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AUTHOR: Janet Mitchell

CONTRACTOR: Cornell University

PRINCIPAL INVESTIGATOR: Janet Mitchell

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NCSEER NOTE

This report is Part I of a two part report. Part II, which is described in the Executive Summary, has not been distributed with Part I due to its highly technical nature. It is available upon request from the National Council, (202) 387-0168.

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EXECUTIVE SUMMARY

The Economics of Bankruptcy in Reforming Socialist Economies

This report addresses the problems of design and implementation of bankruptcy laws during the transition from centrally planned and largely state-owned economies to market-oriented economies with significant degrees of private ownership. The theoretical relevance of this topic derives from the centrality of capital markets in making such a transition and the necessity of clear and enforceable definitions of property rights for the proper functioning of capital markets. The empirical relevance of the issue of socialist bankruptcy is illustrated by the fact that each of the socialist economies undertaking market-oriented reforms has debated or passed bankruptcy laws. Policy makers in these countries envision bankruptcy as a tool for improving the financial discipline of enterprise managers and enhancing the efficiency of resource allocation.

Yet, the meaning of the term bankruptcy in socialist economies and the procedures that should comprise a bankruptcy process are not obvious. In order to understand these issues I identify in Part I of the report goals that a bankruptcy law in any economy might be expected to achieve. I then argue that though the general goals of bankruptcy are similar across economic systems, differences in the level of development of markets and in the roles assumed by a firm's "owners" across economic systems will lead to differences in optimal bankruptcy provisions and in experience with enforcement. This observation implies that bankruptcy provisions and success with enforcement are likely to evolve as financial reform progresses.

I identify a firm's potential owners as all persons with either residual rights to control of the firm or rights to income streams. Differences in the roles of owners across economic systems coincide with differences in the level of development of capital markets; hence, there is a link between optimal bankruptcy provisions and the development of capital markets.

The general goals of bankruptcy that I identify are two. First, a bankruptcy law should ensure that firms that should survive do and that those that should not survive do not. Second, a bankruptcy law should clearly define the priority ordering of owners for the renegotiation or redistribution of the bankrupt firm's assets. The latter goal represents a specification of property rights that is necessary for predictable functioning of financial markets.

In Part I of the report I identify three "stages" of reform in which bankruptcy laws are likely to differ. In an initial stage financial markets are in their infancy, most firms are state-owned, and the government or a bank is the primary provider of investment finance. In a more advanced stage, financial markets are extensively developed, stock and bond markets are widely operative, and firm ownership is dispersed. Finally, one stage of development may consist of an economy with a predominance of labor-managed firms.

Study of bankruptcy provisions in five developed capitalist economies and in three socialist economies aids the analysis of the role of bankruptcy at different stages of financial development. For example, the existence of multiple, competing creditors in the U.S. exerts a disciplinary effect on firm managers that does not exist in the socialist economies at early stages of reform. The absence of multiple creditors in the latter economies implies that, as foreseen by socialist policy makers, bankruptcy laws may be needed to exert a disciplinary influence. Moreover, since government bureaucrats (e. g., ministry officials) serve in many respects as the socialist firm's owners in the initial stage of reform, there exists a potential conflict of interest that may hamper enforcement of bankruptcy laws. These bureaucrats serve in a dual capacity: as the firm's owners and as policy enforcers; therefore, they may have vested interests in ignoring bankruptcy laws that are on the books. Bankruptcy statutes that yield greater power to the firm's creditors and/or are automatically triggered may alleviate this conflict of interest.

Yet, according statutory power to creditors in bankruptcy laws at early stages of financial reform does not guarantee that they will aggressively seek to implement these laws. In both Hungary and Yugoslavia interenterprise indebtedness has become a severe problem despite the existence of bankruptcy statutes. Creditors in both countries have shown reluctance to seek satisfaction of claims and to force their debtors into bankruptcy. This experience suggests that there exists a problem with implementation of bankruptcy laws that is unique to early stages of reform. This problem derives from the beliefs of creditors. Given that the environment until very recently has been one in which bailout was virtually assured and given that everyone knows that the government cannot force every firm in the economy into bankruptcy, it may be rational for noone to initiate bankruptcy proceedings and for everyone to wait for bailout.

Part II of the report* (coauthored with Patrick Legros) examines in more depth the optimal form of a bankruptcy law in a socialist economy at the earliest stage of reform. This paper analyzes the optimal design of bankruptcy rules when there exist no well functioning credit markets, hence where the government is the primary lender, and where enterprise managers possess private information regarding both their initial productivities and their efforts to increase their productivities. Specifically, it examines the extent to which an optimal liquidation policy can achieve an efficient allocation of resources and choice of managerial effort when neither managerial effort nor firms' productivities are observable to those providing investment resources. The regulator/lender designs a contract with the entrepreneur (firm manager) that specifies the amount of investment resources to be provided, a liquidation rule, and payoffs.

We ask the following question. Given that the regulator may precommit to liquidating or to bailing out a firm that encounters financial distress, will the optimal bankruptcy rule be efficient; i.,e., will it always call for bailing out (not bailing out) a firm that the regulator would have chosen to bail out (not to bail out) if he possessed the enterprise manager's private information? We find that in many situations the optimal bankruptcy rule is not efficient: the regulator may bail out a firm that he would have wanted to liquidate in the first-best situation or liquidate a firm that he would have wanted to bail out. This result is significant. Although it is not uncommon to find that bankruptcy laws in economies with well developed financial markets may result in either premature or overdue liquidations, these outcomes are not the direct intentions of lawmakers. In the model of this paper the

* Available upon request from the National Council, Tel # (202) 387-0168.

regulator chooses to implement an inefficient bailout policy because of its incentive effects. This finding implies that in the earliest stages of reform, optimal bankruptcy rules may result in allowing some inefficient firms to remain in operation.

1. Introduction

In each of the socialist economies undertaking market-oriented reforms, bankruptcy laws are envisioned as integral to their success. Justifications that are cited for this view are the positive effects that bankruptcy laws would have in improving financial discipline among enterprise managers and upon the efficiency of resource allocation in the economy. On the one hand, microeconomic reforms are intended to increase the autonomy of enterprise managers in running their firms. Forcing unsuccessful firms to enter bankruptcy is seen as the "stick" that must accompany the "carrot" offered by the rewards of success in the marketplace. On the other hand, eliminating firms for which resources are more productively deployed elsewhere in the economy will increase the efficiency of resource allocation. Reserving resources for the most productive enterprises will increase the average productivity of resources in the economy.

Yet, the meaning of the term bankruptcy in socialist economies and the procedures that should comprise a bankruptcy process are not immediately obvious. Policy makers often appear ambivalent about enforcing bankruptcy-like statutes, and their ambivalence may well extend to the formulation of these statutes. The following 1978 resolution of the Central Committee of the Hungarian Socialist Workers' Party is suggestive of the possible problems associated with definition and implementation of bankruptcy laws.

> Enterprises, plants which are not profitable, the activities of which are not in harmony with the interests of the national economy and which—among the given investment possibilities—cannot be profitable by the means of rationalisation might not be maintained, their losses might not by covered by state subsidies. In such cases the state organs, helped by party and social organizations—as a last solution—have to be determined and use their means for partial or total liquidation.[1]

In this paper I analyze the potential functions of bankruptcy laws in reforming socialist economies in relation to the functions in capitalist economies. I consider how the focus of socialist bankruptcy

[1] Cited in Laki (1985).

laws might be expected to change as an economy becomes progressively market-dominated and how problems of enforcement may vary at differing stages of reform. Finally, I discuss the implications of these issues for enterprise behavior. The paper is organized as follows. The remainder of this section discusses the general purposes that a bankruptcy law in any economy, capitalist or socialist, might serve. It also identifies some potential differences in the roles of bankruptcy in capitalist and socialist economies. Section 2 examines the U.S. bankruptcy law as an example of such a law in a developed capitalist market economy (CME). It links provisions of the law with institutions in the U.S. economy. Section 3 examines differences in bankruptcy laws across capitalist economies. Section 4 discusses economic institutions in reforming socialist economies (SEs) and draws inferences regarding the emphasis and form that one would expect of socialist bankruptcy laws. Section 5 discusses provisions in the Hungarian, Polish, and Yugoslav bankruptcy laws in light of the analysis of previous sections. Section 6 considers problems of enforcement and the expected effects of bankruptcy laws in socialist economies on enterprise behavior. Section 7 concludes.

The principal goals that socialist reformers expect bankruptcy laws to serve have been enumerated above. A natural question to ask is if the goals for bankruptcy are similar in capitalist economies or if bankruptcy laws in the latter serve some alternate purpose. Can one identify a general purpose of bankruptcy that is applicable to all economies? If so, then study of bankruptcy laws in capitalist economies may facilitate identification of the similarities and differences that one should expect to observe with socialist bankruptcy laws and in the success with their enforcement.

