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Corporate Governance and Bankruptcy: a Comparative Study

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Abstract

Recent research work has put forward the concept of “national system of corporate governance” to describe the complex architecture of legal rules, economic mechanisms and mentalities which constrains managerial discretion in a different way according to the country considered. The role played by the legal system in this set of mechanisms is particularly important and, as part of the legal system, the bankruptcy law performs a specific function: designed as a governance device for financially distressed firms, it also acts as a monitoring mechanism for healthy ones. The aim of this paper is to investigate the mechanisms of corporate governance in the context of bankruptcy in a comparative perspective. Relying on a broad definition of corporate governance, we first examine the insolvency codes of five countries (France, Germany, Japan, the United Kingdom and the United States). The stance of the law (creditor-oriented vs. debtor-oriented) is discussed in relation to the legal tradition of each country. We then study the way bankruptcy law in each country articulates with the other governance mechanisms. For that purpose, a typology of those mechanisms is used, based on the type of device each kind of stakeholder is able to activate. Results of both theoretical and empirical studies on bankruptcy are used to understand which of the different devices are used in each country. The comparative approach underlines the impact of institutional differences on organizations through the incentives sent to their stakeholders.

Keywords : Bankruptcy law – National system of corporate governance – Stakeholders - Comparative corporate governance – Market-oriented systems - Bank-oriented systems.

1 Introduction

Recent research work has put forward the concept of “national system of corporate governance” to describe the complex architecture of legal rules, economic mechanisms and mentalities which constrains managerial discretion (i.e. the CEO’s field of action) in a different way according to the country (or group of countries) considered. The study of corporate governance systems has been following two complementary tracks, the first one positive and the other normative. The positive perspective is focused on the influence of national institutional frameworks upon managerial discretion. In this respect, La Porta and al. (1999) have underlined the role played by the legal system: “ The protection of shareholders and creditors by the legal system is central to understanding the patterns of corporate governance in different countries”. The comparison of corporate governance systems has given rise to proposals of classification based on stylized facts about the governance of large listed firms (Berglöf, 1990 ; Franks & Mayer, 1992 ; Moerland, 1995). In a dynamic perspective, the issue of the convergence of corporate governance systems as a result of market globalization is also frequently addressed. The normative approach to corporate governance is centered on efficiency. The issue is then to identify the characteristics of an efficient corporate governance system and to compare existing systems according to those criteria. In particular, as the positive perspective highlights the rapid diffusion of the Anglo-Saxon model among developed countries, the question of its superiority over other systems and of its transferability to other contexts¹ is raised.

The aim of this paper is to investigate the mechanisms of corporate governance in the context of bankruptcy with a comparative perspective. Significant changes in corporate governance indeed occur when firms face bankruptcy. On the one hand, as the worsening of performance becomes more and more obvious, stakeholders will modify their behavior towards the firm. For that reason, the context of bankruptcy is particularly interesting for the study of corporate governance because it allows to take a dynamic perspective which reveals new information about national systems. On the other hand, once a bankruptcy procedure is filed (and especially in the case of reorganizations, on which we focus), a new balance of power is established by the provisions included in each national bankruptcy law. Furthermore, as part of the legal system, the bankruptcy law plays a specific role. Designed as a governance device for financially distressed firms, it also acts as a monitoring mechanism for healthy ones as noticed by the contractual theory of organizations (Jensen, 1993).

¹For example, to transition economies in search of a benchmark.

Our study covers five countries: France, Germany, Japan, the United States and the United Kingdom. For its purpose, we rely on a broad definition of corporate governance i.e. the set of mechanisms that restrict managerial discretion. In doing so, we emphasize the fact that governance mechanisms aim at aligning managerial interests not only with those of shareholders but also with those of all other stakeholders. This is particularly relevant for our research object because not only shareholders and top management but also creditors, customers and usually employees bear the consequences of bankruptcy. In this paper, we use the word “bankruptcy” to refer to the context in which we study corporate governance. As a result of a trade-off between accuracy and simplicity, we have chosen to project the various terms used by US, UK, French, German, and Japan Codes (resp. bankruptcy, insolvency, redressement judiciaire, Insolvenz, and hasan) on a single American word.

The paper is organized as follows. First, in order to understand the effects of bankruptcy on corporate governance, we examine the bankruptcy codes of the five countries studied. The general orientation of the law (rather favorable to the creditors or to the debtor) as well as the role played by the judge in the different procedures are discussed in relation to the legal tradition of each country. The comparative approach followed offers interesting insights on the differences between the national legal frameworks of bankruptcy. We then study the way bankruptcy law in each country articulates with the other governance mechanisms. For that purpose, a typology of those mechanisms is used, based on the type of device each kind of stakeholder is able to activate. The results of both theoretical and empirical studies on bankruptcy are used to determine how the different devices are used in each country. Here also the comparative approach is relevant, underlining the impact of institutional differences on organizations through the incentives sent to their stakeholders.

2 The legal framework of corporate bankruptcy

The main features of the bankruptcy law as it stands in the five countries studied are first described and compared (1.1.). We then consider the stance of the law which may be rather debtor-oriented or creditor-oriented. This orientation is discussed in relation to national institutions such as the judicial tradition and to the political and economic context that prevailed at the time the law was made (1.2.). Finally, we examine the choice between private and judicial reorganization in each country, as out-of-court treatment of firm difficulties sometimes represents the most favored way of resolving conflicts between debtor and creditors (1.3.).

2.1 Features of national bankruptcy laws

After presenting the corporate bankruptcy procedures under the laws of the five countries, we focus on reorganization, which is of greater interest for the study of corporate governance than liquidation.

Table 1 mentions the legal texts dealing with bankruptcy in each country and summarizes the different corporate bankruptcy frameworks.

Table 1 – Corporate bankruptcy frameworks under the law as it stands

Countries	United States	United Kingdom	France	Germany	Japan
Legal texts dealing with bankruptcy and date of adoption	Bankruptcy Reform Act (1978) Bankruptcy Reform Act (1994)	Companies Act (1985) Insolvency Act (1986) Company Directors Disqualification Act (1986) Insolvency Act (1994) Companies Act (1989)	25 January 1985 Law 10 June 1994 Law	Insolvenzordnung (InsO) 5 October 1994 (brought into force 1 January 1999)	Special liquidation and reorganization under the commercial code (1899) Bankruptcy Act (1922) Corporate Reorganization Act (1952) Civil Rehabilitation Law (2000)
Liquidation procedures	Chapter 7 of the Bankruptcy Code	- Voluntary liquidation - Compulsory liquidation	« Single gateway » procedure	« Single gateway » procedure	- Hasan (bankruptcy) - Tokubetsu Seisan (special liquidation)

Corporate reorganization procedures	Chapter 11 of the Bankruptcy Code	<ul style="list-style-type: none"> - Administration - Administrative receivership - Company Voluntary Arrangement - Scheme of Arrangement 	procedure leading either to liquidation or to reorganization by means of a sale plan or a reorganization plan	procedure leading either to liquidation/cession or reorganization (Insolvenzplan)	<ul style="list-style-type: none"> - Kaisha Kosei (corporate reorganization) - Kaisha Seiri (reorganization under the commercial code) - Minji Saisei (civil rehabilitation)
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With the exception of Japan, all the countries studied have deeply renewed their legal framework for the treatment of failing firms during the last twenty-five years, the most recent reform having been carried out by Germany. In that case, the need for a unified law among western and eastern states (Länder) brought the opportunity to modernize the old western procedures² which had long been under intense criticism. As for Japan, the former Composition (wagi) Law has been repealed in 2000 and replaced by the Civil Rehabilitation (Minji Saisei) Law without achieving the global reform the economic context would have called for (OECD, 1998). Table 1 also highlights differences *of complexity among the five* legal systems considered. Two countries (France and Germany) use a single entry point system which means that they have adopted a unified procedure leading either to the liquidation or the sale³ of the firm, or to its reorganization after an observation phase of a few months⁴. In the United States, two options are available : chapter 11 of the Bankruptcy Code for reorganization and chapter 7 for liquidation. The UK and Japan offer a plurality of procedures, especially for reorganization. However, they are not all used with the same frequency. For that reason, the comparison of reorganization procedures is made by selecting only the most frequently used procedure in each country, i.e. the Civil Rehabilitation⁵ in Japan and the Administrative Receivership in the United Kingdom. In the case of France and Germany, we have focused on the reorganization part of the unified procedure. The results of this comparison are summarized in table 2.

