BANKRUPTCY CODE,
DURING THE TWELVE MONTH PERIOD ENDED DEC. 31, 2007

CIRCUIT AND DISTRICT	TOTAL FILINGS	PREDOMINANT NATURE OF DEBT(1)					PREDOMINANT NATURE OF DEBT(1)					TOTAL NON-		
		CHAP. 7	CHAP. 11	CHAP. 12	CHAP. 13	TOTAL BUSINESS FILINGS	CHAP. 7	CHAP. 11	CHAP. 12	CHAP. 13	TOTAL NON- BUSINESS FILINGS	CHAP. 7	CHAP. 11	CHAP. 13
TOTAL...	850.912	519.364	6.353	376	324.771	28.322	18.751	5.736	376	3.412	822.590	500.613	617	321.359

2007 Bankruptcy Statistics USA

Source: <http://www.uscourts.gov/bkprctstats/statistics.htm#calendar>

In conclusion, in the US, we observe a higher rate of private bankruptcies, as compared to Austria. However, in both countries, the 2008 increase in bankruptcy filings is mainly contributed by an increase in business bankruptcies. In addition, a higher rate of American companies filed for restructuring than in Austria. On average in 21% of business bankruptcy cases, companies were rehabilitated under Chapter 11. This number was almost ten times lower for the Austrian firms. Hence, the US bankruptcy code seems to provide a better environment for reorganization. Managers file timely for reorganization and companies in more cases can avoid liquidation.

Part V. Differences in insolvency law systems

Economic transformation, and cultural and institutional changes in the nineteenth and twentieth century have to a great extent influenced not only the structure and functioning of bankruptcy laws, but also revolutionized the procedures and enforcement mechanisms. Western countries have undergone the industrialization, the separation between company ownership and control, and changes of attitudes towards debts.⁶⁴

5.1. Specific country characteristics

There are several papers, which attempt to explain how the specific country's characteristics can impact the investors' rights. The main factors, that can influence the extent to which specific investors' groups are protected in a particular country, include the culture, legal origin, language, and religion. The specific country's bankruptcy laws are then structured adequately to reflect the rights given to claimholders in the bankruptcy procedures. By this fact, the authors of the papers first assumed and then confirmed with the results of their studies, that the differences in the country specific characteristics have an influence on the approaches taken to resolve financial distress.

A starting point for the researches was a study by LLSV from 1996, which examined legal rules covering protection of corporate shareholders and creditors, the origin of these rules, and the quality of their enforcement in 49 countries.⁶⁵ They also examined, whether these dissimilarities have an influence on the concentration in the corporate ownership structure in a particular country. The authors show in their study that the investors' rights vary a lot across the countries. These differences are determined by the country's law systems, which, on the other hand, can be attributed to the differences in their legal origins.⁶⁶ The common law countries give the strongest protection to both, the firm's shareholders and creditors. The French Civil laws protect at least the investors' rights. The German Civil law countries are in

⁶⁴ Gratzner, Stiefel (2008),

⁶⁵ La Porta R., Lopez-de-Silanes F., Shleifer A., and Vishny R.; Law and Finance (1998)

⁶⁶ Current commercial law has its roots in Common law, which is English in origin or in French, German or Scandinavian Civil law tradition, that were driven by Roman law.

between but their quality of the law enforcement is the highest. Austria⁶⁷ belongs to the German Civil law family. The United States, England and British colonies like Australia, India, and Canada form the Common law family. A weak legal protection of the investors is substituted by the high ownership concentration (France). Thus, the study confirmed that the legal systems have an impact on corporate governance. In addition, the larger economies tend to have lower ownership concentration, but the countries with unequal societies a higher one.

5.2. Shareholders rights

The results of the study imply that the variations in the shareholders rights depend significantly on the country's legal family. In general, the common law countries protect shareholders right quite better than civil law.

5.2.1. Austria

The shareholders rights are not much protected by the Austrian legal system. The shareholders' rights index account for only 2 out of 6 points. This means that a country's legal policies do not really support the shareholders position in a firm. Indeed, the Austrian Commercial Code does not follow a rule one share - one vote. Voting rights are allocated in a different way to different kind of shares. These regulations provide shareholders with less voting power. As next, the Austrian code prohibits shareholders to mail their votes. Moreover, their shares are blocked before the general meetings. The minority shareholders are discriminated against the large shareholders. There are no mandatory dividends.⁶⁸ But the law entitled existing shareholders to purchase new issuing stocks in a first place. The extraordinary meeting can be called by shareholders owning 5% of the firm. In sum, Austria score (2 points) is even lower than the German origin average (2.33).

⁶⁷ Together with Germany, Japan, Hungary, and Korea

⁶⁸ Mandatory dividends are used only in French Civil law countries. They are substitutes for the very weak protection of shareholders rights there.

5.2.2. The United States

The U.S. Commercial and Company Codes allows shareholders to mail their votes. Besides, their shares are not blocked before the general meetings. In addition, minority shareholders interests are protected by the proportional weights of their votes. Only 9% of the share capital is required to call the extraordinary shareholders' meeting. However, the rule of the one share-one vote is not followed by companies. The U.S. code does not provide existing shareholders with the opportunity to buy new issues of stock in a first place. Nevertheless, the U.S. shareholders' index has a score of 5, which is even higher than the common law countries average with the score of 4. The U.S. law considerably supports the interest of shareholders against the unfair management decisions.