Bankruptcy is an institution that is inherently linked to debt collection. Yet, the necessity of rules governing the rights of creditors to recover their claims need not give rise to a bankruptcy statute, which treats debts collectively and determines the ultimate fate of the debtor firm. Baird (1987) offers the following "test" for the need for a bankruptcy law. Do existing (nonbankruptcy) institutions ensure that firms that should survive do and those that should not, do not? If so, then there is no need for a bankruptcy law.[2]

Baird's explanation of the need for a bankruptcy law in the U.S. is the existence of a "common pool" problem among creditors. Bankruptcy is initiated when a firm defaults on its debt and when the firm's management and creditors cannot come to some agreement concerning realignment of payments or writing off of debt outside of the bankruptcy procedure. Bankruptcy is generally invoked to halt a "race" by a firm's creditors to sue the firm for fulfillment of their claims once the firm has defaulted on its debt. Such a race may result in a piecemeal dismantling of the firm which yields a total asset (or "pool") value smaller than that which might be obtained if the firm's assets were treated as a whole. Hence, bankruptcy is a response to the common pool problem.[3,4]

I argue in this paper that ensuring that firms that should survive do and that those which should not, do not is one general goal that may be attributed to bankruptcy in any economy.[5] Another goal is to establish the distributional rights of claimants in satisfaction of their claims, in the event that the firm liquidates.[6] The reasons that nonbankruptcy institutions do not satisfy this goal will vary from one institutional setting to another. This general goal then subsumes the two particular goals cited above for socialist economies. First, the normative aspect of the statement may be interpreted as pertaining to efficiency of resource allocation. Second, the success with which the bankruptcy law

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[2] White (1989) considers a similar criterion in studying the U. S. bankruptcy law. She asks whether, given the priority ordering of creditors in bankruptcy, firms liquidate only when their liquidation values exceed their continuation values and only those firms liquidating are ones whose liquidation values exceed continuation values.

[3] Also see Jackson (1986) for a detailed exposition of this problem.

[4] Warren (1987) argues that nonbankruptcy law governing debt collection in the U.S. is designed to treat cases of default on the debt of a single creditor, whereas bankruptcy law treats the case of defaults on multiple debts "in the context of the debtor's imminent collapse." She justifies the need for a bankruptcy law on the basis of the differences in the distributional concerns in the two situations.

[5] For the purposes of this paper I interpret this goal as follows. Firms composed of assets whose value is greater in another activity (or activities) or with another configuration of ownership rights should have those assets or associated rights transformed. A firm that should not survive would be one that is dissolved through piecemeal liquidation of its assets. A firm that should survive might require only a restructuring of production actitivities that maintains the firm's capital stock and labor force intact.

[6] While the question of the appropriate priority distribution of claims is an important one for bankruptcy in economies with developed financial markets, I virtually ignore it in this paper. Given that financial markets are in their infancy in reforming socialist economies, achieving the first goal through bankruptcy is of much greater concern at present than achieving the second.

accomplishes its goal or is enforced will determine its disciplinary effect on enterprise management.

An auxiliary function of bankruptcy in CMEs, and one which serves its general purpose, is the transfer of control over a firm's assets, to a large extent from the debtor to its creditors. A question raised by this observation is the extent to which bankruptcy in socialist economies should entail a change of control and, if so, from whom to whom? Also, should the process of liquidating or otherwise changing the status of a firm in socialist economies be associated with debt collection? I address these questions in Sections 4 and 6 below.

A number of papers in the economics literature have demonstrated the validity of the common assumption that the threat of a transfer of control over a firm's assets from its current owners or managers to another group influences the behavior of the current owners.[7] Bankruptcy offers only one of several possible mechanisms in CMEs by which control may be transferred from one party to another. Other mechanisms for transferring control include takeovers, replacement of management by shareholders, the sale of stock by current stockholders to new buyers, and the voluntary closing of firms. Takeovers, replacement of management, and resale of stock are often unrelated to default on debt repayments; however, they are usually linked to lower performance on stock dividends or prices than expected. They represent efforts by one set of the firm's claimants to improve firm performance or to minimize their individual losses from expected future poor performance.

Consideration of transfers of control and of bankruptcy's general purpose leads to study of two critical dimensions of capitalist and socialist economies: the level of development of markets and the roles assumed by the firm's "owners." Recent efforts in the Western economics literature to identify the defining characteristics of ownership have emphasized "residual rights of control over assets" in contrast to earlier views of ownership that were associated solely with rights to income streams from those assets.[8] Residual rights of control refer to the right of a party to decide upon the deployment of a firm's assets in all situations that are not expressly enumerated in contracts with other claimants or

[7] See, for example Grossman and Hart (1982), Jensen (1986), and Scharfstein (1988).

[8] See Grossman and Hart (1986), Hart (1988), and Hart and Moore (1988).

affiliates of the firm. This view of ownership, along with the more traditional view, may be fruitfully incorporated into discussions of a socialist economy. Indeed, a broad interpretation of ownership would include in the list of a firm's owners and potential owners all individuals with either residual rights of control or financial claims on the firm.[9]

The following diagram presents the typical sets of potential owners, allowing for a broad definition of ownership, for capitalist and socialist firms, respectively.

Stockholders	*Managers*	*Bondholders*	*Other Creditors*

Capitalist Economy

Central Planners	*Ministry or Regional Officials*	*Managers/ Employees*	*Banks*	*Other Creditors*

Socialist Economy

Differences in the interests, rights, and bargaining powers of each group, as well as in the specification of the groups across economic systems, help explain differences in both the need for and the design of bankruptcy provisions across these systems.[10] For example, the stockholders are considered the owners of a capitalist firm as long as the firm remains solvent. Once the firm becomes insolvent, then creditors acquire greater ownership rights. In contrast, ministry or regional officials may be considered to be the owners in SEs, at least as long as the firm remains solvent. Sections 2 and 4 further elaborate the differences for CMEs and SEs.

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[9] Holmstrom and Tirole (1988) conclude in their discussion of ownership that very often rights to income streams accompany residual rights of control.

[10] In theory government officials could be included as potential owners in the capitalist economy and stockholders in the socialist; however, the lists as given are intended to depict those groups most commonly associated with ownership in each economic system. Also, while employees could be included as potential owners in the capitalist firm, they may be classified as "other creditors" when they possess no ownership rights in the firm and as stockholders when they do own the firm.

Whereas the issue of transfer of control in bankruptcy raises the question of the nature of ownership of assets in an economy, the issue of whether or not a firm "should" survive focuses attention on the importance of markets and how such a judgement is to be made. When prices are not market determined, a firm's value in one activity relative to that in another is not evident. Earning losses in one activity is not necessarily an indication that transferring assets to a profitable activity will increase the firm's value to society.

An additional obstacle to determining the survival value of a socialist firm is the general absence of a market for capital. The theoretical standard employed in CMEs to determine whether a firm should survive or not is whether the firm's "value" is greater in continuation or in liquidation. Although the firm's value in continuation is defined as the present discounted value of its profit stream, an estimate of that value is given by the value of its outstanding equity plus debt, where secondary markets exist for both types of claims. In theory, the prices for these claims reflect all available information regarding future income streams to the firm.

What one might reasonably assume for a socialist economy is that, in the absence of a capital market and in the presence of market-determined prices of other goods, information may be gathered and (unbiased) estimates of future earnings made, albeit at a greater cost than in CMEs. The strong argument to be made in favor of capital markets, and one that was made at least as early as Von Mises (1936), is that they provide readily observable estimates of the opportunity costs of capital. Indeed, more than one East European economist has proposed establishment of a capital supervisory board, which would make assessments of the value of capital in firms, likely through limited stock sales, without sacrificing the institution of public ownership.

I do not attempt in this paper to assess the costs associated with optimal allocation of capital in the absence of a capital market. I do, however, discuss how the development of capital markets influences the enforceability of bankruptcy laws and the manner in which bankruptcy provisions would be expected to change as capital markets develop.

The remaining sections of the paper will argue that although bankruptcy laws in all economies may be conceived as pursuing at least one general goal, the emphasis of bankruptcy laws will likely differ according to the differing configurations of ownership and markets in an economy. The success with which a bankruptcy law may be expected to accomplish the general goal will also depend upon these factors.

2. Bankruptcy in the U.S. Economy

The purpose of this section is to describe some of the means by which bankruptcy in the U.S. serves the general goal stated in Section 1 and to identify links between provisions of the bankruptcy code and prevailing economic institutions in the U.S.. The effects of the U.S. bankruptcy law on firm behavior are also considered.