² The liquidation procedure (*Konkursordnung*) dated back to 1877 and the composition procedure (*Vergleichsordnung*) had been adopted in 1935.

³ Under the German law, the firm's sale is considered a liquidation even though the company is in fact still operated insofar as the sale price is used first to pay the creditors but the unsatisfied part of claims cannot be transferred to the purchaser.

⁴ In the case of France, since 1994, the judge has the right to immediately liquidate the firm if it has ceased operations or if it can obviously not be saved.

⁵ The composition procedure, to which the civil rehabilitation has been substituted, was formerly the most frequently used procedure since it accounted for 80 % of the reorganizations in 1999. The success met by the new procedure is such that between April 2000 (when it was brought into force) and December of the same year, the number of procedures opened has increased fourfold compared to that of compositions for the same period of the year before (Nihon Keizai Shimbun, January, 24, 2001).

Table 2 - Comparison of reorganization procedures in five countries

	United States	United Kingdom	France	Germany	Japan
Procedure studied	Chapter 11	Adm. receivership	Redressement judiciaire	Insolvenzplan	Minji Saisei
Collective treatment of creditors	Yes	No	Yes	Yes	Yes
Stay against creditor claims	Yes	No	Yes	Yes	Yes, if the Court decides so
Main objective(s)	Allow the firm a second chance rather than being liquidated	Allow the repayment of the floating charge holder and secured creditors' claims	Safeguard of business, preservation of employment, discharge of liabilities	Allow a more efficient use of the debtor's assets than liquidation	Allow the reorganization of the firm before it is too late to maintain it
Owner of the right to initiate the procedure	Debtor/creditor ⁶	Floating charge holder ⁷	Debtor /creditor / Court	Debtor/creditor	Debtor/creditor

⁶ US Bankruptcy law requires that three or more creditors initiate together an involuntary petition. They bear the burden of proving that the firm is not paying its bills generally. As a result, only 2 to 3 % of chapter 11 bankruptcy filings are involuntary (White, 1996).

⁷ A floating charge is a particular type of security on the firm's assets. Unlike a fixed charge which is a claim on the immovable assets of a company, a floating charge may be taken on the assets as a whole, including stocks and work in progress.

Criteria to initiate the procedure	Insolvency is not required	Violation of a debt covenant	Firm is unable to pay debts as they come due (illiquidity)	Insolvency (Zahlungsunfähigkeit) or overindebtment (Überschuldung) or threat of insolvency (when the debtor initiates the procedure)	Insolvency is not required
Owner of the right to choose between liquidation and reorganization	Debtor ⁸	Administrative receiver	Court	Creditors (simple majority in terms of value of claims)	Court
Countries	United States	United Kingdom	France	Germany	Japan
Owner of the right to run the firm during the procedure	The debtor (debtor in possession)	The administrative receiver	The debtor, possibly under the control of a trustee	A trustee (Insolvenzverwalter) or the debtor assisted by a trustee (Sachwalter)	The debtor
Provisions to ease new financing in reorganization	Yes, new loans are given highest priority (same as administrative claims)	No, new financing is junior to existing claims	Yes, new loans receive postpetition priority but if the firm later liquidates, prebankruptcy secured claims regain priority	Yes, new financing is senior to existing claims in case of failure of the reorganization plan (Insolvenzplan)	Yes, new financing has priority over all existing claims and keeps it in case of a later liquidation

⁸ The debtor is allowed this choice even if the bankruptcy filing is involuntary. Therefore, creditors are unlikely to initiate an involuntary bankruptcy filing because, even if they succeed, managers will probably choose to reorganize under chapter 11 to retain their jobs.

Owner of the right to propose a reorganization plan	During 120 days, the debtor exclusively, then creditors too	No reorganization plan under this procedure	The trustee or the debtor (under the simplified regime)	The trustee or the debtor (with consent of the trustee)	The debtor
Voting rules to adopt the reorganization plan	For each class of creditors, simple majority by number and two-thirds by face value of claims ⁹	No reorganization plan under this procedure	The judge alone decides whether to adopt the plan	For each class of creditors, simple majority by number and value of claims of creditors attending the meeting	For each class of creditors, simple majority by number and value of claims

⁹ This voting procedure is referred to as the unanimous consent procedure. If the reorganization plan is not adopted because a class of creditors has not accepted the plan by the required majority vote, a cram-down procedure may be used to force the nonassenting class to accept proceeds equivalent to a hypothetical liquidation according to the rules of absolute priority. As it requires a valuation hearing by the court, which is expensive, cram-down is rarely carried out but it is used as a threat in bargaining with creditors (White, 1996).

Table 2 highlights significant differences in terms of corporate governance, i.e. in the allocation of control rights to the various stakeholders regarding the future of the failing firm. The main contrast can be found by comparing the British procedure of administrative receivership and the other procedures. First, it is the only one to be privately managed. Then, as the administrative receivership procedure is the method by which the holder of a floating charge enforces his security, it is designed to serve primarily the interest of one creditor, the floating charge holder, who has no incentive to consider the interests of any other party. A floating charge actually confers on the creditor (usually a bank) the right to appoint an administrative receiver upon the occurrence of circumstances specified by the contract between creditor and debtor. The administrative receiver assumes control of the entire firm in order to realize sufficient value from the assets to repay the floating claim after deducting his expenses, fixed claims being paid out of the proceeds from the corresponding securing assets. Although the administrative receiver is given broad powers, including the right to sell the firm in pieces, he is not legally responsible to unsecured creditors. However, he is personally liable for all post-bankruptcy financing. Therefore, given the downside risk inherent to attempting to preserve the firm as a going concern before selling it, both the receiver and the creditor who appointed him will prefer to realize the assets immediately to an amount just equal to the combined value of the secured claims rather than selling later as a going concern for a higher value. This means that many firms will be inefficiently liquidated (Kayser, 1996). Although the 1986 Insolvency Act created the administration procedure which is very much alike the other reorganization procedures depicted in table 2, its use has hitherto been hindered by a veto right exercisable by the holder of a floating charge in favor of an administrative receivership. Thus, the main rescue mechanism in the UK is clearly designed to favor the interests of secured creditors and in most cases, it ends up in the dismantling of the bankrupt firm.

The legal frameworks of the four other countries studied are clearly shaped to temporarily protect the debtor and maintain the business as a going concern. In France, since 1985, creditors are almost totally evicted from the procedure. Although they keep the right to initiate involuntary bankruptcy filings, they take no part to the initial decision whether to liquidate or reorganize the firm, neither do they vote on the reorganization plan. In the other countries, creditors play a more important part insofar as they can vote on the plan. In Germany, they even have the right to initially decide whether the firm will be liquidated or

reorganized after hearing the administrator's report about the economic condition of the bankrupt firm.

Managerial discretion differs widely according to the various laws. It is largest in Japan and the United States, where the debtor typically remains in control¹⁰ during bankruptcy. He also has an exclusive right (at least during 120 days in the U.S.) to formulate the reorganization plan.