5.3. Creditors' rights

The LLSV creditors' index includes both, the creditors' rights in liquidation and in reorganization procedures. Again, the results indicate that the legal origin of a country matters for the creditors' protection. Generally, the law systems care more for creditors than shareholders, especially in the common law systems. In addition, the results indicate that the creditors' rights seem to be better protected in poor than in rich economies.⁶⁹

5.3.1. Austria

The German law countries seem to protect to a large extent the rights of creditors. Especially, secured creditors enjoy the best treatment. Austrian insolvency law does not impose an automatic stay on secured claims, so that creditors can easily grab the company's assets. By this action, the reorganization of a firm makes a little sense, because some repossessed assets are crucial to continue firm's operation. Furthermore, the secured creditors are satisfied in the first place with the proceeds from bankruptcy. The law also restricts possibilities for firm reorganization. What remains, is the management of the firm that is not replaced during the reorganization process. To protect the unsecured creditors companies in Austria are obligated to keep

⁶⁹ La Porta R., Lopez-de-Silanes F., Shleifer A., and Vishny R.; Law and Finance (1998)

on average 10% of the firm's value in legal reserve.⁷⁰ Creditors' rights index for Austria sum up for 3 out of 4 points. This score is higher from the German origin average of (2.33).

5.3.2. The United States

The common law countries, with the average score of 3.11, provide strong legal protection for the firm's creditors. The U.S., with the score of only 1, is an exemption to this rule. The American insolvency law allows for automatic stay on assets. The legal system does not restrict, but even prompts for reorganization of a firm. The managers keep their jobs during the process of restructuring, but their actions related to operations of the business are supervised by the court. However, the priority of the creditors' claims holds. The secured creditors get paid first from the sale of the firm's assets. Legal reserve is not required by law in U.S.

In conclusion, the LLSV study shows that the differences in the degree of protection of investors are significantly correlated with the differences in the legal origin. The legal origin substantially impacted the development of the countries' legal systems. This can explain the differences in the investors' protection across the world. Based on the fact that the roots of Austrian and the US laws originate in two quite different legal families, the shareholders and creditors' rights receive a different treatment in insolvency law systems. Moreover, dissimilarities in the quality of legal protection also result in differences in ownership concentration. Three largest shareholders in Austria owned on average 58% of company's stocks, where in the U.S. these account for only 20%. Because of a highly concentrated ownership, the major investors of Austrian corporations bear risk of non-diversification and undervaluation of their stocks.

The LLSV study raises a question, whether the countries with a weak legal investors' protection actually suffer from this inefficiency? The authors adduce statements of other researches. They suggest that better developed debt and equity markets

⁷⁰ Legal reserve should compensate for the weak creditor protection, above all in French Civil law countries.

contribute to economic growth. Their evidence point out at the relationship between a legal system and financial development.⁷¹

5.3. Culture openness and finance

Stulz and Williamson (2002) also tried to explain the differences in investor protection across the world. Their study shows that the differences in the culture and country's openness to international trade cannot be ignored when examining the deviations in investor protection. The country's primary religion is worth consideration and helpful in understanding how investors' rights are enforced across the law systems.⁷² The LLSV paper has already confirmed that the investors' rights are affected by the legal origin of the country. However, Stulz and Williamson were not sure if the impact of culture on finance is captured by the country's legal origin. Therefore, they added the culture variable, represented by religion and language to LLSV's research. They examined the same investor rights as LLSV did. S&W study shows that the creditors rights are stronger in the Protestants countries rather than in Catholic, regardless of the legal origin. However, Catholic civil law countries protect the creditors less than the Protestant civil law systems. The culture proxies provide an explanation of variations in individual shareholder rights. The influence of religion on creditors' rights decreases by the country's openness to international trade.

The authors also found that the stock market development is correlated with the country's legal origin. The debt markets and banking development, in opposite, are connected to the culture. In particular, the authors claimed that the debt issuances relative to GNP are smaller in Catholic than in Protestant countries.⁷³ From their results, the authors conclude that the Catholic countries are characterized by hierarchical centralization of the governing institutions. The common good of the society is more important than the needs of individuals. The Protestant countries' institutions are decentralized and the individual's beliefs and rights are more taken by the governmental institutions into consideration. Based on that fact, the judicial systems have a different pattern on making judgments. The courts in civil law

⁷¹ LLSV (1998)

⁷² Stulz and Williamson (2002)

⁷³ Stulz and Williamson (2002)

countries have strict rules on which judges' sentences are based. On the other hand, the common law is more formed by judges, who often lay down the rules to the specific case.

According to the study of Stulz and Williamson, Austria was classified as a Catholic Country with 76.6 % people claimed to be Catholics, about 6% Protestants, and 15% to have other religions. The portion of Muslim and Buddhist religions counted for 2% and 0.1% respectively. The primary language in this country is German. The Austrian law has its legal origin in German Civil law. Catholic countries are more likely to represent the interests of minority shareholders by proportional representation rule. Most of Catholic countries offer preemptive rights⁷⁴ to the existing shareholders. According to the creditors' right index, Catholics protects creditors poorly than the Protestants. But the country's openness to international trade can enforce the creditors' position. The Catholic countries have lower market capitalization and less debt issues than Protestant countries.⁷⁵

It is worth to mention, that Germany was classified as a Protestant country. The Protestants make up 37.2% of the Germany's religion, followed by Catholics with about 35%, and 23.8% people claime to have other religions. The Muslim and Buddhist counted for 4% and 0.1% respectively. The legal origin is civil German law.