U.S. bankruptcy law (as well as bankruptcy laws in many other countries) allows two avenues for treatment of the firm's assets. The first, liquidation (Chapter 7), is designed to be chosen when the total value of the assets of the firm as a going concern is less than their value when sold piecemeal. When liquidation is chosen, a trustee appointed by the bankruptcy court directs the disposing of the firm's assets in the way that maximizes their total value. The trustee then distributes the proceeds to the firm's creditors according to a legally specified priority rule. The alternative for a firm declaring bankruptcy is that of reorganization (Chapter 11), whereby the shareholders, management, and creditors will bargain over the plan for the firm's reorganization and the redistribution or settlement of claims to the firm's assets. Reorganization is intended for use when the firm's "going-concern" value exceeds its liquidation value. The debtor firm decides both when to declare bankruptcy and whether to enter the liquidation or the reorganization phase.[11]

Bankruptcy in the U.S. is widely perceived as a transfer of control from a firm's shareholders to its creditors. This transfer is intended to protect the value of creditors' claims once a firm is unable to fulfill all of its financial obligations. Note, however, that the process of debt collection outside of bankruptcy law also accomplishes this purpose, albeit in a different and perhaps more costly manner. Once the firm defaults on its debt, its creditors will sue for recovery of their claims. Control over at least some of the firm's assets will transfer to creditors even in the absence of declaration of bankruptcy.

[11] Reorganization is intended to be applied when the firm is illiquid as opposed to insolvent. Illiquidity implies that the firm cannot meet its current obligations; however, the value of the firm's assets still exceeds the value of its liabilities. Insolvency implies that the value of the firm's liabilities exceeds the value of its assets.

The reorganization procedure of U.S. bankruptcy does not correspond to a complete transfer of control from stockholders to creditors. Rather, it represents a bargaining process whereby ownership rights to the firm are renegotiated among stockholders, firm management, and numerous classes of creditors. The firm's stockholders and management actually *gain* bargaining power in reorganization relative to that which they would possess outside of the bankruptcy proceeding. Powers or advantages gained by management include an automatic stay on creditors' actions to collect debt, retention of control of the firm during the reorganization process, control of the filing of a reorganization plan during the first four months of reorganization, cessation of the accrual of interest on unsecured debt, ability to breach contracts for which performance remains due on both sides, and avoiding powers, which allow management to recover property that might have been seized by aggressive creditors in the period just preceding bankruptcy.[12]

The bargaining process initiated in reorganization and the relative gain in bargaining power by stockholders permits a number of interpretations of this mode of bankruptcy. One possible view is that reorganization provides the opportunity for the survival of firms that should survive but that would not if liquidation were the only available option in bankruptcy. Reorganization, then, allows the stockholders to gain bargaining power in situations where the going-concern value of the firm exceeds its liquidation value. One might conclude on the basis of this view that, at least in the eyes of U.S. lawmakers, U.S. nonbankruptcy law and institutions embody too great a risk that firms that should survive do not.

White (1988) offers an additional interpretation of the role of reorganization. In her view, if liquidation were the only option available to firms in financial distress, stockholders and managers might undertake very risky investments as the firm's financial problems worsened in order to avoid liquidation at all costs. The firm's assets might be virtually worthless by the time that bankruptcy was actually declared. Reorganization offers a compromise to the firm's managers and stockholders by

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[12] Johnston (1988) presents a detailed discussion of the powers gained by management relative to creditors in reorganization.

allowing them to file for bankruptcy, with the prospect of continuing in business, while there is hope left for the firm. Moreover, if attempts to devise a reorganization plan fail and the firm must liquidate, the value of assets will not have been driven to zero.

This argument, for which there appears to exist some empirical support,[13] is based implicitly on the existence of informational asymmetries between stockholders and creditors or between management and both stockholders and creditors. For, if creditors were able to know when a firm is commencing a financial downfall, they could either place covenants in debt contracts restricting management from taking risky actions when the downfall begins or they could more aggressively attempt to recover their claims once they observed the problems.[14] On the other hand, if stockholders alone were able to observe the severity of the firm's financial problems, they would most likely attempt to sell their stock before driving the value of the firm's assets to zero. The remaining possibility is that only the firm's management knows the true financial state of the firm, until it reaches some critical stage at which the firm's possible demise becomes evident to all current and potential claimants. At this point the stockholders are unable to bail out and the creditors begin their race to sue the firm. Management, in the meantime, will have taken risky actions with the assets. Adding the possibility of reorganization in this case would presumably benefit management, stockholders, and creditors by raising creditors' expected returns on outstanding debt and the management's and stockholders' expected future earnings with the firm.

A third explanation for the existence of reorganization in the U.S. is primarily political. White (1988) cites Congress' favoring of reorganization as a result of their concern with "saving. . . jobs, reducing the burden on the unemployment compensation and welfare systems, and avoiding disruption

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[13] For example, White (1989) reports that in a sample collected by the U.S. Department of Justice from firms entering bankruptcy in all of the districts of the U.S. in 1980-1981, the average ratio of total liabilities to assets of those liquidating was 7.3, whereas the ratio for those filing to reorganize was 1.4.

[14] Note that in France, Germany, Japan, and England creditors have the right to petition for commencement of bankruptcy proceedings. I discuss the implications of this difference in bankruptcy laws in Section 3.

to local communities." Warren (1987) references several Congressional comments on the Bankruptcy Code that refer to issues such as "protect[ing] the investing public, protecting jobs and saving troubled businesses." Congressional concern with the social or political costs of bankruptcy has not extended, according to White, to concern that reorganization may allow firms that should not survive to continue in operation.

The political explanation for the reorganization phase of bankruptcy is potentially of great importance in comparing bankruptcy laws across capitalist and socialist economies. Whereas the tendency to protect firms, their workers, and associated customers from liquidation is commonly associated with socialist economies, there appears to exist a range of levels of government involvement across capitalist economies in protecting bankrupt firms.[15] For example, English bankruptcy law provided for no reorganization phase until 1985, whereas recent modifications of French bankruptcy law have given workers extraordinary powers in participating in the bankruptcy bargaining process.[16] Planned modifications to the German bankruptcy law include a unified liquidation and reorganization procedure that is motivated by concern for the level of integration of firms and workers in the German economy and the possible externalities arising from firm liquidations.[17]

Critics of the reorganization procedure argue that it allows firms that should liquidate to survive, that it permits transfers of wealth from creditors to debtors through the undertaking of risky actions on the part of debtors, and that it relies on administrative valuations of the firm rather than a market valuation that could be obtained if the reorganizing firm were sold as a going concern to a new owner with the new owner left to decide whether the firm should continue in operation or be liquidated. In fact, the majority of firms which file for reorganization in the U.S. either subsequently convert to the liquidation procedure or undertake "liquidating reorganizations," in which the assets of the firm are

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[15] I restate this idea as a formal conjecture in Section 6.

[16] For example, a workers' representation committee is now consulted during the bankruptcy court's deliberation of a reorganization plan and prior to layoffs. See Simeon et al. (1987) for a description of the French bankruptcy law.

[17] See Klasmeyer-Kubler (1983).

sold as a whole rather than piecemeal through the liquidation procedure.[18] Those that do survive may have advantages that are unrelated to the difference in going-concern and liquidation values. In a study of 30 firms undertaking reorganization, Franks and Torous (1989) report that firms in the sample which survived the reorganization procedure tended to be larger than those not surviving.

In summary, bankruptcy law in the U.S. is argued to arise in part out of the conflicting interests of stockholders and creditors and in part out of the conflicting interests of individual creditors with respect to the entire group of creditors. The liquidation procedure is designed to maximize the value of the firm's assets available to the group of creditors as a whole and to distribute proceeds from the sale of the firm's assets among the creditors according to a specified priority rule. Reorganization allows for the redistribution of ownership rights among the claimants of a financially distressed but viable firm. It may also, however, allow firms that should liquidate to continue in operation.

What are the effects of U.S. bankruptcy law on firm behavior? If one assumes that state (nonbankruptcy) law remedies for collection of debt would exist even in the absence of a bankruptcy statute, then it is unclear how much of a disciplinary effect the liquidation avenue of bankruptcy exerts on firm management. The disciplinary effect is already created by the ability of creditors to seek recovery of claims, or in other words, by the state of development of financial markets and the clear definition of property rights associated with claims. That creditors cannot force a firm to declare bankruptcy, however, even though, for example, they might be able to prove that the firm is insolvent, may weaken this disciplinary effect.

The terms of the reorganization phase may in fact lessen financial discipline by allowing stockholders and/or managers to take risky actions during the reorganization period to attempt to turn the firm's fate. Indeed, in order to succeed in replacing the current management, creditors must provide evidence of "substantial impropriety or wrongdoing" by management.[19,20] The effect of

[18] Data on the population of firms filing for bankruptcy in Manahattan from 1980 to 1982 and reported in White (1988) corroborate this observation. Of 64 firms originally filing for reorganization, 34 ended in liquidation.

[19] Johnston (1988, p. 64).

reorganization on the efficiency of resource allocation is also ambiguous, since it is unknown the extent to which otherwise financially nonviable firms successfully complete reorganization procedures. Financial discipline among U.S. managers may be argued to follow less from the existence of the bankruptcy statute *per se* than from the number of competing or potentially competing claimants to a firm's assets whose presence is made possible by extensively developed financial markets.