In France and Germany, managerial discretion is more constrained. According to the French law, the debtor continues to manage the firm in the case of smaller firms¹¹ (simplified regime). In the case of larger ones (general regime), an administrator is appointed by the judge with a duty ranging from supervision to the replacement of the manager depending on the degree of distrust the judge feels about the debtor. The administrator also works together with the judge to structure the reorganization plan. The German procedure is even more constraining for the debtor. Self-administration is indeed admitted but only upon the debtor's voluntary bankruptcy filing in case of threat of insolvency and it is subject to creditors' approval. In all other cases, an administrator will be appointed by the Court.

Table 2 also highlights the discretionary power of the judge over the progress and outcome of the procedure. Formally, it is highest in France and Japan but in the French case, Commercial Courts customarily impart considerable influence to the administrator upon the fate of the failing firm. On the contrary, in the case of administrative receivership, the Court has very little discretion, its function being to supervise the procedure run by the receiver. Germany and the United States are two examples of countries where the Court plays an important part in arbitrating between conflicting interests even though they may not have a decisive influence on the outcome of the procedure.

Finally, we consider the way the legal frameworks deal with the interests of other stakeholders such as employees, suppliers, customers¹² who would bear costs in the event of a liquidation. The most directly exposed to such a risk are clearly the employees. Only the French and German procedures dispose that they can appoint representatives to act on their behalf and in their interest. However, in France, the employees' representative is only given

¹⁰ However, the U.S. Bankruptcy Code disposes that bankruptcy judges can appoint an outside official (a trustee) to manage the firm and formulate the reorganization plan in such cases as fraud or incompetence of the debtor.

¹¹ However, it is possible to opt for the general regime and we have observed that courts do appoint an outside official to assist the debtor when reorganization seems possible (Pochet, 2001).

¹² As an example, a supplier can be hurt by the loss of a liquidated customer. In a similar way, the loss of a supplier can have an adverse impact on a company, for instance by increasing its supplying costs.

an advisory capacity, particularly concerning the layoffs included in the reorganization plan. In Germany, within the context of co-determination (Mitbestimmung), employees traditionally take part to major corporate decisions . Consistently, the administrator must negotiate both the lay-offs and social plan with the employees' representatives in the event of a restructuring of operations. Nevertheless, in order to speed up the process and hence heighten the survival probability of the bankrupt firm, a judicial decision may replace the approval by the employees' representatives¹³ (Trockels, 1997).

As for the other stakeholders, it should be noted that except for the administrative receivership whose aim is focused on the interest of a single creditor, the other legal frameworks indirectly give considerable weight to these interests through incentives to keep the firm running as a going concern which allows the continuation of relations between those stakeholders and the firm (Franks, Nyborg & Torous, 1996).

Table 2 has been used to stress the differences induced by various legal frameworks in the governance of the bankrupt firm. However, notwithstanding those differences, the relative formal unity of bankruptcy laws should be noted.

2.2 Institutions, economic context and the stance of the bankruptcy law

The principles underlying the national legal frameworks differ in some fundamental respects.

Basically, there are two possible aims for a bankruptcy law : saving firms or paying the creditors. Though they may not be totally incompatible, it seems very difficult to achieve both. Therefore, according to its main objective, each legal system will arbitrate between the conflicting interests of at least two categories of stakeholders, the debtor and the creditors. The provisions included in the law will thus reflect the choice made between maintaining the business as a going concern and favoring the repayment of claims. Consequently, the stance of the law varies from one country to the other and some legal frameworks may be considered debtor-oriented whereas the others are rather creditor-oriented.

As institutions, bankruptcy laws change over time. The aims they pursue at a certain time appear to be the outcome of the incremental evolution the law has undergone in each country. In this section, we try to show that path dependence can explain both the similarity in the form and the differences observed in the stance of bankruptcy laws as they presently stand. The unity in bankruptcy laws (which can be found especially in liquidation procedures)

¹³ As a general matter, the new insolvency law (InsO) has tried to loose the legal constrains bounding managerial discretion as far as layoffs are concerned. This has resulted in a decrease in employees' protection.

is mainly due to their common origin and to the similar evolution they have gone through towards more clemency to the debtor. As for differences in the orientations of the present laws, they stem from the contexts (both political and economic) that prevailed at the time they were elaborated.

First, we can say that contemporary bankruptcy laws of the five countries studied all derive from the bankruptcy rules that were established in the cities of Northern Italy during the Middle Age, whether directly¹⁴ (as for Germany, France and Great-Britain) or indirectly¹⁵ (in the case of the United States and Japan). Those rules had themselves benefited from borrowings from the Roman law due to the development of Roman law studies in the first Italian universities which were actually founded at that time¹⁶. Thus, in order to organize the liquidation of the debtor's assets, jurists borrowed from the Roman procedure the concepts of *venditio bonorum* (i.e. global sale of assets) and *missio in possessionem*, i.e. the right for the creditors' representative to manage the debtor's assets (Saint-Alary-Houin, 1999).

At that time, bankruptcy was a penal procedure directed against businessmen who had failed to keep their promises and, like the Roman law by which it was inspired, the rules enacted by the Italian cities were very harsh towards the debtor, considered a criminal¹⁷. During the following centuries, a distinction has progressively been made between the fraudulent bankrupt, exposed to the most severe punishments, and the honest one who may benefit from an arrangement with his creditors. Such a change for a less harsh bankruptcy law is a general tendency in European countries. It has been going on until the latest major reforms of the present-day period. Moreover, the depressed economic context that prevailed at that time (i.e. 1985, 1986, 1994 in the case of France, the UK and Germany respectively) deeply contributed to the promotion of a rescue culture in those countries.

However, those reforms occurred in various political contexts according to the countries, which resulted in some legislations keeping a rather repressive nature whereas the others take the economic constraints of reorganization into greater consideration. In that way,

¹⁴ Through fairs in which merchants from all countries took part and whose transactions were ruled by special customs (fair laws). The first English bankruptcy statutes were passed in 1542, under Henry VIII. In France, edicts by François I (1536) and Charles IX (1560) provided for criminal punishments against bankrupt individuals.

¹⁵ As a result of the adoption of the English bankruptcy law by the United States when they were founded and of the American bankruptcy law by Japan in 1945.

¹⁶ For example, the university of Bologna, the first in Italy, was founded in 1088.

¹⁷ The English term *bankruptcy* comes from the Italian for broken bench, "*banca rotta*", because of the practice to destroy the trading bench of a businessman who did not pay his debts in medieval Italy.

the UK law remains largely unfamiliar to the rescue culture¹⁸ both because of a long tradition of priority given to the repayment of claims and of the ideology of the Conservative Party¹⁹, which was ruling in 1986, at the time the bankruptcy system was renewed (Armstrong et Cerfontaine, 2000). As for the French and German laws, they clearly express the intention to ease the reorganization of bankrupt firms and consequently include dispositions likely to reach this objective. Such dispositions may have consequences for some stakeholders' rights. For example, the new German law involves a noticeable reduction in the employees' rights in order to speed up the procedure and thus favor the survival of the firm. Such a change occurred in a political context characterized by the prolonged ruling of the CDU. Contrasting to this, the 1985 French reform which has been conducted by the socialist Minister of Justice R. Badinter, innovated in integrating employees into the procedure. It also suppressed the automatic replacement of the debtor by an outside official that prevailed before. Both dispositions are consistent with the two main goals of the French law, i.e. the safeguard of business and preservation of employment even though those purposes have proved difficult to reconcile.

In the matter of bankruptcy, the United States have distanced themselves from their English heritage since the nineteenth century and have adopted a pragmatic approach. Whereas early federal bankruptcy laws were only temporary responses to bad economic conditions (the 1800, 1841 and 1867 laws were respectively repealed in 1803, 1843 and 1878), the economic upheaval of the Great Depression yielded much bankruptcy legislation²⁰. Since then, the underlying principle has been that bankruptcy derives from competition and therefore bankruptcy law is the legal mechanism by which inefficient firms are forced out of the market while viable ones may be reorganized²¹. Hence, chapter 11 of the U.S. Bankruptcy Code still remains one of the most favorable frameworks in the world for the manager of a failing firm who wants to reorganize.