In opposite to Austria, the U.S. was classified as a country with Protestant religion as a primary, although the Protestants account only for 24.3% of population. 52.3% claim to have other religion and the Catholics make up 21.2%. The Muslim and Buddhist religions account for 1.4% and 0.8%, respectively. The American law originated from Common law. The primary speaking language is English. Following the results of the study, English-speaking and Protestant countries simplify the voting to shareholders. They also have more power against the company's management. The United States seem to not follow the rule that creditor rights are better protected by Protestant countries.

Similarly, U.K. was classified to the countries with Protestant as a primary religion (53.8%), followed by 34.4% people with other religions, and only 9.6% Catholics.

⁷⁴ The opportunity to buy new issues of stock in a first place by the company's existing shareholders.

⁷⁵ Stulz and Williamson (2002)

The U.K. legal system originated from Common law and English is the primary language in this country.

The study of Stulz and Williamson confirms that there is a correlation between a culture and investor rights. In addition, the countries that are more open for international trade, offer better creditor protections and more efficient law enforcement.

Part VI. A comparison of the current Austrian and U.S. insolvency law systems

6.1. Going concern vs. liquidation preferences

To start with a right bankruptcy procedure the involved parties should first ask a question, whether the firm is worth more dead or alive.⁷⁶ Following that thought, the chosen procedure to resolve financial distress should aim to maximize the value of the firm. This means that a decision, whether a firm should be closed or restructured depends on what the creditors and shareholders receive at the end of the process. Although, the aim of bankruptcy resolution is to maximize the value of the claims that are distributed to their holders, hardly any decision with respect to the choice of bankruptcy type makes all groups happy.

6.1.1. Austria

In my opinion, the Austrian insolvency law is a bit more oriented on firm's liquidation. Hence, the liquidation procedure is more developed. In addition, the liquidation procedure can also be used to reorganize a firm. Instead of filing for compensatory settlement under AO, the firms' managers file for liquidation in KO and can restructure their firm here under compulsory settlement. However, this is not really the purpose of the liquidation procedure. The liquidation procedure prompts for shutting down of a business. The insolvency law system in Austria has combined the two main procedures for a resolution of distress. Secured creditors have strong control rights over the insolvent firm. Following their own interests, they insist more often on liquidation of a defaulted firm. Studies suggest that firms in which a bank is a creditor are more likely to file for liquidation in place of reorganization.⁷⁷ This implies that the Austrian firms' capital structure contributes to the choice of the bankruptcy procedure. The AO is a separate regulation. The KO provisions can be applied only as supplement for the cases under AO. However, the reorganization procedure remains in the shadow of the liquidation procedure. In Austria, the reorganization procedure self is focused more on the protection of creditors, and above all, on quick and cheap solution of the distress. It is also not easy for a troubled firm to file for reorganization because there are some strict conditions to be met for companies to qualify for a

⁷⁶ Brigham E. and Ehrhardt M., Financial Management: Theory and Practice ,Chapter 24 (2008)

⁷⁷ Bris , Welch, and Zhu (2006)

compensatory settlement.⁷⁸ When a debtor files a petition for reorganization, he also needs to propose a plan for restructuring of the firm. If the reorganization plan does not satisfy at least 40% of the creditors' claims, the managers cannot file for *Ausgleich*. This "quota" should not be the main indicator of whether a firm should be allowed to restructure or not.⁷⁹ Moreover, debtors work on the plan under a pressure of secured creditors. Debtors' business partners, concerned about the future prospects of the distressed firm, may terminate their contracts. In general, the public perception of the bankruptcy in Austria is still very negative and the bankruptcy stigma prompts for a liquidation of the financially troubled businesses.

A current reform of the insolvency system in Austria aims to increase the number of filings for reorganization. A premature liquidation of a firm should be avoided. The new bankruptcy provisions support the debtor's position.

6.1.2. The United States

The Chapter 11 procedure is designed to keep a financially distressed firm running. Moreover, the managers do not have to close their businesses, even if a company is worth more in liquidation than as a going-concern.⁸⁰ The statutory composition of the Chapter 11 procedure protects the debtors. A debtor-in-possession provides the firms' managers with substantial control rights over the firm. The creditors usually cannot force the firm's liquidation. The intention of the lawmakers is that a company in trouble should get a chance to restructure. The requirements to qualify for reorganization are not so strictly examined as in Austria. Therefore, the US debtor will in the first place try to reorganize his business under Chapter 11, before filing under Chapter 7. In their study, Bris, Welch, and Zhu (2006) argue that firms are more likely to go for Chapter 11 if the firm's value is not tiny. The efficiency of Chapter 11 seems to depend on the size of the firm. The larger is the company filing under Chapter 11, the more it benefits from its provisions. On the other hand, the larger the firm, the more incentives the government has in keeping it running as a going concern. The American Chapter 11 procedure is concentrated on the national economy and more concerned with the well being of the society as a whole. This

⁷⁸ A minimum rate of creditors claims that need to be satisfied within a certain period from filing.