[20] Miller (1977) provides hypothetical examples of situations in which stockholder/managers could easily make expected gains through risky behavior.

3. Bankruptcy Across Capitalist Economies

Arguments made in Section 1 suggest that the level of development of markets and the roles of the firm's owners are two critical factors in understanding the manner in which bankruptcy may be expected to serve its postulated goals. Discussion in Section 2 of reorganization in U. S. bankruptcy points, in addition, to the importance of political preferences in shaping bankruptcy laws. This section highlights some of the major differences in the bankruptcy laws of five capitalist economies: England, France, Germany, Japan, and the U. S.. (The appendix contains a description of the major provisions of the bankruptcy statutes by country, with the exception of the U. S..) It links the variations in laws to differences in financial markets and policital proclivities across countries. These differences should shed further light on what types of bankruptcy statutes one might expect in the reforming socialist economies and on the degree of success to be hoped for in accomplishing bankruptcy's goals.

As suggested by the evaluation of the U. S. bankruptcy law, the following factors are among the relevant distinguishing characteristics in bankruptcy laws: how the law is triggered; whether provision is made for reorganization as well as liquidation; who controls the firm during reorganization; what the bargaining process is in the case of reorganization, and what importance is attached to employees of the bankrupt firm in terms of either distributing claims or developing a reorganization plan. I also describe differences in priorities attached to the satisfaction of workers' claims in bankruptcy.

Triggering the law. As was already noted in Section 2, of the five capitalist economies under consideration, the U. S. is the only one in which creditors do not have the right to initiate bankruptcy proceedings. The debtor firm's board of directors[21] is the sole body with this right. Moreover, there are no conditions specified in which the board of directors must file for bankruptcy. In contrast, France, Germany, and Japan require that the debtor file for bankruptcy when certain criteria are met. In particular, debtors in France must report default on claims due within fifteen days of such event;

[21] I will use the term management synonymously with board of directors in the discussion unless there are situations in which the interests of the two groups could be expected to differ. In the latter case, I will make a distinction between the two groupsrs.

German debtors must file within three weeks of the time at which they are either unable to repay debts or become insolvent; and Japanese debtors must file for bankruptcy if they are either illiquid, actually default on debt, or are insolvent. Creditors or debtors may file for liquidation in each of the economies with the exception of the U. S.

These observations raise two questions. First, could the disciplinary impact of the U. S. law be improved by allowing creditors to petition for bankruptcy of the debtor? Second, which is more important, allowing creditors to petition for bankruptcy or requiring the debtor to declare bankruptcy according to certain criteria? By forcing the debtor to declare bankruptcy, the French, German, and Japanese laws appear to guard against the possibility that management and stockholders take risky actions when they realize that the firm's financial state is deteriorating. For, if debtors are legally required to declare bankruptcy under conditions that may be verified *ex post*, failure to do so can result in severe penalties. Allowing creditors to petition for bankruptcy instead of requiring debtors to declare may not accomplish the same effect due to asymmetries of information between the debtor and its creditors, whereas forcing debtors to declare bankruptcy in particular circumstances mitigates the problems arising from asymmetries of information.

The ability of U. S. managers to file for reorganization was cited in Section 2 as mitigating the problem of managers taking risky actions in the U. S.. Does this imply that the requirement that the debtor declare bankruptcy is essentially ineffective when the debtor has the option of entering reorganization? If so, one would expect to see this requirement in laws which do not contain reorganization statutes. Indeed, while the current German law includes provisions for a debt composition (reorganization) phase, the requirements for entering composition are so stringent that, according to one source, only one percent of bankruptcies actually proceed as compositions.[22] Both the French and the Japanese laws contain reorganization provisions. In fact, every firm that declares bankruptcy in France passes through an observation period in which a court determines whether rehabilitation of the enterprise is possible. So the relative merit of forcing the debtor to declare

[22] Klasmeyer-Kubler (1983). I discuss below reorganization provisions in the bankruptcy laws.

bankruptcy in addition to allowing it to declare reorganization remains an open question. One possibility is that adding this requirement assures that bankruptcy will occur before or no later than the time at which a firm's liabilities exceed its assets. As was noted in Section 2, although one sample of U. S. firms declaring bankruptcy showed average ratios of liabilities to assets much lower for those entering reorganization, the average ratio for the reorganizing firms was nevertheless greater than 1.

Finally, in order to assess the value of permitting the creditor to file for the debtor's bankruptcy, one must ask under what circumstances an individual creditor would want to push a firm into bankruptcy, where the claims of all creditors will be considered together and where the individual's prospects of recovering the entire claim will be lowered. One possible situation in which this might appear in a creditor's interest is if the remedies available to the creditor outside of bankruptcy are lacking. Alternatively, if a creditor feels that there is little chance of receiving anything outside of bankruptcy because (s)he has not raced quickly enough to the court to seek the claim, then forcing the firm into bankruptcy may yield a higher expected payoff. Finally, if creditors fear that the value of their assets is declining under the firm's management, then forcing the firm into bankruptcy, where management will either be replaced or monitored by a court appointed trustee, may preserve the assets' value. This factor would be important in a country, such as Germany, where reorganization is not a realistic option and, hence, where one would expect the risk of a decline in asset value to be high. It is perhaps significant to note that of the five capitalist economies the U. S. is the only one in which the debtor's management remains in control during reorganization and in which creditors do not have the right to petition for the debtor's bankruptcy. Perhaps the incentive for a creditor to do so in the U. S. is very small due to the arms-length relationship that is maintained between debtors and creditors.

The conditions under which a bankruptcy law is triggered determine to a great extent the risks that a firm will be forced to liquidate "too soon" or "too late." Forcing liquidation "too soon" will cause the sale of assets whose value is greater in their current use. From the criteria for declaring bankruptcy in the five capitalist economies, one may conclude that the U. S. lawmakers were more concerned with the risk of early liquidation. In France, Germany, and Japan the fear was perhaps for liquidation too late. England seems to fall somewhere in between these groups.

Reorganization vs. Liquidation. Of the five capitalist economies, France places the greatest emphasis on reorganization, and political preferences provide the explanation. The current bankruptcy law was passed by the socialist government in 1985, and the goal as stated by the lawmakers was "first and foremost to save the debtor's ailing enterprise and the employment attached thereto."[23] The current German law is heavily biased toward liquidation. In order for the debtor to enter the composition phase of bankruptcy, it must be able to satisfy at least thirty-five percent of unsecured claims with cash. This requirement effectively rules out composition for the large majority of German firms in bankruptcy. Proposed reforms to the German law contain provisions for reorganization, with the rationale that the greater interdependence of firms in the German economy, thus the greater externalities associated with bankruptcy, warrant introduction of a viable reorganization procedure.

Separate statutes for reorganization and liquidation exist in both Japan and England. Parties with the right to file for reorganization in Japan are a firm's board of directors, individual creditors holding more than one tenth of the firm's capital, or shareholders holding more than one tenth of the outstanding shares. A firm engaged in a liquidation proceeding may also file for reorganization if two-thirds of the capital holders approve. The party filing for reorganization in Japan must pay the administrative costs of the procedure in advance. Claimants with the right to file for reorganization (administration) in England include the firm's director and any creditor. A firm which has entered the liquidation procedure, however, may not file a petition for administration.

Reorganization. Bankruptcy proceedings begin in France with an observation phase, during which an adminitrator is appointed by the court to evaluate the financial standing of the firm and design a reorganization plan if (s)he judges that the firm can be rehabilitated. The administrator also has the power to operate the firm during this period. The reorganization plan may specify

[23] Simeon et al, p. 18A-9, who make reference to the bankruptcy law, Law No. 85-98.

continuation of the operation of the firm in its entirety or the sale of part or all of the firm. Sale of any part of the firm must be based on offers received by the administrator during the observation period. The criterion by which the court is to accept an offer for purchase of a part of the firm, however, leads potentially to a contradiction: the court should accept the offer "best ensuring the maintenance of employment levels and the repayment of creditors." Since reorganizing firms frequently need to reduce their size, these two goals may come into conflict. Once a draft reorganization plan is devised, it is sent to the debtor, the workers' representative committee and to the creditors' representative (appointed by the court) for comments. Note that the criterion for acceptance of the plan, however, is approval by the court. In theory all parties could be opposed to the plan, yet the plan could be approved by the court.

Reorganization in Japan begins with court review of the firm's financial documents and discussions with the firm's top management, with creditors, and with the firm's employees. Acceptance of the reorganization petition relies on three factors: (1) profitability of the firm, including its ability to pay overhead costs of operation during the reorganization period; (2) likelihood of obtaining the consent by a majority of creditors for the reorganization plan; (3) and existence of a suitable trustee of the firm. The court-appointed trustee has the power to operate the firm during reorganization, and (s)he also drafts a reorganization plan. Once the draft is complete, the trustee calls three meetings of the claimants for discussion of the plan. The claimants vote on the plan at the third meeting. Acceptance of the plan requires approval by four-fifths of the value of claims of secured creditors and two-thirds of unsecured creditors. Recent practice has excluded the shareholders from the list of claimants with voting rights. Liquidation proceedings begin if the creditors reject the plan. .