¹⁸ This comment is mentioned in the final report by the DTI/Treasury Working Group on Company Rescue and Business Reconstruction Mechanisms. This working group has been set up in 1999 by agreement between the Chancellor of the Exchequer and the Secretary of State for Trade and Industry to review corporate bankruptcy law and practice in the UK and make recommendations.

¹⁹ The Conservative Party advocates both individual freedom and accountability as its counterpart. Thus, managers of a failing firm, whether they have proved incompetence or dishonesty, must be punished.

²⁰ In particular, the Bankruptcy Acts of 1933 and 1934 as well as the Chandler Act of 1938 which included substantial provisions for reorganization of business.

²¹ We do not discuss here whether such a screening process actually works or not. However, it has often been argued that the American bankruptcy law fails to send the right incentives to failing firms which means that some firms may liquidate even in circumstances when their resources would be most valuable if they continued operating and others may continue to operate even when their resources could be better employed through some new use (see for example White, 1989).

Japan exemplifies the case of an old legislation that lacks consistency (OECD, 1998). Three reorganization procedures coexist respectively adopted in 1899, 1952 and 2000. The older one has been deeply influenced by Japan's westernization wave during the Meiji era (1868-1912) and especially by German law whereas the second directly derives from the old chapter X of the U.S. bankruptcy law²². The American occupation of Japan (1945-1952) induced a second phase of westernization and the partial adoption of American law, particularly the economic law²³. As for the Civil Rehabilitation procedure that has been approved in April 2000, it has been inspired by chapter 11 of the present U.S. Bankruptcy Code. Whereas the Corporate Reorganization procedure of 1952 has been focused on larger firms, the new procedure is especially aimed at small and medium size companies. Designed to replace the old Composition procedure, it includes several dispositions which speed up and ease the rehabilitation of the debtor in distress. Hence, as it presently stands, the Japanese bankruptcy law appears like a mosaic of procedures, one being the heritage of the Roman-German tradition of severity towards the debtor, the two others emphasizing the reorganization of businesses.

2.3 Out-of-court workout versus formal bankruptcy reorganization

In each of the five countries considered, an out-of-court arrangement between a failing firm and its creditors is legally possible. However, such arrangements are much more frequent in some countries (and under certain circumstances) than otherwise. In this section, we try to highlight some of the factors that influence the workout-bankruptcy choice. In a well-known paper, Jensen (1989) has underlined “the privatization of bankruptcy” which occurred in the United States during the 1980s. At that time, private restructuring was generally the preferred method for dealing with default because companies were highly leveraged and thus received strong incentives to take corrective action as soon as they defaulted on their debt. Moreover, as shown in a study by Gilson, John and Lang (1990), private restructuring is much less costly than formal reorganization under Chapter 11. However, the early 1990s have seen some obstacles dampening out-of-court exchange offers: the LTV ruling and a change in the tax code penalizing debt forgiveness (Mc Connell and Servaes, 1991). At about the same time, a new technique emerged which blends some features

²² Created by the 1898 Bankruptcy Act and amended by Chandler Act (1938), Chapter X organizes the first reorganization procedure in American history. The equity receivership procedure protects failing firms against their creditors but, being costly and constraining, it actually gives the firm little chance to avoid liquidation.

²³ Significant borrowings in that field include, among others, the anti-trust legislation and intellectual property law.

of the out-of-court workout with the formal Chapter 11 procedure. As the term suggests, in a “prepackaged bankruptcy” the distressed firm jointly files a bankruptcy petition and a reorganization plan after having secured creditors’ informal consent to the plan. In most cases, such a method allows the plan to be confirmed almost immediately, thus saving time (and money) compared to a regular Chapter 11 procedure. While prepackaged bankruptcy appears to be the response to the early 1990s rulings that hindered workouts, more fundamentally, it helps solve the holdout problem inherent to informal reorganization. A workout can pass only if creditors unanimously agree to the terms of the restructuring. However, each individual creditor has an incentive to reject any restructuring of his claim even though the restructuring collectively benefits all creditors. By filing a prepackaged Chapter 11, the firm can thus benefit from less restrictive voting rules as acceptance of the plan requires an affirmative vote by only 50 percent of the creditors by number in each class and two-thirds by value of claims. The extent of the holdout problem depends partly on what type of debt is restructured. In brief, a concentrated debt is easier to informally reorganize than extensive claims held by trade creditors. Consistently, empirical research (Chatterjee, Dhillon and Ramirez, 1996) shows that firms with a greater proportion of trade credit use a court-supervised Chapter 11.

In Japan too, failing firms tend to privately reorganize, especially small and mid-sized ones (OECD, 1998) but the economic rationale to this behavior may not be enough to account for the extent of the phenomenon. The Japanese legislation is certainly complex and largely obsolete. For example, among the three formal reorganization procedures in force until April 2000, only two (reorganization under the commercial code and composition) could be used by small firms. Yet, the composition procedure did not provide for *an automatic stay of secured* claims and in a reorganization under the commercial code, unanimous consent of creditors is required to adopt the plan (Eisenberg and Tagashira, 1994). As a result, some ailing firms might have had no other option but to privately reorganize²⁴. However, there might be a further explanation to the reluctance of Japanese distressed firms to opt for a formal bankruptcy reorganization. In Japan, there is a deeply rooted tradition of “jurisphobia” (Noda, 1966). As a general rule, the Japanese profoundly believe that taking court action is not the best way to settle a conflict between two persons. They consider that justice is more a matter

²⁴ In this respect, the repeal of the Composition Law and its replacement by the Civil Rehabilitation law in 2000 is likely to modify the small and medium size firms’ behavior as statistics already seem to demonstrate (see note n° 5).

of finding an harmonious equilibrium between conflicting interests rather than strictly ruling according to the law. When making a decision, the Japanese judge is supposed to take into account not only economic but also psychological issues and especially the need for preserving each litigant's honorability (Koyama and Kitamura, 1989). For that reason, non-contentious procedures, and particularly conciliation, play an important part in the Japanese society. Hence, the search for negotiated settlements by failing firms may be considered an expression of that strong dislike for a judicial solution.

In Europe too, an out-of-court workout between a firm and its creditors is possible. In Germany, entirely private reorganizations have dominated until 1999, albeit no disposition in the law explicitly provided for such settlements. The previous legal framework indeed provided for a composition procedure (Vergleichsordnung) aimed at reorganizing distressed firms but it was so constraining for the debtor that in practice reorganizations within this procedure have been extremely rare (Kaiser, 1996). France and Great-Britain each offer a solution halfway between negotiation and formal reorganization, *respectively called* negotiated settlement (règlement amiable) and Company Voluntary Arrangement (CVA). However, both procedures have been seldom used, partly because they did not provide for an automatic stay²⁵. In the absence of such a stay, company rescues can indeed be made more difficult or even be thwarted because, until the arrangement is formally approved, any creditor can take legal action against the assets of the company hence jeopardizing the prospects of reaching an arrangement. In order to rectify this state of affairs, the Insolvency Act 2000, which received Royal Assent on 30 November 2000 provides for an optional moratorium (i.e. a temporary stay) of 28 days for small companies²⁶. This disposition is expected to make CVAs more attractive to small companies by offering them a breathing space to put a rescue plan to creditors. Furthermore, a notable feature is that the directors remain in full control of the company during the moratorium, albeit with an insolvency practitioner exercising a monitoring role. In this respect, the Insolvency Act 2000 can be seen as a first move towards a more debtor-oriented system (Flynn, 2000). In the case of France, some Commercial Courts have tried to institute prevention mechanisms so as to facilitate an early out-of-court treatment of financial distress. However, contrasting with the British process of change that has just been described, the French Ministry of Justice is presently considering the removal of the

²⁵ In France, since 1994, the President of the Commercial Court can order a temporary stay of claims upon a petition of the debtor.