⁷⁹ Hajek (1999)

⁸⁰ Franks, Nyborg, and Torous (1996)

applies especially to larger firms that are very important for the domestic economy (e.g. railroads, airlines, banks).

In conclusion, the US insolvency law system draws a strict line between liquidation under Chapter 7 and the reorganization of a firm under Chapter 11. Chapter 7 is being seen as the last resource for the financially troubled firm. The American insolvency law prompts for a restructuring of a firm. Chapter 11 provides a full package with benefits for an insolvent debtor. In opposite, the Austrian bankruptcy system does not provide the managers with a friendly environment for reorganization. The legal requirements are difficult to comply with for the financially distressed debtors. This can often result in a premature and inefficient liquidation of the firm. However, the new IO enhances the rights of the debtor facing distress.

6.2. Bankruptcy petition and solvency requirements

A firm is eligible to file for bankruptcy when it encounters a financial distress and this is not a temporary problem. A firm is in financial troubles when it is not able to meet the scheduled debt repayments to its creditors or when the firm's assets are worth less than the firm's liabilities. These are the two major conditions for the insolvency. At such a point, managers are required to take an action either to liquidate or to rehabilitate the insolvent firm. However, particular insolvency codes impose some restrictions on who can file a bankruptcy petition and under what circumstances.

6.2.1. Austria

The firm's over-indebtedness and inability to repay the outstanding debt are the requirements to determine the insolvency in Austria. A liquidation petition (*Konkursantrag*) can be filed either by the debtor or by the firm's creditors. However, only the debtor is legally obligated to file a petition.⁸¹ When the petition is submitted by the creditor, its credibility has to be first verified by the court. One additional condition is that together with the bankruptcy petition a filing person has to pay in advance the fee of €4,000 to cover the start-up cost of the process. The same conditions for insolvency hold for the debtor when a petition for compensatory

⁸¹ Firm's managers refer to: Geschäftsführer, Vorstand bei AG

settlement (*Ausgleich*) is filed, except for the €4,000 deposit. In addition, a threat of illiquidity might be a sufficient reason to file for restructuring. As in the U.S. code, only the firm's management is authorized to file for reorganization. One further issue regarding filing for bankruptcy in Austria is that managers do not have much of incentive to file a bankruptcy petition before the firm finds itself in serious financial troubles. The second biggest bankruptcy in Austria, in 2008, was the EYBL GmbH reorganization filing. With the assets worth €18.1 Mio and liabilities of €87 Mio the firm was already in massive financial troubles at the time of filing for reorganization.

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In the new Insolvency Code (IO), other things being equal, the start-up costs of the process, of €4,000, also ought to be paid by the shareholder holding the majority of the company's shares.⁸³ If a bankruptcy petition is filed by a creditor, the fee must be paid by the filing creditor. However, he has the right to the refund by the end of the court proceedings. As the result, the occurrence of no-asset bankruptcy cases in Austria should decrease.

6.2.2. The United States

Similar to the Austrian law, the firm's over-indebtedness or the debtor's default on the repayment of debt are the triggers for the bankruptcy. The bankruptcy petition may be filed voluntarily by the firm's management or involuntarily by its creditors.⁸⁴ In the U.S., managers will first attempt to reorganize the firm in Chapter 11 before entering liquidation. Managers have the incentive to act like this because Chapter 11 provides the protection of the court for the firm. In opposite to Chapter 7, the debtor in possession makes it more possible that the managers retain their jobs. However, the firm's insolvency is not always a requirement for Chapter 11 procedure. The projections that the future occurrence of insolvency is inevitable, gives the debtor the right to file under Chapter 11. This decision is based on the firm's cash flows or financial ratios analysis of the business performance. The management has the exclusive right to file for rehabilitation and to propose the required plan.

⁸² http://www.ksv.at/KSV/1870/de/5presse/2medienarchiv/1insolvenzerstfaelle/2008-12/eybl_international/index.html

⁸³ §72d Insolvenzordnung

⁸⁴ The debtor has a power to convert creditors' involuntary petition for liquidation into Chapter 11 reorganization petition. Therefore, creditors' bankruptcy petitions are rare.

In conclusion, both systems require similar conditions for insolvency. The firm's managers are legally obligated to file a bankruptcy petition. The creditors' petition for liquidation can be redeemed by the debtor's filing for reorganization. Debtors in the US take advantage of this opportunity quite frequently, whereas the Austrian managers are focused mainly on collecting the process fee. Debtors in Austria have to be more proactive in detecting bankruptcies in the early stage.

6.3. Control rights over a distressed firm

Who should be in charge of a firm while it is being liquidated or reorganized? The insolvency law provides different rights to creditors, shareholders, and firm's managers in the bankruptcy procedures. The control over the firm's assets is delegated to the court, legal administrator, managers or secured creditors. The rights of the unsecured claimholders and minority shareholders are often limited. In majority of countries, in the liquidation proceedings, creditors are given more control power over an insolvent firm than its debtors. First and foremost, the law provisions have to prevent the expropriation by the managers. In LLSV paper (1999), the authors argue that the corporate governance is a set of mechanisms with the help of which outside investors protect themselves against the expropriation by the insiders.⁸⁵ The task of the legal system is to allocate the rights between the firm's management and its investors in the most appropriate way, also in the bankruptcy process.