Court acceptance of a petition for administration (reorganization) in England hinges on four criteria: (1) the potential survival of the firm or any part of it as a going concern; (2) probability of approval of a voluntary agreement (composition) between the firm and its creditors; (3) approval of an agreement drafted by the court administrator; (4) "a more advantageous realization of the [firm's] assets" than could be achieved through liquidation. The court accepts the administration petition on the basis of one of these criteria, issues an administrative order outlining particular goals to be achieved, and appoints an administrator (usually an accountant) who takes control of the firm. The administrator may also dispose of any of the firm's property, including secured assets. Within three months the adminstrator submits a plan describing how the goals of the administration procedure are to be attained. Acceptance of the plan requires approval by creditors representing more than one half of the value of outstanding claims. The court may decide to proceed with the administrative order even if the plan is rejected.

The firm in England may also undertake "voluntary administration" by proposing its own plan of debt composition or reorganization to be administered by a qualified insolvency practitioner. The firm proposes the plan and a nominee for practitioner. The nominee supervises a meeting of the debtor and creditors at which the plan may be discussed and revised. Similar criteria as for the regular administration procedure apply for acceptance of the plan. If the plan is rejected, the nominee may apply for either formal administration or liquidation. A firm may propose voluntary administration at any point in an administration or liquidation proceeding.

Priority of workers' claims. Workers' claims for past salaries in the U. S. are given priority among the claims of unsecured creditors. Secured creditors and administrative expenses have priority over unsecured creditors in both liquidation and reorganization in the U. S.. Consistent with the lawmakers' intent in designing the French bankruptcy statute, workers in France enjoy special priority among creditors. Employees have the right to receive up to six months of back pay, and this sum is payable before any unsecured creditor may be compensated. The bankruptcy administrator must pay the last sixty days of pay to employees within ten days of the filing of bankruptcy. This payment is due before satisfaction of any secured or unsecured creditor's claims. In Germany payment for three months of salaries may be made to the firm's employees after satisfaction of secured creditors' claims and the payment of procedural costs. Workers are among the preferred (unsecured) creditors in

German bankruptcy. Since the party petitioning for reorganization in Japan pays the procedural costs in advance, the list of priorities does not include these costs. Salaries for six months preceding reorganization are among the preferred obligation rights, which are the first claims satisfied. Examples of other preferred oblgation rights are expenses for the common benefit and taxes. Preferred obligation rights are satisfied before claims of secured or unsecured creditors. In England debts relating to salaries of emplyees rank equally among preferential creditors with four other types of claims. Preferential creditors receive compensation in a liquidation after the payment of expenses for the liquidator and the satisfaction of secured (with a fixed charge) creditors. The number of months of back pay for which employees are eligible is specified by statute.

4. Bankruptcy in Reforming Socialist Economies

It would be difficult to argue that practices in socialist economies entail a strong risk that firms that should survive do not. On the contrary, one may credibly argue that no workable institution exists guaranteeing that firms that should not survive do not. Indeed, the stated goals of socialist reformers with respect to bankruptcy laws imply that their principal concern is the latter.

It is clear that the need for such reallocations of assets may occur independently of default on debt. This observation raises the following questions. Why do socialist policy makers tend to emphasize the need for a bankruptcy procedure as opposed to other mechanisms for transferring ownership and control? Is bankruptcy a more critical institution than others?

One of the principal reasons that policy makers have focused on bankruptcy is that situations of default on debt generally entail provision of subsidies by the state.[24, 25] Since the aggregate amount of such subsidies is quite large in most SEs, their existence poses a significant burden on government budgets and, correspondingly, on monetary authorities. Imposition of a bankruptcy law that requires settlement of claims through either debt composition or sale of the firm's assets transfers the source of payment of the firm's obligations to the firm's assets; therefore, strict enforcement of bankruptcy statutes would reduce the government's financial burden.

A second reason for emphasis on bankruptcy is that in the absence of well developed capital markets that provide other mechanisms for transfers of control, default on debt provides an objective signal that may be used to trigger an assessment of a firm's going-concern value versus its liquidation value. As was discussed in Section 1, the absence of market-determined prices and a capital market

[24] The term default on debt includes any situation in which a firm earns losses, since unpaid production costs are obligations to other parties.

[25] For example, subsidies to Polish enterprises in 1989 equalled fourteen percent of GDP and twenty-nine percent of state expenditures. The average percentage of GDP accounted for by subsidies in the European Community during the years 1981-1986 was approximately three percent (Schaffer (1990b). Production and consumption subsidies in Hungary constitute the single largest expenditure in the Hungarian state budget, and Chinese subsidies to loss-making firms accounted for thirteen percent of the state budget in 1988 (Brada, 1989).

render administrative identification of advantageous competing claims on a firm's assets arbitrary and subjective. In fact, Hungarian authorities have experimented since the late 1970s with the triggering of decisions regarding a firm's fate by use of an administratively determined "indicator" such as a target rate of profit (Laki, 1985). Such a task poses severe difficulties in practice due to the dual roles of government authorities as enterprise "owners" and policy enforcers. For example, branch ministry officials who might be in an appropriate position to calculate profitability or efficiency indices for firms under their supervision are also in prime positions for adjusting data or making biased estimates.[26]

A final explanation for focus on a bankruptcy law or on any set of laws governing recovery of overdue claims is the necessity for the adequate development of financial markets of rules specifying the rights of creditors to recover claims. Financial markets will not function efficiently without such a codification of rights.

Absence of other economic mechanisms for transfer of control will imply that the bankruptcy procedure is invoked more often in SEs than in comparable CMEs. Yet, successful implementation of other mechanisms will most likely require extensive development of financial markets and multiple types of claims, which themselves require well defined property rights of creditors.

A corollary of the observation that there exist no institutions in SEs guaranteeing that firms that should not survive do not is that the mechanism by which creditors may sue to recover their claims does not function in SEs as it does in CMEs. Two features of SEs explain this phenomenon: the willingness of state organizations to cover firms' financial obligations via subsidies, enterprise reserve funds, and the like; and the lack of independence between bureaucratic "owners" of enterprises and major creditors. Consequently, if the owners are not inclined to sell any of a firm's assets to meet financial obligations, some sort of deal will be struck between either the owners and the firm or the owners and the bank. It is the cooperative relationship between the bureaucratic supervisors of enterprises and the enterprise's major creditors that permits the survival of firms that should fail.

[26] For instance, Laki (1985) cites cases of Hungarian ministerial officials "solving" the problems of firms under their supervision by altering the prices and taxes facing these firms.

Yet, as stressed above, the particular concerns associated with design of bankruptcy laws in SEs will depend upon existing economic and financial institutions. Differences in these institutions across socialist economies and at different stages of reform may be illustrated via the list of owners given in Section 1. One type of economy may be described as that which is either beginning a process of market-oriented reforms, such as the Soviet Union, or which has undertaken reform, such as Hungary, but where a mixture of plan and market have created a "dual dependence" on administrative and market processes.[27] Financial markets are not well developed, and primary sources of investment finance are banks and enterprise retained earnings.[28]

A second type of economy is one that has achieved primary dependence on markets, with well-developed financial markets characterised by bank credit, individual bondholders, and possibly individual stockholders. The type of economy for which Hungarian reformers appear to be striving falls into this category. Yet a third type of economy is a labor-managed economy, such as that of Yugoslavia, where workers control enterprise decision making and where there exists a mix of market and administrative processes. Since there are no ministries in the Yugoslav economy, however, administrative intervention occurs at the level of local or regional politicians.

As market-oriented reforms progress and financial markets develop, control over assets, hence "ownership," shifts roughly rightward in the diagram of Section 1. As control shifts rightward, the focus of bankruptcy laws is likely to change. I argue that at early stages of reform effective bankruptcy laws must be aimed at increasing the independence (or bargaining power) of claimants competing with ministerial officials, whereas as control shifts rightward, the focus may shift to ensuring that firms are not prematurely dismantled through the actions of individual creditors. Bankruptcy laws written at earlier stages of reform may also exhibit much less concern for the priority of creditors in the distribution of a liquidated firm's assets, since financial markets are generally undeveloped.

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[27] This term was originated by Kornai (1986).

[28] While it may seem odd to place the Soviet Union and Hungary in the same category of reform, the crucial aspects of the classification for this discussion are the strong influence exerted by government bureaucrats and the low state of development of financial markets.

