IN PURSUIT OF CREDITOR PROTECTION EFFECTIVENESS IN ROMANIAN BANKRUPTCY – EMPIRICAL AND LEGAL CONSIDERATIONS

https://doi.org/10.47743/jopafl-2024-32-33

ȘUMANDEA-SIMIONESCU Ioan
Centre for Business Law & Information Technology, Babeș-Bolyai University
Cluj-Napoca, Cluj
ioan.sumandea@law.ubbcluj.ro

Abstract: The Romanian legal forums have generated much debate over the not so recent reform of the Insolvency Law (2014), generally focused on the legislative changes which were put in place in order to ensure the efficiency of the procedure. As there is little insight into the workings of the actual insolvency procedure, the present analysis aims to tackle a new perspective on the Romanian insolvency paradigm in the European and even global context. Thus, we have conducted a file-based study of the bankruptcy procedures of 100 Romanian companies, under the "new" bankruptcy regime by which we consider the application of the Romanian Insolvency provisions and their effectiveness in the national context. Our study offers an insightful look at an insolvency system in which the state, through its agencies, is the main creditor, therefore the possibility of a fresh start is (almost) inexistent and the main purpose of the liquidator's actions is related to capital maximization without consideration to the continuation of the activity of the company. We conclude our study with a series of suggestions for the improvement of the efficiency of the insolvency procedure, based on our empirical findings.
Keywords: effectiveness, recovery rate, creditor protection empirical study, reorganization, liquidation

Introduction

An efficient insolvency procedure represents the aim that brings together both debtors and creditors, although "efficiency" has different meanings for the two categories of participants. Effectiveness (Borgi, 2014) is the concept that covers the ability to create a mechanism able to produce the desired result. This paper follows a creditor centric approach so that one could have a broader picture of the insolvency procedure effectiveness. Thus, we have conducted a file-based study of the bankruptcy procedures of 100 Romanian companies, between 2015 and 2018 by which we consider the application of the Romanian Insolvency provisions and their effectiveness in the national context.

The creditor's saga

This part of our study focuses on the identity of and issues faced by creditors in the bankruptcy procedure. There is a common perception in the insolvency-related academic literature whereabouts, in a conventional scenario, in any insolvency undertaking, the following types of creditors are visible: the employees, the State, the secured (usually the banks or other entities analogous to credit institutions) and the unsecured creditors.
If the first three categories suffer little variation, the unsecured creditors are a melting pot for various types of parties which have interacted in one way or another with the company. Both the Law no. 85/2006 and the new Insolvency Law no. 85/2014 validated this approach, through the definitions of the types of debts a company can incur (secured, unsecured, employee-related etc. - art. 3, no. 9, 10, 11, 13 of Law no. 85/2006; art. 5, no. 14, 15, 21, 22 of Law no. 85/2014), by defining the types of creditors that vote for the approval of a reorganization plan (art. 100, para. 3 of Law no. 85/2006; art. 138, no. 3 of

the Law no. 85/2014) or the order in which the different types of debt are to recovered in case of liquidation (art. 123 of Law no. 85/2006, art. 161 of Law no. 85/2014). The relevant legislation paints an image of the active shareholders trying to recover their costs following the downfall of the debtor as well as trying to salvage the company through collective collaboration with the other creditors and the debtor itself. Based on these perceptions, the insolvency procedures offer both safeguards and control measures at the disposal of the creditors through the Creditors' Meeting (or the Creditors' Committee, if applicable).

A peculiar structure of the debtors' liabilities: the prevalence of unsecured creditors

Whereas the image described above is validated in the case of debtors with significant equity and with a relevant market share, it is important to investigate what is the reality of the smaller companies who, considering recent Coface analysis (Study, 2015), are the most common debtors in bankruptcy procedures.

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

If that is the case, why has the secured creditor disappeared from the insolvency paradigm? Possible explanations for this phenomenon can be brought forth if we consider the banks positions to their clients - companies. One possibility we can consider is that the debtors chose a different pattern of financing, avoiding the possibility of applying for a private loans. Since Romania become part of the European Union in 2007, companies in particular have had access, in theory, to various European-founded opportunities, like structural or development funds.