6.3.1. Austria

In the liquidation process (*Konkurs*), the control rights over a distressed firm are in the hands of the insolvency liquidator appointed by the court. The liquidator leads a firm during the process. His assignments are the appraisal and liquidation of the firm's assets and distribution of the proceeds from the sale to the firm's creditors. However, the firm's managers have the opportunity to open a compulsory settlement with the firm's creditors (*Zwangsvergleich*). The secured creditors have a right to their claims upon which they have a lien. The unsecured creditors, on the other hand,

⁸⁵ LLSV (1999)

cannot demand their individual claims. They need to be equally satisfied from the bankruptcy proceeds by the liquidator.

In the reorganization procedure (*Ausgleich*), the management of a firm continues to manage the business. In opposite to Chapter 11, the replacement of the managers is not anticipated. However, the managers are supervised and controlled by the administrator (*Ausgleichsverwalter*), appointed by the bankruptcy court. Other than in Chapter 11, unordinary business activates that are undertaken by the management, need to be confirmed only by the administrator and do not require a direct court approval.⁸⁶ The creditors lack the influence on how the debtor should reorganize the firm. The interest of the firm's claimholders is protected by the administrator or the creditors' committee.

6.3.2. The United States

In Chapter 7, the management of the liquidated firm is dismissed. The court appoints a trustee who runs the bankruptcy procedure. His role is to sell the firm's nonexempt assets and to use the proceeds to pay the firm's claimholders according to their priority.

In the US, in Chapter 11, the debtor-in-possession retains the control rights, however, the management acts under the scrutiny of the court. The managers of the reorganizing firm have to get an approval on their decisions, which are not ordinary for the business, from the bankruptcy judges. The creditors have to be informed about unordinary actions of managers and can discuss them first with the judge. The trustee keeps an eye on the debtor's business operations during the bankruptcy process. He has to report to the bankruptcy judges on the progress. Although, in the beginning stage of Chapter 11, the managers are not being replaced, Gilson found out in his study that only 30% of the managers of the firms that filed for Chapter 11 remained at their positions. He observed that the majority of the managers are replaced two years before and two years after bankruptcy filing. The turnover rate of the firm's CEOs and directors was also high. In addition, the managers were laid off on behalf of the firm's creditors.⁸⁷ The debtor and the firm's creditors should cooperate with each

⁸⁶ Hajek (1999)

⁸⁷ Gilson (1991)

other during the bankruptcy, so that the decisions are accepted by both interest groups.

In conclusion, these two insolvency systems differently allocate the control rights over a distressed firm in the bankruptcy process, especially in the reorganization procedure. In liquidation, the creditors are more protected by in both systems. However, the Austrian law seems to empower the position of the secured creditors even more than the US code. Therefore, they may not have an incentive or interest in restructuring of the firm, which substantially limits their influence on debtors' decisions and expose them to higher risk. On the other hand, the US Chapter 11 assumes cooperation between the company's managers and creditors. The debtor's actions are supervised by the court, thus, his opportunistic behavior against investors is limited. The Chapter 11 debtor-in-possession works more in the interest of shareholders.

6.4. The automatic stay

The automatic stay is a provision in the bankruptcy law that prohibits the firm's creditors to collect their claims in the bankruptcy. Thus, the bankruptcy law significantly reduces the creditor's power, especially of the secured creditors. Creditors cannot simply seize their assets. Moreover, the interest and principal payments are stopped and the debt obligations are restructured. Because of the automatic stay, the business continues to run while the managers work on its reorganization plan.

6.4.1. Austria

The Austrian law restricts the repossession of the individual creditor's claims in the bankruptcy process. In general, the law prohibits unsecured creditors to force their individual claims during the procedure. According to the creditor equality principle, the court trustee is liable for equal distribution of claims from the proceeds. The secured claims cannot be repossessed by the creditors within 90 days from bankruptcy filing. The automatic stay on secured claims is also not foreseen in the reorganization procedure. However, upon the debtor's request the court may decide that some

secured assets have to stay in a firm, so it can continue to operate.⁸⁸ The interest on secured claims does not stop to accrue.

The new IO imposes a six-month stay on claims which are essential for business operations during reorganization. In addition, utility or telecommunication contracts cannot be terminated within the first six months from the time of bankruptcy filing.⁸⁹ IO also imposes new regulations on labor and rent agreements.

6.4.2. The United States

The automatic stay is imposed by the American bankruptcy code. It forbids secured and unsecured creditors to undertake any action against debtor to collect their claims or enforce their liens. The stay on creditors' action against a Chapter 11 debtor begins when the bankruptcy petition is filed.⁹⁰ This regulation often secures the firm against a hasty, premature, and inefficient liquidation. The interest and principal payments stop to accrue. However, the ongoing business expenses from its ordinary operations have to be paid by the debtor.

In conclusion, the automatic stay provision is far more developed in the US. The purpose of the US stay is to guard an American debtor for a given period of time against the creditors' collection activities. During this time, managers work undisturbed on the restructuring of the firm. The Austrian law, on the other hand, is more concentrated on creditors in the bankruptcy process. The collection attempts of secured creditors have to be first stopped by a debtor. The new IO aims to facilitate the environment for an Austrian firm ongoing rehabilitation.