A crucial point to note is that the bailing out of enterprises comes about only through the willingness of ministerial and other low-level officials to cooperate with enterprise management in requesting aid. When ministry officials' rewards are linked, either directly or indirectly, with the output of enterprises under their supervision or when they suffer personal or political costs from dismantling firms, they are likely to serve as advocates for firm managers. Moreover, ministerial participation in investment decisions places some burden of responsibility for default on debt on administrative officials. Both of these observations describe elements of relations in economies of type one. Knowledge that officials will be advocates of the firm may exert a negative effect on managerial effort and, therefore, tend to reduce financial discipline.[29]

More difficult to analyze is the situation where, in the progress of reform, branch ministries have been eliminated or have lost most of their power relative to functional ministries and where enterprise managers may bargain directly with the latter. Whereas bargaining over financial parameters with functional ministries may permit a firm to avoid or alleviate expected financial problems, it is hard to see the incentives for this type of cooperation on the part of the functional ministries, since these ministries are not held responsible for the performance of enterprises under their purview. The extent to which enterprise managers bargain directly with functional ministries in the Hungarian economy, for example, remains an open question. In Poland it appears as if branch ministries may still perform the bargaining function, despite reforms that have diminished their powers at the expense of those of the functional ministries. Crane (1988, p. 6) describes the altered relationship between the branch ministries and enterprise managers as follows.

> [Branch] ministries often intercede with the Ministry of Finance concerning tax and subsidy questions and attempt to provide the enterprise with inputs. They were perceived [in interviews with 56 enterprise managers] more as partners than as opponents, especially as enterprise managers argued that the power of the ministries

[29] Schaffer (1989) presents a simple two-period model where planners cannot make managerial compensation contingent upon observed effort and cannot commit *not* to rescue firms. He shows that equilibria may involve lower efforts of firm managers and, therefore, more bailouts of firms than would prevail in the presence of commitment.

to order particular actions was now much more limited than before.

The inability of ministerial officials to refrain from requesting bailouts of firms signals a problem of enforcement of bankruptcy laws on the part of these officials and suggests that their bargaining powers in bankruptcy proceedings be limited. More generally, if the political costs of dismantling failing firms are so high that central planners are also unwilling to carry through with bankruptcy proceedings, then bankruptcy laws are likely to exert little effect. In this case more attention should be paid to lowering these costs, either through development of institutions that reduce the degree to which bankruptcy need be invoked or through institutions that directly reduce the costs associated with liquidations. Discussion of these problems appears in Section 6.

The discussion above indicates that ministerial authorities in economies of type 1 exert strong claims on the firms under their supervision. Their ability to influence decisions made by enterprise managers and to determine the fate of loss-making firms bestows upon them the role of "owners" in much the same way that stockholders are the owners of capitalist firms. Yet, these owners possess stronger bargaining power with respect to other economic agents than their capitalist "counterparts." Competing claimants in the form of potential acquirers through stock purchases are nonexistent in the socialist economy. Remaining sources of claimants with any significant potential bargaining power are banks, as major creditors, and enterprise suppliers, as less major creditors. Strengthening the bargaining powers, or powers to recover claims, of these groups would raise the probability that firms that should not survive do not.[30]

That government officials can prevail upon banks to bail out firms indicates that the banking system is not independent of the bureaucratic owners of firms. Reforms aimed at increasing the independence of banks, such as the financial reform begun in Hungary in 1987, would appear necessary

[30] Note that strengthening claimants' power to recover claims introduces a risk, as discussed in Section 2, that firms that should survive will not because of aggressive actions on the part of individual creditors. A renegotiation of contracts may achieve a socially efficient outcome if the value of the firm is greater in continuation than in liquidation, and a codified reorganization procedure may be necessary to serve this purpose if the number of creditors is large enough.

to enhance the role of banks as independent, competing claimants.[31] It remains to consider the potential role of enterprise suppliers in exerting a counterbalance to the dominance of ministerial owners. If claimants such as enterprise suppliers are able to recover some or all of their unpaid claims against a firm, then they automatically diminish the power of the firm's bureaucratic owners to keep it in operation. A question that arises is why a firm's claimants are not more aggressive in seeking recovery of their claims.

Several factors explain the potential passivity of supplier-creditors *vis-a-vis* their debtors. First is the expectation that the debtor's obligations will be covered and payment will eventually be forthcoming. Second, if the debtor is a monopsonist or the primary buyer, the supplier may be dependent on it for its survival. Third, if the supplier is controlled by the same branch ministry, then the managers may have no incentive to aggressively attempt to recover its claims. Fourth, creditors may be indifferent to their own financial standing if they, too, expect to be bailed out.[32] It is obvious that in each of these situations enterprise obligations must eventually be covered, and the banking system must eventually accommodate.

While one means of moving toward bankruptcy's general goal in an economy of type 1 is to strengthen the power of claimants to recover their claims and to reduce the power of bureaucratic owners to intervene unilaterally to prevent debt collection, reliance on aggressive actions of creditors through a statutory strengthening of their powers in the event of insolvency is unlikely to succeed in eliciting these actions. As suggested above, important reasons for creditors' inaction may include their beliefs that firms will not be liquidated, as well as a dependence on authorities who may have strong interests in fighting bankruptcy. This implies that the triggering of a bankruptcy law may need to be automatic, independent of the creditors' "race" to recover their claims. The success with which a bankruptcy law is likely to be enforced will increase as the bargaining power of the bureaucratic owners is decreased or as the rewards of these groups are altered to induce actions that accord with efficient

[31] Bartlett (1989) offers a pessimistic view of the progress of Hungarian financial reform.

[32] I am grateful to Perry Patterson for stressing this point.

resource allocation.

An economy of type 2 is, by definition, one in which the power of bureacratic ownership is diminished relative to that of enterprise managers and possibly stockholders. Well developed and well functioning financial markets will provide more independent creditors who should be inclined toward more aggressive recovery of claims. Recall, however, that a necessary condition for aggressiveness on the part of creditors is a well codified system of property rights. The more aggressive and numerous the group of creditors, the more the considerations in the design of bankruptcy law may resemble those for the U.S., i.e., defining priority rights for creditors and yielding more bargaining power to owners and managers in the reorganization process.

Finally, in a labor-managed economy (LME) the firm's employees control decision making. Whereas employees effectively hold residual rights of control over enterprise assests in a socialist LME, the fact that capital is socially owned implies that employees' ownership rights are limited. Evidence of social ownership in Yugoslavia is seen most clearly in regulation of the amount of enterprise "dividends" that employees are allowed to pay out in lieu of retaining earnings in the firm.

The question of who should be the appropriate representatives of the social owners in a socialist LME is an open one and has posed a dilemma for Yugoslav policy makers and academicians alike. The manner in which the problem appears to have been resolved in practice is seen in the constitutional amendments passed in November, 1988. Amendment Ten states that Organizations of Associated Labor (socially owned enterprises) are the holders of rights, duties, and responsibilities regarding social property.[33] Workers in socially owned enterprises have thus been designated as the representatives of social capital. Yet, local and regional political officials have most often served *de facto* in this capacity in the past, and the current version of the bankruptcy law provides these officials with an explicit role in the design of bankrupt firms' reorganization plans. This participation leads to potential problems of cooperation between officials and financially distressed firms that resemble those of firms and ministries

[33] See Sturanovic (1989) for a description of the changes in the Yugoslav constitution.

in other SEs.

The banking system in Yugoslavia has been decentralized since 1965; therefore, one might argue that problems of cooperation between banks and government officials or firms should be negligible. This might suggest that enforcement of bankruptcy laws would pose fewer problems than in other SEs. Banks, however, are founded by enterprises, and the founder enterprises act as bank owners, determining bank policies. For example, a bank's credit is usually extended only to its enterprise members. It is plausible that the enterprises contributing larger amounts of founding capital to the bank wield greater influence in its decision making. While one might imagine that more efficient enterprise founders would object to a bank's continued lending to an inefficient member, it appears that at least during noncrisis periods in the past, members have allowed banks to act as insurers, subsidizing financially distressed firms. Banks, therefore, have not been aggressive in the past in recovering claims nor in denying credit to firms in financial difficulty.

The following section describes the bankruptcy laws of Hungary, Poland, and Yugoslavia, as examples of SEs of types 1 and 3, respectively. Section 6 discusses the design of these laws in light of the discussion of this section and explores problems of enforcement.

5. Socialist Bankruptcy Laws: The Cases of Hungary, Poland, and Yugoslavia

Hungarian Bankruptcy

The bankruptcy law in Hungary was passed in September, 1986[34] and envisions a three-stage procedure for treating the financial problems of enterprises. First, when an enterprise encounters illiquidity problems, either it, its creditors, or the Hungarian Chamber of Commerce may request a "reconciliation procedure," whereby the enterprise and its creditors gather under the supervision of the Hungarian Chamber of Commerce and attempt to work out a resolution. The agreement between these parties may stipulate the order of satisfaction of claims, the rescheduling of debt repayments, or the percentage of debts to be written off.