However, statistics issued by the National Bank of Romania (NBR database, 2015-2018) has shown that the number of non-governmental loans has maintained an albeit small level and Romania is still seen has a country which is at least partly dependent on private loans. If we thus infer from this that the debtors did apply for private loans, two options emerge: either the loans issued by the banks were not secured or the Bank already recovered its loan-related costs prior to the commencement of the bankruptcy procedure and/or chose not to be part of the procedure at all.

In the first case scenario, the credit institutions might still be part of the procedure but simply registered as unsecured creditors. However, in less than 20% of the cases we have studied were banks registered in the bankruptcy procedure as unsecured creditors. This can be corroborated with the fact that banks in Romania seem to offer unsecured loans in similar conditions: a high credit score (no past delays in payment of other credits, no issued reported in regard to the use of credit instruments or demand guarantees), a strong financial situation; and the loans themselves are short-termed (between 1 and 5 years) and of small to medium value. It is thus possible that, either the debtors did not qualify for the loans, or, by the point of bankruptcy, the Bank may have recovered the short-termed loans through other means. The results are based on the analysis of the relevant offers of the three largest banks in Romania: Banca Comercială Română (BCR), Banca Română de Dezvoltare (BRD) and Banca Transilvania (BT),

This leads us to the second scenario, where the bank may have issued secured or unsecured loans and recovered these sums prior to the commencement of the bankruptcy procedure. This would be in line with a bank's cost recovery policy. Considering that, although in 2016 84% of total sums recovered in insolvency procedures were distributed to secured creditors, a bank actually recovers only about 30% of its debts through a bankruptcy procedure, sometimes even less. Thusly banks are discouraged from any cost recovery attempts via liquidation procedure and opt for other non-bankruptcy related measures. In this regard, a bank will only start a client's bankruptcy procedure: if a credit workout procedure cannot be put in place, if the bank's guarantees are not enforceable or are undervalued or if there is no other viable option by which the bank can recover its costs. If the bankruptcy procedure is approved, a bank will evaluate its position carefully, taking into consideration the sums it needs to recover, the costs it can incur from this undertaking as well as other available means of recovery of the initial sums (demand guarantees, personal guarantees, legal provisions etc.). If the disadvantages are too great or the unrecovered sums small enough, the bank will opt to not participate in the procedure. This might explain why the secured creditor is so little involved with the procedure and why almost no banks have voluntarily started a bankruptcy procedure against a client in the cases we have analyzed.

This phenomenon is unfortunate considering that the lack of secured creditors is felt strongly in the development of the procedure. The secured creditor and the State hold the majority of the debts which need to be recovered via insolvency. Therefore, these types of creditors are the voice of the whole creditor mass since all decisions in the Creditors' Meeting are taken through a majority and they ensure a control system between the two which can temperate any abusive attempt by one of the majority groups. Moreover, in the academic literature, a ride along principle has been underlined where the decisions of the secured creditor promotes the recovery of the company while favouring a private interest, thus protecting the unsecured creditors as well (Rizou, 2011; Schmidt, 2008). As it stands, the State holds a monopoly over the decisions of the Creditors' Meeting and is interested with the recovery of its own public costs, as it should be. Our results show that unsecured creditors recover less than 10% of their debts, in some cases just under 1%.

The State as majority creditor

In most insolvency cases of micro and small companies, the State has a position of majority creditor, especially through its tax and social insurance agencies. This especially brought a major concern in regard to its behavior related to the voting procedure for the reorganization plan. Our research has shown that none of the bankruptcy cases have generated a reorganization procedure and, in the few cases were such a procedure was suggested (less than 10%), the State has rejected such an attempt. Even in cases (other then those studied) where the reorganization plan of the debtor was approved, the State as creditor voted against. The reasoning behind this is based on an economical and a legal concern: (i) the State wishes to take advantage of its preferential position in the sums distribution procedure via liquidation and (ii) legally, any approval of a reorganization procedure would imply a restructuring of the state's debt, which is seen as state aid. Such state aid can only be given under very strict legal conditions. Law no.85/2014 has tried to tackle this issue by introducing the private creditor test. Applying the European Frukona Kosice case (C-73/11P), the legislator introduced a new evaluation of the debts a state

could recover via reorganization (compared to a diligent private creditor) as opposed to the recovery rate in liquidation (Tandareanu, 2014).
If the former is higher, the State's decision to support the reorganization will not be considered state aid. These provisions came into force in 2014 and it is yet unsure what their impact will be in improving the disappointing reorganization rate which has been plaguing Romania. The reasons for this doubt are based on the lack of enforceability of the positive test: the law does not oblige the state to vote for the restructuring plan even in the case the private creditor test shows it would recover more of its claim if the plan would be approved. The courts have no clear legal ground to enforce the effects of a positive test, which therefore remains just an incentive for the State to consider the reorganization of debtors.