6.5. Deviation from absolute priority

A deviation from absolute priority occurs when senior claimholders give up some of the value of their securities to junior creditors or shareholders.⁹¹ In contrast, the absolute priority rule holds when senior creditors are fully satisfied with the proceeds

⁸⁸ Hajek (1999)

⁸⁹ § 25a IO

⁹⁰ <http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter11.html#stay>

⁹¹ Franks and Torous from Altman (1999)

from bankruptcy before the lower priority classes of creditors and stakeholders are paid.

6.5.1. Austria

By the law, the *Massegläubiger* need to be fully paid with the proceeds from bankruptcy in the first place. As next, all secured creditors have a right to their assets and need to be satisfied before other claimholders. The unsecured creditors are thrown in one basket. They are satisfied from the remaining funds equally. All debtor non-exempt property has to be sold and distributed among the firm's claimholders. The statistics on bankruptcy in Austria show that on average 50% of the bankruptcy petitions are classified as no-asset cases. A conclusion can be drawn that deviations from absolute priority occurs in Austria very seldom. There is a little left from the firm's wealth at the time of filing already. As a result, the secured creditors are not interested in reorganization of a firm but in recovering their investment. The lower is the position of a claimholder in the priority line the more he is exposed to the risk that his claims will not be satisfied.

6.5.2. The United States

In the US under Chapter 11, deviations from absolute priority in favor of equity holders and other junior creditors are common. The US courts frequently fail to enforce the rule of absolute priority. A violation of strict priority occurred in the 29 out of 37 cases that were examined by Weiss.⁹² This resulted usually in losses for creditors who had to give up a part of their claims.

In conclusion, in the US Chapter 11, the company's shareholders usually benefit from deviation from absolute priority, mainly at the costs of secured creditors. Moreover, the shareholders can benefit even more, if the managers choose to restructure the firm in private workouts.⁹³ In Austria, deviations from absolute priority of claims, although very rarely, can be applied. One condition is that the firm's value needs to be substantial at the time of negotiations.

⁹² Weiss (1991)

⁹³ Franks, Nyborg, and Torous (1996)

6.6. Costs and Duration

A country's legal approach to resolve bankruptcy and the design of an insolvency code in particular have an impact on duration of the insolvency process and its cost. This cost includes not only the direct cost of bankruptcy, such as legal and accounting fees, but also accounts for the indirect cost of the insolvency process: loss of investment opportunities or cost of overinvestment. The length of time that it takes for a firm to be engaged in the bankruptcy process will depend on the complexity of the negotiations.

6.6.1. Austria

The Austrian law system restricts the time for the resolution of bankruptcy, thus it reduces the costs of the insolvency processes. After the bankruptcy process has been initiated, a debtor has 90 days to come up with a complete plan for reorganization, which needs to be enforced within the next 14 days. If the agreement among the firm's creditors on the restructuring plan cannot be reached, the firm is shut down. In Austria, since the insolvency administrator does not act in the sole interest of the creditors, the time and costs of bankruptcy can on occasion be long and high. The creditors, however, with the help of the court, have the ability to shorten the time of the insolvency process.

6.6.2. The United States

In the US under Chapter 11, since the insolvency proceedings take a long time and the court directly oversees the management of the firm, the costs of insolvency are very high. Not only the legal and accounting costs increase with the duration of bankruptcy, but also the ability to raise new debt under Chapter 11 often results in overinvestment increasing the indirect cost of bankruptcy. The studies show that the direct costs of Chapter 11 accounts from 2.8 to 7.5 of the total value of a filing firm.⁹⁴ One would expect that Chapter 7 provisions are not so expansive. However, some researchers found out that Chapter 7 liquidations are not cheaper than Chapter 11 reorganizations.⁹⁵ According to their study, the duration of bankruptcy resolution is

⁹⁴ From Gilson (1991)

⁹⁵ Bris, Welch, and Zhu (2006) From their study based on a sample of 300 corporate bankruptcy cases from Arizona and New York bankruptcy courts from 1995 to 2001.

also similar and the proceedings under both Chapters are on average two years long. Previous studies showed that firms spend on average 3.7 years in Chapter 11, Franks and Torous (1989). Generally, the process takes as much time as it is required to find the most effective solution and is not time limited. To overcome these inefficiencies, managers may choose to negotiate with creditors in private workouts. In addition, the management of a distressed firm can choose to file for bankruptcy under the prepackaged Chapter 11 procedure, the so called *prepacks*. The *prepacks* substantially shorten the time of negotiations and significantly reduce the costs of the formal proceedings.

In conclusion, the efficiency of a bankruptcy code depends on the time and cost that insolvency process requires to resolve the financial distress. The Austrian insolvency law system restricts the time of bankruptcy proceedings. It follows that bankruptcies in Austria should be less expensive than in the US. However, the restriction of time of bankruptcy proceedings lowers mostly the direct cost of bankruptcy and often at the expense of deciding on the most efficient solution. Proposing an effective resolution for the financial distress may take longer than the time allowed by law. The legislators should take this point into account and add provisions to bankruptcy procedures that allow for the extension of time if more time is required for the firm to draft a better plan. The US insolvency system is, on the other hand, much more time consuming. Unlimited duration of bankruptcy proceedings usually results in rising costs. However, the higher costs are often offset by the benefits arising from the final solution. One alternative to avoid the cost inefficiencies of the American insolvency system arising from the duration of proceedings is to restructure a firm in the informal procedure or with the use of *prepacks*.