²⁶ Eligible companies must satisfy two or more of the conditions for being a small company under the Companies Act 1985: turnover of not more than £2.8million; assets of no more than £1.4 million; or no more than 50 employees.

optional stay of claims by the President of the Commercial Court in the negotiated settlement procedure. According to a working paper issued by the Ministry of Justice, this disposition imparted a judicial character to a procedure that had originally been designed only as a court supervised arrangement. Such a shift could mislead creditors who might overestimate the judge's power in the procedure and thus be reluctant to engage in a negotiated settlement.

3 Bankruptcy law as part of the national system of corporate governance

We have hitherto described the legal frameworks of corporate bankruptcy in five countries in order to analyze how the law modifies corporate governance once a firm has filed a bankruptcy petition. This analysis has tried to highlight factors that contribute to settle the stance of the law. However, as a monitoring device for firm managers, bankruptcy law is not isolated. On the contrary, it is connected with the other (economic, legal, cultural) mechanisms that shape each national system of corporate governance. We first set out a typology of those mechanisms (2.1.). Then we try to offer a comprehensive view of how academic work accounts for the articulation of bankruptcy law with other corporate governance devices in various national contexts (2.2.).

3.1 A typology of corporate governance mechanisms

In a previous research work (Pochet, 2001), we have built a typology of governance mechanisms based upon the following criterion: which class of stakeholder is able to activate each control device? To identify classes of stakeholders, we rely upon Freeman's definition for "stakeholder" as "any group or individual who can affect or is affected by the achievement of the organization's objectives" (1984). We then posit that each governance mechanism is, whether directly or indirectly, activated by a stakeholder, be the resulting influence on managerial discretion intentional or not. Some kind of mechanisms are specific to a class of stakeholders, others can be used by all classes. This typology has been worked out having in mind to describe a firm's governance structure i.e. the architecture of mechanisms that constrains managerial discretion in a particular firm. However, it can easily be transposed into a typology of mechanisms working at the macroeconomic level. Using a single criterion to categorize governance devices, we then get a double typology, one focused on stakeholders' behavior at the firm's level and the other relating to a national system of corporate governance.

Table 3 –A typology of corporate governance mechanisms
from firm structure to national system

Stakeholders	Governance structure (micoeconomic mechanisms)	Governance system (macroeconomic mechanisms)
Shareholders	Direct control via general meetings Board of directors	Legal mechanisms (company law)
	Hostile takeovers Exit from capital	Financial market
Banks	Guarantee taking (collaterals) Covenants	Legal mechanisms (contract law, bankruptcy law,...)
	Credit rationing Credit maturity ²⁷ Interest rates Termination of credit relationship	Market for financial intermediation
Employees	Employees' representatives Strike	Unions Labor laws
	Resignation	Labor market
	Law and regulation applying to the firm	Legal system

²⁷A short maturity induces frequent renegotiations. Monitoring is thus more constant (Shleifer & Vishny, 1997).

State	Subsidy granting Authorization granting	Political market
Customers/Suppliers	Terms of payment	Market for trade credit
	Breach of contractual relationship	Market for goods and services
Managers	Mutual monitoring Formal organizational structure	Managerial labor market
All classes of stakeholders	Trust Reputation	Market for relational capital
	Business culture Media	Cultural environment

Some brief comments will allow us to specify the content of table 5 and to clarify some of the terms used:

- Considered from a governance system perspective, this typology highlights three kinds of control devices: control by market forces which results from the addition of individual monitoring of managers (by customers, investors, employees,...), control by the legal and regulatory system and in a broader way, control by cultural mechanisms (business culture, media, ...).
- Although not in contractual relationship with the firm (whether explicit or implicit) entities affected by externalities do qualify as stakeholders according to Freeman's definition. If they do not appear in table 5, it is because their influence on managers is exerted indirectly, via the action of other stakeholders like customers (using boycott) or the State.
- Whether at the governance structure or governance system level, each class of stakeholders can choose between several control devices. Some of them may be either substitutes or complementary devices. For example, direct control by shareholders attending general meetings can be considered a substitute to the

board of directors, the relative intensity with which each mechanism will be used depending upon the degree of ownership concentration of the firm. In the same way, La Porta & al. (1999) suggest that the legal system and the financial market play complementary parts: where individual investors' rights are well protected, financial markets can expand more easily.

- The concept of legal system derives from comparative law studies. It covers the set of legal constraints that ties human behavior i.e. both the content of legal rules and their enforcement by courts. As noted by La Porta and al., "In different jurisdictions, rules protecting investors come from different sources, including company, security, bankruptcy, takeover, and competition law, but also stock exchange regulation and accounting standards". Thus, all those laws are essential elements of corporate governance. However, as argued before, corporate governance is not limited to the protection of investors. Therefore, labor and contract laws do matter too.
- Some mechanisms among those belonging to a corporate governance system are usually put together into an entity called a financial system, namely the financial market, financial intermediation and trade credit. A financial system can be defined as a set of "institutional arrangements that allow the transformation of savings or credit into investments" (Christensen, 1992). A traditional way of classifying financial systems has been to contrast bank-centered systems, such as those of Germany and Japan, to market-centered systems such as those of the United States and the UK.
- The market for relational capital is mentioned by Charreaux (1997) as a governance device based upon social relations between individuals. It is similar to Coleman's concept of market for social capital (1988). According to Coleman, social relations are a source of three different kinds of social capital: information collected through them, obligations related to services done, and social norms bounding human action. Numerous research work has been devoted to networks of managers and especially networks of directorate ties (Allen, 1974 ; Burt, 1983). However, managers' relational network is not limited to peers, it also includes other stakeholders (like employees, customers, or suppliers) with whom they may form implicit contracts in order to become entrenched (Shleifer & Vishny, 1989).

- In this respect, the political market may be considered a part of the market for social capital insofar as it relies upon the relational network linking managers with government authorities (at the local, regional, national or even supranational levels) as well as with political parties. In some countries, like France or Japan, both markets are all the more interlocked since managers of large companies tend to have spent time in the political realm at the beginning of their career. As for United States, Grundfest (1990) highlights the tradeoffs realized by the legal system between the interests of various stakeholders (shareholders, bondholders, managers) and the correlative importance for managers to lobby for the protection of their interests.
- Cultural environment is a residual class of governance devices that assembles all constraints on managerial discretion other than those which have explicitly been mentioned elsewhere in the typology of macroeconomic mechanisms. Business culture and the media system, among others, belong to that class.

The main interest of such a typology for this particular work comes from its general nature. As such, it can be used to analyze any corporate governance system, which is an essential condition for the implementation of a comparative method. Nationality is indeed a contingency factor of corporate governance, mainly because legal systems differ among countries. However, the different kinds of mechanisms which may constrain managerial discretion (market forces, legal system, cultural factors, as mentioned earlier) are the same everywhere. In a particular country, the relative intensity with which each mechanism is going to work will depend upon a firm's characteristics (particularly size and legal structure), first because company law varies under those criteria, and second because relations between managers and other stakeholders are generally influenced by those features. Hence, comparing national corporate systems requires to refer to firms that are equivalent in terms of size and legal structure.

To conclude this presentation, we can say that the constituents of a national system of corporate governance draw a complex set of control mechanisms, first because of their number and second, because they are interrelated. We now aim to examine how bankruptcy law as part of a corporate governance system articulates with other mechanisms in different national contexts.

3.2 The articulation of bankruptcy law with other corporate governance devices: a survey of literature

Research work about national systems of corporate governance consists in both empirical and theoretical contributions. We first refer to the main models developed by comparative studies on corporate governance and to the usual typologies based on them. This theoretical literature underlines the different ways in which bankruptcy law articulates with some other governance devices. Two kinds of systems are contrasting: those in which formal bankruptcy procedures play a major part in reorganizing distressed firms and those where their role is of secondary importance compared to workouts (2.2.1.). Results of empirical work on the governance of failing firms are then presented (2.2.)