If it is impossible for the debtor and the creditors to achieve an agreement, the Chamber of Commerce must submit a request to the Reorganization Office to determine if economic rehabilitation of the enterprise should take place or if bankruptcy should be initiated. Rehabilitation may normally be undertaken only if liquidation would result in one of the following situations: 1) creation of serious regional unemployment problems; 2) compromise of the fulfillment of the obligations of an international agreement; or 3) jeopardizing of national defense interests. A request to initiate rehabilitation on the basis of reasons other than these three must be approved by the Council of Ministers.

Rehabilitation may last for three to six months and is designed to restore the solvency of the firm and ensure its long-term viability. During this period, the rehabilitation authority, along with the firm's founders, not only decides how to settle the firm's debts but also determines the changes in firm organization and operations necessary to avoid the recurrence of financial problems. The rehabilitation authority may hire an outside consultant to evaluate the firm's management and production process.

In the event that the Reorganization Office decides that there is an insufficient basis upon which to rehabilitate the firm, it must petition the appropriate court to request that liquidation be

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[34] See Ministry of Finance (1986).

initiated.[35] In this case the petition for liquidation is submitted on the basis that the enterprise is "permanently insolvent."[36] The court then examines the financial standing of the firm and evaluates the petition for liquidation The court appoints a bankruptcy authority, or "liquidator," who oversees the sale of the firm's assets and the satisfaction of claims against it. The assets are to be sold "for the best price obtainable on the market."

Justifications cited by the Ministry of Finance for the general need for a new bankruptcy law included the following. The existing law did not apply to all enterprises. The law specified a rigid order of satisfaction of creditors' claims, including the state, that bestowed advantages upon some parties and disadvantages upon others. Only the founding organs (usually ministries) possessed authority to declare enterprises bankrupt. In addition to the potential conflict of interest in this arrangement, there existed no explicit criteria by which these organs were to establish the need for bankruptcy.

The new law aimed at creating a procedure of unbiased decision making with respect to the resolution of a firm's financial problems. It was also intended to protect the interests of creditors by allowing for a more flexible system of settling claims and by ensuring sufficient publicity of bankruptcy proceedings that all creditors could present their claims.

The new law revived, from the period prior to 1940, the participation of a court in carrying out bankruptcy proedures. The role of the court attests to the recognition by Hungarian lawmakers of the possible conflict in their interests and those of lower regulatory bodies. The court was to be a third disinterested party. Furthermore, the bankruptcy law was passed at a time when increasing authority was being devolved to enterprise managers from the state. The revival of the court created a mechanism for balancing the powers of these two groups and for the enforcement of the implicit

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[35] Bankruptcy may also be initiated as the result of a decision to dissolve the enterprise without legal successor.

[36] The law defines the status of permanently insolvent as that in which either "for a long time" [the firm's] debts have exceeded the value of its assets or execution of claims against it have proven unsuccessful.

contract existing between them.

An amendment to the Hungarian bankruptcy law passed on March 1, 1990 to take effect as of May 1 stipulated that whereas creditors may request initiation of bankruptcy proceedings, debtors who have "discontinued making payment" must do so. Creditors and banks have not initiated bankruptcy proceedings as was intended by the lawmakers. A more recent amendment states that firms whose defaults on payments to creditors are less than the value of unsatisfied claims against another firm are not legally obliged to initiate bankruptcy proceedings against themselves when they force the other firm into bankruptcy. This amendment is a response to a growing problem of interenterprise indebtedness. Section 6 discusses the significance of these amendments in the context of enforcement of the bankruptcy law.

Polish Bankruptcy

The reform program introduced in Poland in January, 1990 changed many aspects of firm taxation and subsidization; however, one of the taxes remaining is the "dividend tax," which was introduced in 1989 and which applies to the portion of a firm's capital stock that is estimated to have been centrally funded, as opposed to created through the firm's retained earnings.[37] According to Schaffer (1990b), the intention of Polish reformers is eventually to eliminate this tax. Nevertheless, provisions for reorganization and liquidation of Polish enterprises appearing in amendments passed in March, 1990 to the Law Governing Regulations for State Enterprises hinge on the payment of the dividend tax.[38] Specifically, if an enterprise fails to pay the dividend tax, a "curing" procedure must be initiated. The parent agency of the state enterprise supervises the curing procedure, which is introduced for a specified duration. The parent agency establishes a curing commission, which is composed of representatives of the firm's employee council, of the ministry of finance, of banks which

[37] See Schaffer (1990b) for a description of this tax and of the major components of the Polish reform program.

[38] See "Amended Law Governing Regulations for State Enterprises," Joint Publications Research Service (JPRS), May 10, 1990.

are enterprise creditors, and of the parent agency. The curing commission assumes the powers of the employee council and appoints a temporary manager of the enterprise. The temporary manager participates in the drawing up of the rehabilitation program for the firm and is charged with implementing the program.

The curing procedure may be ended when the enterprise pays both its current dividend and the one in default and when the firm's financial status suggests that its problems are resolved. The parent agency may also terminate the curing procedure in favor of liquidation if it believes that the proposed rehabilitation program will not succeed. If a firm has not paid both its current dividend and any past dividends in default by the end of the specified period of the curing procedure, then the parent agency will initiate liquidation proceedings.

The amended law on state enterprises contains additional provisions regarding the liquidation of enterprises. Enterprises may be liquidated at the request of its employee council or of the parent agency. In the case of liquidation the Council of Ministers will determine by decree "the types of employee claims which are maintained or guaranteed by the state treasury and the guidelines for awarding them." Also relevant to the probability of enterprise banrkuptcy, the parent agency may order at its own initiative the merger or breakup of a state enterprise. The minister with responsibility for the line of business of an enterprise may also decide upon the breaking up of an enterprise.

Yugoslav Bankruptcy

The Yugoslav bankruptcy law is automatically triggered. It envisions procedures of three degrees of severity: pre-rehabilitation; rehabilitation; and liquidation. Pre-rehabilitation entails measures to be taken by firms[39] in order to eliminate problems of illiquidity, of quarterly losses reported during the

[39] In accordance with legal practice until the constitutional reforms of 1988, the bankruptcy law of 1986 treats the "firm," or the basic economic unit, as the Basic Organization of Assocation Labor (BOAL), which corresponds in most cases to a division or plant of a Western firm. BOALs are combined into Organizations of Associated Labor (OALs), which correspond to Western firms. Unless otherwise indicated, I employ the term firm or enterprise synonymously with BOAL.

year, or of other financial disturbances. Rehabilitation consists of a program of measures designed to: 1) eliminate the causes of yearly losses reported in annual balance sheets (ABS); 2) secure assets in an amount at least equal to any uncovered losses reported in the ABS; 3) assure conditions for long-term successful operation of the firm. Liquidation procedures are to be initiated in the following situations: 1) a firm that should have undertaken a program of rehabilitation did not; 2) a firm undertakes a rehabilitation program but is not in the "position to fulfill its long-term obligations;" 3) the firm requests liquidation proceedings.

Every firm that enters bankruptcy begins with either a pre-rehabilitation or rehabilitation program, unless it chooses to be liquidated directly. Rehabilitation, or reorganization, then, is automatic; liquidation occurs only if efforts at reorganization have failed. Although the most recent bankruptcy law prior to the constitutional reforms was passed in December, 1986,[40] it was one in a series of laws and amendments pertaining to rehabilitation and liquidation. The Law on Rehabilitation and Liquidation of Organizations of Associated Labor, passed in 1980,[41] established the current framework. The amendments to the 1980 law primarily effected changes in the regulation of personal incomes (PIs) for loss-making enterprises and strengthened the scope and application of rehabilitation programs. Consistent with the trend of enlarging the role of rehabilitation are the innovations appearing in the 1986 law, which pertain principally to the rehabilitation process.[42]

It becomes clear upon a reading of the bankruptcy law that the intent of Yugoslav lawmakers is to treat liquidation as a vehicle of last resort; loss-making firms have the opportunity to attempt to improve their financial positions through a reorganization plan before being forced into liquidation. At the same time, the decision to draw up a reorganization plan is not discretionary; any firm reporting an

[40] See Zakon o sanaciji i prestanku OUR-a, *Službeni list*, #72, 1986.

[41] See Zakon o sanaciji i prestanku OUR-a, *Službeni list*, #41, 1980.

[42] Comparisons of past and present versions of the bankruptcy law in this section rely on discussions in Ude (1988), Mates (1987), and Zakošek (1986). In a recent paper Knight (1985) describes some of the provisions of the bankruptcy law of 1983. Many of these provisions have not changed substantially in the newer version. To the extent necessary for the purposes of this paper, I shall repeat the description of these provisions.

annual loss must enter the reorganization phase. Furthermore, any firm reporting a loss in any quarter is required to undertake steps (pre-rehabilitation) to prevent further financial problems. Hence, a firm's creditors need not aggressively pursue their claims in order to drive the firm into the bankruptcy procedure. This aspect may be a means of circumventing problems of cooperation between banks and firms and among firms themselves. It also appears to constitute an attempt to resolve financial problems before they reach a magnitude at which pressure is placed on monetary authorities for accommodation.