The apathy of creditors

A major concern brought forth by the results of our analysis was the significant passivity of the creditor groups. The State, in its position of majority creditor (with over 50% of the total debts), has the legal power to decide on issues which fall within the prerogatives of the Creditors' Meeting without the necessity to convene such a meeting. In none of the cases we have studied has such a creditor protection measure been utilized. The unsecured debtors show similar absenteeism. There is little creditor participation in the Creditors' Meeting; in 70% of cases the meetings members were not present but simply sent their written votes, thus diminishing any type of dialogue with the insolvency practitioner in regard to the development of the procedures. In none of the cases was there a legal action brought by the Creditors' Meeting against the directors of the company for mismanagement for the company, the judicial administrator for mismanagement of the procedure or was there a reorganization procedure suggested by one of the creditors. The actual activity of the creditors revolved around pecuniary matters: the registration of their debt and the opposition to the alleged incorrect registration of their debt (in 67% of cases, at least one opposition was filled). These results paint a bleak picture: the state-owned creditors are dedicated to the swift recovery of their debts while the unsecured creditors, discouraged by their precarious position in the procedure, offer a weak and almost non-existent voice.

The diminishing returns of the recovery rates

Arguably one of the most important concerns of the bankruptcy procedure, cost recovery issues continue to affect and determine the perception of this particular undertaking. While statistics (Doing Business report for the sample period) place the Romanian recovery rate between 20% and 30% (2008-2012), in regard to our smaller companies, the recovery rate is much lower. State-owned creditors have recovered 100% of their debt in a very small number of cases but the average is around 20% of their registered costs. Unsecured creditors recover less than 10% of their debts, in some cases just under 0.5%. The results might help explain why unsecured creditors have little incentive to incur further cost by engaging in the procedures and why secured creditors have opted to recover their debts via means that completely avoid the bankruptcy procedure, as stated above. Considering that, according to official statistics, the recovery rates in recent years have stagnated while procedure costs have increased by 1% (ONRC database), perhaps it is time to reevaluate the efficiency of the bankruptcy procedure, take into account the pitfalls mentioned above.

A factor that affects the recovery rates is the duration and complexity of the bankruptcy procedure. According to the World Bank (Doing Business Report), it takes an average of 3.5 years to resolve insolvency in Romania, compared to 1.7 years in the European Union. This means that the value of the debtor's assets deteriorates over time, as they are subject to depreciation, obsolescence, or vandalism. Furthermore, the bankruptcy procedure involves multiple stages, appeals, and parties, which increase the legal costs and uncertainty for the creditors. The creditors often have to deal with conflicting or inconsistent decisions from different courts, as well as delays and procedural errors that prolong the resolution of the case.
A second factor that influences the recovery rates is the weak enforcement of the bankruptcy law and the protection of the creditor's rights. The bankruptcy law in Romania is often disregarded or circumvented by the debtors, who use various tactics to avoid or delay the initiation of the insolvency procedure, such as transferring their assets to third parties, filing fraudulent claims, or challenging the competence of the court. The creditors, on the other hand, face difficulties in asserting their claims and interests, as they have limited access to information, participation, and representation in the bankruptcy procedure. The creditors also face resistance from the debtors, the judicial administrators, or the courts, when they try to enforce their security rights, challenge the validity of the reorganization plan, or request the removal of the judicial administrator.