3.2.1 *Market-oriented versus bank-oriented systems: a comparison of firm reorganization based on stylized facts*

Numerous research work has been devoted to comparative corporate governance. As traditional comparisons of corporate governance systems focus on the institutions financing firms, the classification of governance systems derives from that of financial systems. Hence two models are contrasted, the first one being found in the United States and the United Kingdom, the other one applying to Japan and continental Europe (especially Germany). Those models have been given different names according to the authors²⁸ but the way they are characterized is very much similar in each case. All this research work is of a theoretical nature. It relies upon the stylized facts method and specifies each system's characteristics after the governance structures of large listed firms implicitly considered the best model.

Among stylized facts used to contrast the two models they respectively describe, Berglöf (1990) and Moerland (1995) consider the degree to which banks are involved in firm financing and monitoring. In bank-oriented systems, universal banks provide both a significant share of equity financing and debt financing to corporations, thus exercising a direct monitoring as large blockholders. Market-oriented systems, in contrast, have corporations whose equity ownership and debt financing are both widely dispersed, hence leaving banks unable (and without any incentive) to monitor firms. These features lead to at least two kinds of consequences. First, as a general matter, creditors appear to be much more concentrated in the bank-oriented model than in its market-oriented counterpart because of the

²⁸ Berglöf (1990) contrasts a market-oriented system with a bank-oriented system whereas Franks and Mayer (1992) consider an outsider system and an insider system. Moerland (1995) distinguishes between a market-oriented system and a network-oriented system. All authors thus refer to the nature of the main monitoring devices included in each model.

significant share of debt financing provided to a firm by its main bank. In other respects, the strict separation between shareholders and debtholders in the market-centered model is a source of potential agency conflicts between those two classes of stakeholders which have no equivalent in the bank-oriented model. As a result, treatment of financial distress according to each model differs widely, as suggested by banking theory.

Consistently with the classification of corporate governance systems, banking theory contrasts two models to describe the relationship between bank and corporation. On the one hand, in the arm's length (Anglo-Saxon) model, the bank manages credit risk by relying on diversification, and treats each credit as an independent operation. Hence, it has little incentive to invest in acquiring private information about its customers. Monitoring of the debtor is exercised through debt covenants which specify the firm's obligations. On the other hand, in the customer relationship model (Sharpe, 1990) which applies to Germany and Japan, credit risk is much more concentrated. Partners of the credit relationship work together in order to establish a long term cooperation based on trust and information sharing. Monitoring by the bank is implemented directly through board membership. The two models differ as for the bank's behavior in case of financial distress. In the first case, distrust predominates. It materializes through the bank's defection by means of the debt covenants. Contrasting to this, in the relationship lending model, continuation of the relationship and support to the firm are favored.

Those features, as well as previously mentioned differences in debt concentration generate widely differing reorganization costs. In the bank-oriented system, higher concentration of creditors reduces coordination problems which might hinder debt renegotiation (Gertner & Scharfstein, 1991 ; Detragiache, 1994). Moreover, the informational advantage provided by a long term credit relationship allows the bank to better evaluate the firm's viability and to consistently adapt its behavior. Private renegotiation is thus facilitated and use of a formal bankruptcy procedure will be limited to firms that seem non-viable. Information and free-rider problems associated to diffusely held bond financing in the market-oriented system make debt renegotiation much more difficult. They lead to creditors' preference for a formal bankruptcy as the unique means of revealing information about the actual surviving prospects of the distressed firm.

Theoretical approach of corporate governance systems thus seems to suggest that the articulation of bankruptcy law with other disciplinary mechanisms differs according to the kind of model we consider. Whereas formal bankruptcy procedures are destined to play an

important part in the reorganization of Anglo-Saxon distressed firms, their role is only accessory in Germany and Japan, being a substitute to banks in conducting reorganizations when their outcome seems uncertain. As for the French system, it belongs to the Latinic systems depicted by Moerland as a kind of hybrid class. Its features indeed combine some of the market-oriented systems' characteristics (as the role of banks and the importance of trade credit) and some other resembling the bank-oriented system's (cross-shareholdings among large industrial groups and interlocking directorates). As for the governance of distressed firms, it seems to be rather similar to market-oriented systems because of the predominance of judicial procedures in French firms' reorganization.

Empirical results of various studies conducted in each of the five country we consider will now be examined and discussed in the light of the theoretical arguments that have just been set out.

3.2.2 Empirical studies and the governance of the failing firm in different national contexts

Empirical studies seldom address the issue of how failing firms are governed, in a global perspective. They rather focus on one particular disciplinary mechanism to check if it actually works in the context of financial distress. Not surprisingly, the market-oriented system of corporate governance has been the main target for empirical research work about failing firms and with the exception of one recent study by Franks and Sussman (2000), all that work deals with the US governance system (see Table 4 p. 24). Franks and Sussman's work has been sponsored by the Working Group on Company Rescue and Business Reconstruction Mechanisms. It aimed at providing a detailed view of the rescue process for small to medium size companies that had been classified as in financial distress by three UK clearing banks. Though the findings of this study may not be directly contrasted to those applying to US firms because US samples typically consist in large, listed firms, they offer unprecedented insights about the behavior of UK banks to distressed firms. First, bank debt is highly collateralized and in most cases includes a floating charge that allows the bank to exercise control over the bankruptcy procedure. Second, there is no evidence of automatic liquidation upon default. Rather, the firm is put under pressure to undergo restructuring and the willingness of the company to restructure is significantly related to the size of debt repayments demanded by the bank. Third, during rescue the bank receives substantial repayment of debt outstanding while debts due to trade and expense creditors tend to expand. Now, if formal bankruptcy ensues the bank will recover about three quarters of its indebtedness whilst trade creditors will receive almost nothing. These findings show that

banks are able to and do play a leading role in informal rescue work as 75 % of companies emerge from bank supervision and avoid formal bankruptcy procedures. However, trade creditors bear the major part of the risk associated with the rescue process as they do not share the bank's knowledge of the company's financial position and their lending is unsecured.

Findings of empirical work about US distressed firms suggest that there are efficient disciplinary mechanisms for poorly performing managers. The study by Gilson (1990) shows that corporate default engenders significant changes in the ownership of firms' residual claims and in the allocation of rights to manage corporate resources. This shift in the governance of distressed firms is attested by concrete facts: managerial turnover (Gilson, 1989, 1990; Hambrick and d'Aveni, 1992), cuts in CEO compensation (Gilson and Vetsuypens, 1993), discipline by managerial labor markets (Sutton and Calahan, 1987; Gilson, 1989) which even seem able to discriminate between good and bad managerial performance in the case of firm failure (Canella, Fraser and Lee, 1995). However, the composition of the board of directors seems to influence the ability of this disciplinary mechanism to implement an effective monitoring of the distressed firm: the outcome of distress is more likely to be bankruptcy when conditions for independence of directors are not met (Daily and Dalton, 1994). Despite evidence that hostile takeovers are more likely to occur when firms have been performing poorly (Morck and al., 1988) and that takeovers play a direct role in disciplining poorly performing managers (Martin and McConnell, 1991), very few distressed firms seem to be the target of hostile takeovers. According to Gilson (1990), the reason might be "that bank creditors, who are made extremely powerful by a default, can effectively block any merger that threatens to diminish their control over the firm's assets". Banks indeed gain additional control on failing firms through restrictive covenants and increased collaterals (Gilson 1990). Therefore, they are generally reluctant to provide debt relief (Asquith, Gertner and Scharfstein, 1994) and might fare better in formal bankruptcy procedures than informal workouts. However, this latter issue is not strongly documented. Chatterjee, Dhillon and Ramirez (1996) indeed find that Chapter 11 firms have significantly higher levels of bank debt than prepack and workout firms but Gilson, John and Lang (1990) find opposite results.