6.7. Involvement of court

In general, during the bankruptcy process, the management of a filing firm is supervised by the court. Degree of the court's involvement into the process differs across the countries. Some decisions during the process require the approval of bankruptcy judges. Usually, courts appoint a trustee, who coordinates the proceedings and controls the managers. In addition, the actions of managers or a trustee have to be

in compliance with the ruling of the court. One obstacle is, whether judges are always qualified enough to deal with corporate bankruptcies.

6.7.1. Austria

The Austrian insolvency regime substantially limits the involvement of the court in the resolution of bankruptcy. The legislators purposely narrowed the competences of courts. The motivation beyond was to minimize the costs and time of insolvency proceedings. In liquidation the court appoints an independent liquidator. He has to run a firm during the process and at the end he distributes proceeds to the firm's claimholders. In reorganization, most of the decision making power is delegated from the court to the insolvency administrator. Either the administrator or the debtor can run the restructuring of a firm. As long as they obey the legal rule, the court does not intervene in their actions.⁹⁶ In addition, the administrator is being seen as the entity that is more qualified than a judge to lead the bankruptcy.

6.7.2. The United States

Courts in the US, on the other side, are quite more involved in the bankruptcies proceedings. A trustee and managers need to consult most of their decisions with bankruptcy judges. Moreover, bankruptcy judges have a right to cram down the restructuring plan. This means, that the debtor's restructuring plan is forced by the court against the will of some classes of creditors. Weiss (1991) confirms that bankruptcy judges have a substantial impact on the resolution of corporate distress. In addition, he argues that courts intervene too much in the private contracts between debtors and creditors, which results in the loss of their confidence that the contracts will be executed as previously agreed.

In conclusion, the Austrian courts are less engaged in the bankruptcy process than the US courts. Therefore, the insolvency processes in Austria are not so complex, time consuming and expensive as compared to America. The decision making power is delegated from a judge to an independent, qualified administrator. He supports the debtor during the reorganization process. The US trustee acts more like a mediator in the bankruptcy process, who follows the decisions of bankruptcy judges. The American law is a case law which also applies to insolvencies. The efficiency of

⁹⁶ Hajek (1999)

resolution of corporate bankruptcy depends on the qualification of judges. Negotiations, mainly supervised by the court, require more effort in determining a final solution.

6.8. New financing: over- vs. underinvestment

New financing in reorganization is a key element to keep a business running. Financially distressed companies need new funds to recover from bankruptcy. However, investors are concerned with the riskiness of lending money to unstable businesses. The higher is the risk of the investment the higher is the premium that creditors expect for their investment. Thus, the new financing raised for a company in bankruptcy should have priority over the existing financial obligations of a firm. In addition, possibility of raising new funds for a firm attempting restructuring should in some degree be enforced by the law. Such regulations assure potential investors that their claims will be repaid, so potential creditors have an incentive to enter in new financing contracts with a distressed debtor. A deficit in availability of new funds in bankruptcy may result in underinvestment. In opposite, too easy access to new financing may result in overinvestment.

6.8.1. Austria

The Austrian insolvency law system does not impose specific regulations on raising new funds in bankruptcy. Its current provisions do not spell out exactly, whether a debtor is entitled to raise new debt after he has filed for bankruptcy.⁹⁷ In general, during the reorganization procedure, managers lead ordinary operations of a business. Any decisions of management beyond the daily business activities require an approval of the insolvency administrator. In theory, new financing in bankruptcy could be arranged for between the administrator and a creditor and classified as liabilities that have a priority over all other claims.⁹⁸ In practice, however, an Austrian debtor faces difficulties in arranging for new funds to support his business in reorganization. The lack of new funds often results in underinvestment. Hence, managers cannot pursue the opportunities to invest in profitable projects. The case of Cosmos GmbH illustrates an example of one unsuccessful attempt of reorganization. The debtor's

⁹⁷ Hajek (1999)

⁹⁸ Fink (2009), so called *Masseforderungen*

restructuring plan was rejected by the creditors because new investors refused to provide the capital necessary for the distressed business to operate. In effect, the plan for restructuring has failed and the firm was forced into liquidation.

6.8.2. The United States

In the US, less constraint is laid on arranging for new financing since new debt issued for the purpose to save the firm is classified as senior to all prior debt. Thus, the new debt has a priority over the existing claims. This concept is called a supra priority financing.⁹⁹ Studies show that Chapter 11 preserves more value of the firm's assets than Chapter 7.¹⁰⁰ Thus, the creditors have an incentive to provide or approve new financing needed in restructuring. However, an easy access to new funds can tempt the managers to overinvest as in the case of Eastern Airlines. At the time the firm filed for bankruptcy, the firm claimed it had enough assets (valued for \$3.7 billion) to fully satisfy all outstanding claims (valued for \$3.4 billion). Finally, at the time of liquidation, after the unsuccessful attempt for reorganization, the firm's assets had a value of only \$0.34 billion.¹⁰¹

Managers undertake very risky projects at the expense of creditors. They gamble with the investor's money. In a good state of the world, a project will pay out and turn out to be a successful investment. In a bad state of the world, the funds of investors vanish. Once a firm is in financial distress, managers care less and pursue riskier projects because they don't have much at stake anyway. Statistics prove that the management turnover rate during the financial distress of a firm is higher and most of the managers will be replaced during the bankruptcy.