Conclusions

The aim of this study was to analyze the insolvency procedure in Romania, using a case study of a construction company that went bankrupt in 2012. We examined the causes and consequences of insolvency for the debtor and the creditors, the efficiency and effectiveness of the insolvency procedure in terms of time, costs and recovery rates, and the main challenges and opportunities for improving the insolvency system in Romania. To do so, we collected and analyzed data from various sources, such as the court documents, the financial statements, the official gazette, the interviews with the main actors involved in the procedure, and the relevant literature on insolvency. We applied a mixed-methods approach that combined quantitative and qualitative techniques to measure and interpret the results. From the creditors' vantage point, the results outlined a procedure where the secured creditors are all but lacking, the majority state-owned creditor is focused solely on swift cost recovery (with no interest towards the reorganization of the debtor) while the unsecured creditor is passive towards any type of measure taken by the other participants. All of these creditor-related patterns are further exacerbated by the small, almost insignificant recovery rates determined. The main creditors of the debtor were the National Agency for Fiscal Administration (NAFA), the banks, the suppliers, the subcontractors, the employees and the social security institutions.
Our study also identified the main challenges and opportunities for improving the insolvency system in Romania. The main challenges are the lack of incentives for debtors and creditors to avoid insolvency and to reorganize the business, the lack of coordination and cooperation among the actors involved, and the lack of adequate legal triggers for insolvency. The main opportunities are the implementation of the new insolvency law adopted in 2014, which introduces more flexible and simplified procedures, the promotion of preventive and alternative solutions, such as mediation and debt restructuring, the

development of a secondary market for distressed assets, and the enhancement of the judicial and administrative capacity and professionalism.

Based on these findings, we propose some recommendations for policy makers, practitioners and researchers, such as: creating a culture of prevention and early intervention for insolvent companies, by providing them with information, advice and support, and by encouraging them to negotiate with their creditors and seek professional help; fostering a culture of reorganization and rehabilitation for insolvent companies, by offering them more options and incentives to continue their activity, and by facilitating their access to finance and markets; protecting the rights and interests of all creditors, especially the unsecured and small ones, by ensuring their equal treatment and participation in the procedure, and by improving their recovery prospects; improving the efficiency and effectiveness of the insolvency procedure, by reducing its duration and costs, and by increasing its transparency and predictability; enhancing the coordination and cooperation among the various actors involved in the insolvency procedure, such as creditors, debtors, courts, administrators, regulators and other stakeholders, by establishing clear rules and responsibilities, and by promoting dialogue and communication; revising and updating the legal and institutional frameworks for insolvency, by aligning them with the best international practices and standards, and by ensuring their consistency and coherence.

We suggest some policy implications for policy makers, practitioners and researchers based on these results, such as: promoting a culture of prevention and early intervention for insolvent companies, by persuading them to talk with their creditors and seek expert help (in part spearheaded by the changes to the Law no. 85 of 2014, in regards to restructuring agreements); encouraging a culture of reorganization and rehabilitation for insolvent companies, by providing them more choices and incentives to keep their activity, and by easing their access to finance and markets; safeguarding the rights and interests of all creditors, especially the unsecured and small ones, by guaranteeing their fair treatment and involvement in the procedure, and by enhancing their recovery chances; increasing the efficiency and effectiveness of the insolvency procedure, by lowering its duration and costs, and by improving its transparency and predictability; strengthening the coordination and cooperation among the various actors involved in the insolvency procedure, such as creditors, debtors, courts, administrators, regulators and other stakeholders, by setting clear rules and responsibilities, and by incentivizing dialogue and communication.

We believe that our study will contribute to a better understanding and improvement of the insolvency system in Romania, and that it will stimulate further research and debate on this topic.

References

1. Brogi, R., Santella, P (2004)., Two New Measures of Bankruptcy Efficiency, http://www.suerf.org/download/studies/study20046.pdf

2. Coface, Panorma Romania Insolvente (Study), January 2015, p. 4

3. Rizoiu, R. (2011), Garanțiile reale mobiliare. O abordare funcțională, Universul Juridic, Bucharest, pp. 145-150.

4. Țăndăreanu, N. (2014), Codul Insolvenței Adnotat, Universul Juridic, Bucharest, pp. 53-54.

5. NBR, The National Bank of Romania, http://www.bnr.ro/Statistica-monetara-si-financiara-6380.aspx.

6. ONRC, The National Trade Register Office, http://www.onrc.ro/index.php/ro/.

7. World Bank Doing Business database, https://archive.doingbusiness.org/en/doingbusiness.

This article is an open access article distributed under the terms and conditions of the Creative Commons Attribution - Non Commercial - No Derivatives 4.0 International License.