Table 4- Empirical studies and the governance
of the distressed firm: the case of the US/UK (to be continued on page 25)

Disciplinary mechanism considered		Findings	
Control by shareholders	Ownership structure	Influence of blockholders	There is evidence of a shift in control over corporate resources from incumbent management and the board of directors towards nonmanagement blockholders and creditors in firms that either file for bankruptcy or privately restructure their debt (Gilson, 1990).
		Influence of banks	Bank lenders frequently become major stockholders. However, this stock must be divested within approximately two years, according to legal restrictions to stockholding by banks in nonbank firms (Gilson, 1990). Bank lenders are responsible for 21 % of management changes in financially distressed firms (Gilson, 1989).
	(Hostile) takeovers		The probability of hostile takeovers is inversely related to firm performance (Morck & al., 1989). The rate of management turnover increases following corporate takeovers and pre-takeover performance is significantly worse among takeover targets that undergo a post-takeover management change (Martin & McConnell, 1991). For a sample of 111 publicly traded firms that either went bankrupt or privately restructured their debt, twelve have been acquired in a friendly merger and only two became the target of an attempted hostile takeover (Gilson, 1990).
	Board of directors	Influence of board composition on the outcome of financial distress	Bankrupt firms are more likely to have CEOs serving simultaneously as board chairpersons. These firms also have higher proportions of affiliated (according to SEC's regulation 14A conditions) directors than the control firms (Daily & Dalton, 1994).

		Replacement of the CEO	52 % of sampled firms experience a senior management change if they are either in default on their debt, bankrupt, or privately restructuring their debt (Gilson, 1989). On average, only 46 % of incumbent directors and 43 % of CEOs remain with their firms at the conclusion of the bankruptcy or debt restructuring (Gilson, 1990). There is evidence of a high and accelerating turnover rate in the top management team of declining firms (Hambrick & d'Aveni, 1992).
		CEO compensation	Incumbent managers of distressed firms who are not replaced often incur substantial cuts in their salary and bonus. Newly appointed CEOs with ties to previous management are paid 35 % less than the outgoing CEO. In contrast, outside replacement CEOs are paid 36 % more than their predecessors (Gilson & Vetsuypens, 1993).
Control by managers		Managerial labor market	The stigma of bankruptcy threatens the career of any manager affiliated with a failing firm (Sutton & Calahan, 1987). Managers who resign from financially distressed firms are not employed by an exchange-listed firm for at least three years after their departure (Gilson, 1989). Managers associated with banks that failed for reasons arguably beyond the manager's control are twice as likely to regain comparable posts as managers at other failed banks (Cannella, Fraser & Lee, 1995).
Control by suppliers		Supply of trade credit	Trade creditors maintain or even slightly expand their credit outstanding, particularly for companies that end up in formal bankruptcy procedures, although they will receive very little in that case (Franks & Sussman, 2000).
		Influence on the workout-bankruptcy decision	Chapter 11 firms have significantly greater proportion of trade credit than prepack and workout firms (Chatterjee, Dhillon and Ramirez, 1996).
		Influence on the workout-bankruptcy decision	On average, bank debt amounts to 40 % of total liabilities in firms that successfully restructure, but only to 25 % in firms that file for Chapter 11 (Gilson, John & Lang, 1990). Firms filing for Chapter 11 have more bank debt than prepack and workout firms (Chatterjee, Dhillon and Ramirez, 1996).

Control by banks	Credit rationing	Banks often accept renegotiations of debt repayment but scarcely grant new financing and never renounce to the repayment of debt principal (Asquith, Gertner & Scharfstein, 1994). The size of debt repayments demanded by the bank is significantly related to the behavior of the firm (i.e. downsizing, managerial replacement) (Franks & Sussman, 2000).
	Termination of credit relationship	There is evidence of substantial rebanking during rescue though it seems difficult to identify whether re-banking is at the request of the bank or at the request of the customer (Franks & Sussman, 2000).
	Covenants Collaterals	Banks gain additional control over firms' investment and financing policies through restrictive covenants in restructured bank loans. Agreements that grant banks increased collateral are also relatively common (Gilson, 1990).

Disciplinary mechanisms for poorly performing managers, both internal and external, seem to be at work in the Anglo-Saxon corporate governance system. Contrasting with the predictions of the arm's length banking model, banks may play an effective though temporary role in restructuring distressed firms through their increased share of firms' common stock. Increased and enduring monitoring by banks is also implemented by means of restrictive covenants in privately restructured lending agreements that give banks more say in firms' investment and financing policies. To summarize, financial distress in the UK/US governance system seems to induce a general substitution of monitoring by external blockholders and banks for monitoring by directors.

Table 5 summarizes the findings of French empirical work about the governance of distressed firms. It should be noted that, with the exception of the study by Pigé (1996) whose sample consists of listed firms, all studies focus on small and medium size, unlisted companies. This simply reflects the fact that very few listed firms go bankrupt in France, first because the absolute number of listed firms is small and second because institutional mechanisms (such as a support from the French State whose stakes in large companies have until recently remained significant) prevent them to fail. Therefore, these results should be considered with care when being contrasted to those of other corporate governance systems.

Table 5- Empirical studies and the governance of the distressed firm: the case of France

Disciplinary mechanism considered		Findings
Control by shareholders	Replacement of the CEO	CEO turnover probability is negatively related to the performance of the firm and positively to ownership concentration (Pigé, 1996). CEOs are removed in almost one firm out of four from a sample of 30 bankrupt firms (Pochet, 2000).
	Takeovers	Three bankrupt firms (10 % of the sample) have been acquired in a friendly merger (Pochet, 2000).
Control by customers	Breach of contractual relationship	When economic difficulties affect the whole branch of industry, customers tend to remain in relationship with the distressed firm (Gasner, 2000).
Control by employees	Resignation	In case of economic difficulties affecting the whole branch of industry, employees stay in the distressed firm because they have little chance to find a new job elsewhere (Gasner, 2000; Pochet, 2000). Employees with specific human capital tend to stay in the distressed firm. When resignations are observed, they concern employees with general competencies (Pochet, 2000).
Control by suppliers	Supply of trade credit	Suppliers tend to support the distressed firm by lengthening the terms of payment when they are bound in a partnership with the firm and have thus made specific investments (Gasner, 2000).

Control by banks	Credit rationing	<p>In a first stage, banks react to financial distress by granting new financing. Then, they tend to withdraw their support, especially when management is judged responsible for the firm's difficulties (Bloch, Bourdieu, Colin-Sédillot & Longueville, 1994).</p> <p>Almost two thirds of the sample of distressed firms benefited from a support by at least one bank (Pochet, 2000).</p> <p>Multibanking (i.e.relying on more than one main bank) heightens the probability for the distressed firm of benefiting from a financial support (Refait, 2000).</p> <p>Some banks financially support distressed firms even though they are aware of their little chance of recovering. This may be either the result of a lack of monitoring or a way of playing for time (Vilanova, 2000).</p>
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Small and medium size French firms are typically family-owned. Therefore, the main conflicts of interests occur between majority and minority shareholders. In that kind of firms, the board of directors actually plays no disciplinary role. However, some families loose the control of their company when it goes bankrupt, showing that some shareholders choose to exit from the firm. In that case, the CEO is systematically replaced. Even when the family keeps control of the failing firm and manages to reorganize it, the CEO is often replaced by another family member or family-appointed CEO (Pochet, 2000). Behavior from stakeholders such as customers, suppliers and employees depends on two main factors: the magnitude of specific investments they have laid out in the distressed firm and the opportunities of exiting from their relationship to it. Both are good indicators of their degree of dependency to the firm. Results from the studies by Gasner (2000) and Pochet (2000) document these issues. As for banks, convergent findings show that they do provide financial support to distressed firms, at least for some time. If the firm nonetheless goes bankrupt, then the bank will use its information on the firm's condition to decide whether to withdraw support or to maintain it. Only firms with good prospects of reorganization will be provided new financing. French banking law is indeed very severe with banks which would abusively support nonviable firms, thus misleading other stakeholders about the actual financial condition of the firm. Therefore, French banks tend to be cautious when it comes to new financing of bankrupt firms. However, considering the high level of competition among French banks may explain that multisourcing by firms heightens their probability of receiving support by at least one bank in

case of financial distress. Banking relationships in France thus appear to be of a hybrid type: whereas the banks do not play any role in privately reorganizing distressed firms, they do provide a substantial support by granting new financing and debt forgiveness. In this respect, the French banking model is situated halfway between the arm's length and the customer relationship models.