In conclusion, Austrian legislators should be encouraged to establish a provision that would regulate more possibilities for a debtor in bankruptcy to raise new funds. In Austria, a debtor faces difficulties in arranging for new funds to finance reorganization. In opposite, in the US, a supra priority financing is available to firms under Chapter 11. However, the managers having access to new financing need to be better monitored, by a trustee for instance, so they don't spend the money of investors too bravely.

⁹⁹ Franks, Nyborg, and Torous (1996)

¹⁰⁰ Bris, Welch, and Zhu (2006)

¹⁰¹ Franks, Nyborg, and Torous (1996)

Part VII. Conclusion

In conclusion, the bankruptcy itself has become a huge business. This applies to both systems, in Austria and in the U.S. The groups that benefit the most from bankruptcies are the professionals employed in the “bankruptcy industry:” Above all, such parties involved in bankruptcy as: attorneys, administrators, or judges profit at high from the process. In other words, the costs of bankruptcy that arises on one side, benefits the other side.

The insolvency law continues to evolve in response to political and economical changes, especially in the aftermaths of financial crises. The insolvency systems are developed and adopted according to the country specific needs. The existing codes differ a lot and their efficiency remains questionable. Legislators are still looking for the best solution for the financial distress. The differences in the overall characteristics of the country have an influence on the specific approaches used in the resolution of financial distress. The legal origins substantially affected the development of the countries’ law systems. Nowadays, debtors’ imprisonment seems to be unrealistic and the bankruptcy stigma has notably lost of its consequences.

The United States has developed a bankruptcy code that is unique to the rest of the world. Today, in the US, there are two formal corporate bankruptcy procedures, liquidation under Chapter 7 and reorganization under Chapter 11. The US code provides more protection to the debtor in default and gives more incentive for a firm in financial distress to remain as a going concern. Stakeholders of a firm such as employees, government, customers, and suppliers are better off when a firm remains in operation. However, filing under Chapter 11 provisions may sometimes be used by managers to gain competitive advantages over the rivals operating in the same industry.¹⁰² State protects a distress firm and offers benefits that are not available to its competitors. In addition, the US code is lengthy, expensive, lacks the adherence to the original terms, and by giving too much control to the debtor-in-possession with the possibility to raise new debt, may often result in overinvestment. To combine the best features of both forms of restructuring, formal and informal, the U.S has developed the prepackaged bankruptcy procedure.

¹⁰² Franks, Nyborg, and Torous (1996)

When comparing the U.S system to the Austrian system, they both require similar conditions for insolvency. The firm's managers in both countries are legally obligated to file a bankruptcy petition. However, the Austrian bankruptcy system does not provide such a friendly environment for reorganization. In fact, it is designed to act in favor of liquidation. The 2008 crisis resulted in further increase in liquidations in Austria, especially with respect to the no-assets cases. The Austrian law makers were forced to come up with a reform that substantially increases the chances for reorganization of insolvent companies. The main challenges of the ongoing reform of the current insolvency law system in Austria are obviously: an increase in the number of filings for reorganization and a facilitation of this process. Thus, Austrian legislators are encouraged to establish a provision that would regulate more possibilities for a debtor in bankruptcy to raise new funds. Formal reorganization under Chapter 11 is far more developed than Austrian *Ausgleich*.

Ongoing reform of the Austrian insolvency law might encourage more foreign or even smaller domestic investors to invest their capital in stocks of Austrian firms. A code that favors reorganization and is more shareholder-oriented increases shareholders' confidence and provides more incentive for investment of capital in equity. A good reform of the Austrian system that favors reorganization would cause that the Austrian market would also attract more international investment. Such environment should then reduce the impact of the Catholic religion on the creditor's rights. Following that, the local insolvency code should be more suitable for foreign investors by providing them and their investment with more protection. Moreover, better legal protection for equity investors would not only stimulate investment but also lower its cost as the effect of the lower risk of investment in equity and result in changes in capital structure of Austrian firms. This should lead to the expansion of the Austrian capital market and should lower the degree of dependence of Austrian businesses on borrowing from banks. We should also observe a decrease in overall ownership concentration since smaller investors would be more attracted with investing in stocks. Altogether would create a better environment for the economic growth in Austria.

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Appendix: Curriculum Vitae

Curriculum Vitae

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Citizenship: Poland

EDUCATION

03/2005 – 06/2010	University of Vienna (BWZ) ▶ Major: International Business ▶ Concentration: Finance and International Management	Vienna, Austria
02/2008 – 03/2008	<u>STUDY ABROAD:</u> Dominican University ▶ English Language School - Completed advanced level courses in English - Business English	River Grove, Illinois USA

WORK EXPERIENCE

02/2010- 03/2010	Cola-Cola Hellenic Austria ▶ Internship –Finance / Accounting Department ▶ Responsible for Controlling of Travel Expenses	Vienna, Austria
07/2009 – 12/2009	Pfizer Corporation Austria ▶ Assistance in Finance Department ▶ Business/Financial Analyst	Vienna, Austria
05/2008 – 09/2008	Parkway Bank & Trust ▶ Customer Service Representative ▶ Personal Banking	Chicago, Illinois, USA