Empirical studies about the governance of the distressed firm in bank-oriented systems focus almost exclusively upon the Japanese case, as reflected by table 6 on p. 28.

Table 6- Empirical studies and the governance of the distressed firm:
the case of Japan and Germany

Disciplinary mechanism considered			Findings
Control by shareholders	Ownership structure	Influence of blockholders	Ownership by blockholders of Japanese firms that restructure their operations during performance declines increases the likelihood of downsizing and management change (Kang & Shivdasani, 1997).
		Influence of banks	Sumitomo Bank's restructuring of Mazda exemplifies the typical combination of bank-induced managerial changes, financial support, and pressure on suppliers that main banks provide to distressed firms in Japan (Pascale & Rohlen, 1983). Appointments of bank directors increase significantly with poor stock performance and with earnings losses (Kaplan & Minton, 1994). The frequency of asset downsizing and layoffs in Japanese firms that restructure their operations during performance declines increases with the ownership by the firm's main bank (Kang & Shivdasani, 1997).
	Board of directors	Replacement of the CEO	In Japan, top executive turnover is negatively related to earnings, stock and sales performance. Turnover is most sensitive to negative earnings (Kaplan, 1994). The likelihood of nonroutine executive turnover is negatively related to firm performance. Firms with ties to a main bank are more likely to remove top executives for poor earnings performance (Kang & Shivdasani, 1995).

		CEO compensation	In Japan, top executive cash compensation is positively related to earnings, stock and sales performance. Compensation is most sensitive to negative earnings (Kaplan, 1994).
Control by banks		Credit rationing	Housebanks do provide liquidity insurance in situations of unexpected (i.e. small-sized) deterioration of borrower quality (Elsas & Krahn, 1998). Firms belonging to a financial keiretsu ²⁹ are less liquidity-constrained and have lower costs of financial distress than independent firms due to monitoring by the main bank (Hoshi, Kashyap & Scharfstein, 1990).

One recent study (Elsas & Krahn, 1998) questions the issue of bank-customer relationships in Germany and implements a direct comparison between housebanks and “normal” banks as to their credit policy. The results established by Elsas & Krahn are consistent with those of Hoshi and al.(1990) for Japan, showing that close relationships between a firm and its main bank provide implicit liquidity insurance when the borrowing firm experiences financial distress. Both results seem to confirm the view that firms with financial structures in which free-rider and information problems are likely to be small get more easily financial support in situation of distress. However, such a behavior from the main bank might be at the expense of other stakeholders, resulting in managerial entrenchment and serving as a form of insurance against liquidation (Kaplan & Minton, 1994). Other results from empirical studies about Japanese governance do not support this latter view. First, as noted by Hoshi and al., when main banks help troubled companies, they do not just infuse money but also actively act to restructure them and tend to replace managers. Such a behavior is abundantly documented in the case study of Mazda by Pascale and Rohlen (1983). It is also highlighted by convergent findings from Kaplan (1994), Kaplan and Minton(1994), and Kang and Shivdasani (1995, 1997). Those studies also show that not only the main bank but also nonfinancial corporate shareholders play an important role in governance. In brief, patterns of behavior by those stakeholders are consistent with an important monitoring and disciplining role. Such a result is consistent with the view that the relationship-oriented system of corporate governance in Japan substitutes for the more market-oriented system in the US/UK. In other terms, closer monitoring by main banks and large corporate shareholders

²⁹ *Keiretsu* is the Japanese word to describe a group of firms including financial institutions. “The main features of these groupings are extensive intragroup trade and a capital structure with elaborate cross-holdings of debt and equity, a strong domination for the group’s main bank in corporate borrowing, and historically high levels of gearing in member firms” (Berglöf & Perotti, 1994).

in Japan is able to offset the lack of managerial incentives such as takeovers, stock-options, and proxy fights when firms financial distress. It should be noted, however, that the deregulation of the corporate bond market in Japan since the early 1980s, combined to the economic slowdown³⁰ in the 1990s may have weakened significantly the capacity of banks to perform the monitoring function they had been providing so far. Kaplan and Minton find no change in the performance-appointment of outside directors relation over the 1980s. Unfortunately, we lack empirical studies covering at least part of the 1990s (the latest work by Kang and Shivdasani covers the 1986-1990 period) to document this issue. Anecdotal evidence about the increasing pressure from shareholders on management (as reflected by the increasing number of shareholders litigations against management misconduct and intensified demand of shareholders for higher efficiency and transparency of management) may also be viewed as an attempt of outside shareholders to substitute a direct monitoring of the corporations to the weakening delegated monitoring by the main banks. Such a shift towards a more market-oriented system of governance in Japan has still to be documented by empirical research.

4 Conclusion

The purpose of this paper is threefold. It first examines the Bankruptcy Codes of five countries and compares the allocation of control rights they operate among the various stakeholders of the failing firm. It then relates the general orientation of the law to institutional factors such as the legal tradition and to contextual factors like the economic and political background in which legal reforms have been implemented. Finally, it considers the way bankruptcy law in each country articulates with the other governance mechanisms. About the first point, the main contrast can be found by comparing the UK procedure of administrative receivership and the other procedures. Whereas the former is privately managed and is clearly oriented towards the interests of a single creditor (usually a bank), procedures of the four other countries studied are shaped to temporarily protect the debtor and maintain the business as a going concern. There is a general tendency of bankruptcy laws to take a greater account of economic constrains and give priority to reorganization over liquidation in all five countries. Although all legislations derive from a very harsh Roman law, they have been progressively moving towards less severe dispositions, especially corporate bankruptcy laws. Such a move seems to accelerate in case of economic slowdown.

³⁰ Due to accumulated problem assets, banks have become more cautious in extending new loans and reluctant to renew existing ones, thus creating a serious credit crunch in the economy (Yasui, 1999).

However, the pace of change has varied from a country to the other according to political factors.

The articulation of bankruptcy law with other corporate governance mechanisms has been considered by both theoretical and empirical academic research. Models of corporate governance systems contrast two main patterns: in the Anglo-Saxon countries, formal bankruptcy procedures are destined to play an important part in the reorganization of distressed firms because information and free-rider problems between shareholders and debtholders are likely to occur ; this differs widely from the case of Germany and Japan where formal procedures are accessory and work as a substitute to banks in conducting reorganizations when their outcome seems uncertain. Results provided by the empirical literature are of a double nature. First they suggest that, despite the differences in the two governance systems, managers of distressed firms are indeed disciplined by effective mechanisms. In other terms, different patterns of institutional arrangements among countries lead to outcome equivalencies in terms of governance of the distressed firm. Second, they show a less contrasted reality than depicted by models. Large leveraged US firms have demonstrated that there may exist incentives for all parties to privately reorganize in the Anglo-Saxon governance system and that legal constraints to such settlements could be circumvented by institutional arrangements such as prepackaged bankruptcies. Conversely, though private reorganizations have long been the dominant way of dealing with financial distress in Germany and Japan, recent institutional changes such as the introduction of a new bankruptcy law and the deregulation of financial markets might well induce in both countries a shift towards formal bankruptcy procedures. Such issues related to the dynamics of corporate governance systems have begun to be questioned only recently and remain a fascinating field of research.

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