One of the major innovations of the 1986 bankruptcy law is the inclusion of illiquidity as a cause for undertaking pre-rehabilitation.[43] If an enterprise experiences illiquidity problems for 20 consecutive days or 45 nonconsecutive days within a quarter, then it must undertake a pre-rehabilitation program. If the illiquidity is not eliminated within 120 days, then the social accounting agency SDK (*Služba društvenog knjigovodstva*) or the socio-political community (SPC)[44] in which the firm is located must initiate liquidation proceedings. The provisions concerning liquidity problems in the new law constitute an attempt to combat the longstanding problem of interenterprise credit and lax financial discipline in Yugoslav enterprises. They also constitute an attempt to force firms to resolve financial difficulties which are likely precursors of annual losses. A pre-rehabilitation program must contain measures designed to eliminate the financial problem and its sources and a statement of the length of time required to undertake the measures. The program must be sent to the SPC, SDK, and creditor banks.

Similarly, a rehabilitation program must contain the causes of the reported loss[45] on the ABS, the means of and time period for securing assets to cover the uncovered loss, and the time period foreseen

[43] Illiquidity is defined as a situation in which a BOAL's orders for payment of debts cannot be fulfilled on the day that they are due.

[44] Socio-political communities correspond to local governments.

[45] Because it is the responsibility of the workers' council of the reorganizing firm itself to determine the "causes" of its losses, the incentives are to cite "objective" causes, such as outdated technology, rather than poor business decsisions on the part of managers or low effort on the part of the work force. There is also an incentive to cite a cause that may be used as a basis for acquiring additional investment funds.

for completion of the program. The latter is specified through a self-management agreement (SMA) concluded between the firm and its "rehabilitators," or the organizations supplying funds to cover the BOAL's losses. Once a BOAL has drafted its rehabilitation program, it must send it to: 1) other BOALs with which it is linked by a SMA;[46] 2) the SPC; 3) the appropriate republican organ; 4) creditor banks; 5) self-management communities of interest,[47] in order to obtain a lowering of taxes and postponement or lowering of other payments; and 6) the SDK.

Whereas a key issue in the bargaining during the reorganization phase in the U.S. is the degree to which the value of different creditors' claims will be satisfied, a major responsibility of the rehabilitating firm in Yugoslavia is to secure coverage of its uncovered losses. Table 1 presents data on the sources of this coverage in the years 1984 and 1985. Notable in this table is that only approximately one percent of total losses are written off by creditors; however, it must be noted that the claims represented in a firm's accounting losses include interest but not principal payments on debt. Primary sources of loans to cover reported losses are other BOALs, generally within the same OAL, socio-political communities, and banks.

Another of the innovations in the 1986 bankruptcy law is to restrict the percentage of losses that are covered by reimbursable assets to 70. At least 30 percent of these losses must be covered by nonreimbursable assets or the writing off of debts. The intention of the restriction is to make it more difficult to find rehabilitators (thereby increasing the probability that firms that should not survive do not);[48] however, a possible unintended consequence is to increase the percentage of losses that will be covered by grants or government subsidies. The data from Table 1 suggest that the restriction will indeed exert some effect on the distribution of funds to cover losses.

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[46] This would include all other BOALs within the OAL, as well as other firms with which the BOAL has commerical contracts.

[47] Self-management communities of interest are organizations which provide social services, such as education and healthcare.

[48] If a firm does not secure coverage of its losses in a given year by June 30 of the following year, then the SDK is required to notify the SPC, which must begin liquidation proceedings within 30 days.

In addition to attempting to make it more difficult to secure rehabilitators, the 1986 law also strengthened their role in the process of rehabilitation. Other BOALs within the same OAL, in the course of deciding about coverage of the BOAL's losses, may prepare a rehabilitation program for the BOAL if they judge that the BOAL's proposed program is not sufficient to resolve its problems. The rehabilitation board, comprised of the rehabilitators, also has the right to manage the BOAL for the duration of the rehabilitation program. The rights of the rehabilitators, if exercised, alleviate a problem of moral hazard in the construction and execution of the rehabilitation program. Rehabilitators are not forces to rely solely upon faith that managers are undertaking the appropriate efforts to devise and implement the plan. Nevertheless, while the language of the law on this subject may be stronger than that of the preceding version, there previously existed the possibility of the rehabilitator's influencing the rehabilitation program, either informally by supplying funds conditional upon certain provisions in the rehabilitation program, or formally through a self-management agreement.[49]

The final instrument for strengthening rehabilitation is that of salaries, or personal incomes (PIs). Before citing the sanctions specified by the bankruptcy law, however, it is necessary to describe in greater detail the process of determination of PIs in Yugoslav firms. From the firm's revenues are deducted nonlabor costs of production, interest (but not principal) payments on credit, and a number of taxes and other obligations. The remainder is divided into four funds: personal incomes; collective consumption, which is use to provide a number of fringe benefits to employees; accumulation; and reserve. Because the allocation of enterprise income into the business accumulation fund implicitly involves a sacrifice of salaries for retained earnings, enterprise income in any given year is considered to be a function of both "current" and "past" labor. The amount allocated to the PI fund is supposed to represent compensation for "current" work. An additional amount may be deducted from "accumulation" to be paid to workers on the basis of "past" work.

[49] Previous versions of the bankruptcy law, however, did not explicitly allow the participation by the rehabilitators in the decision making of the loss-making BOAL.

The sanctions of the bankruptcy law rely in part on this artificial distinction. Firms reporting quarterly or yearly losses may pay incomes according to differing formulae based on "current" work. For example, although enterprises reporting losses on their ABS may pay only legally guaranteed minimum PIs[50] until their losses are covered, once this event occurs, they are allowed to pay PIs on the basis of "current" work until it is established that in the current year no loss will be reported. Given the impossibility of determining the portion of enterprise income generated by "current" and "past" labor and given that the initial proportions of enterprise income allocated to the PI and accumulation funds are endogenous, the sanctions of the bankruptcy law regarding payment of incomes according to "current" work are virtually meaningless. The law gives the incentive to workers to allocate the maximum allowed PIs according to current work. The severity of the sanctions on PIs therefore depends upon the extent of the restrictions on the initial repartition of enterprise income into the four funds, hence upon administrative regulation of the division of enterprise income into internal funds.

In summary, the Yugoslav bankruptcy law comes into effect automatically, thereby circumventing problems of cooperation between banks and their enterprise founders. All firms pass through a reorganization procedure before liquidation. Whereas employees have bargaining power in reorganization through their ability to design a reorganization plan, local governments and those supplying reorganization credits have veto power over the plan. Given the past relationships between banks and their enterprise founders, it is not clear to what extent banks will actually constitute a countervailing force in the bargaining process between debtors and creditors.

[50] To give an idea of the magnitude of legally guaranteed minimum salaries, that of Croatia in 1988 was defined to be 70 percent of the average PI paid in the republic in the previous quarter.

6. Problems of Enforcement

I have argued in previous sections that differing institutions governing ownership and operation of markets will yield differing forms of bankruptcy laws. In the U.S. and in other capitalist economies, which have extensively developed financial markets and diffuse ownership of firms, the bankruptcy codes focus on defining the priorities and rights of creditors. The existence of a reorganization procedure allows some firms to survive that would otherwise have been liquidated.

In Hungary, where ownership is concentrated in bureaucratic hands and where financial markets are rudimentary, the bankruptcy law allows bargaining to determine creditors' priorities in debt compositions. It limits the option to reorganize to particular circumstances appearing to involve significant externalities; therefore, it focuses on guaranteeing that those firms which should not survive, do not. The law also introduces a bankruptcy court, in part to circumvent exercise of ministerial discretion in the bankruptcy process.

The Yugoslav law is triggered automatically, thereby avoiding problems of cooperation between potential policy enforcers and enterprises. Yet, the law provides for reorganization for all firms entering bankruptcy. The provisions that bankruptcy is triggered automatically and that all firms entering bankruptcy are potentially rehabilitated are also characteristic of the French bankruptcy law, passed in 1985 by the ruling socialist government.

The bankruptcy law in Poland requires that a rehabilitation procedure commence when a firm defaults on payment of a dividend tax. The parent agency conducts the evaluation of the firm's financial status and determines whether the firm should be rehabilitated or liquidated. The parent agency also supervises the rehabilitation process.

Despite substantial differences in institutions in Hungary and Yugoslavia and in their bankruptcy laws, both countries have experienced similar problems of enforcement.[51] Indeed, it is no secret that in

[51] The bankruptcy statutes in Poland were passed too recently to permit evaluation of the success with enforcement. I nevertheless comment below on the prospects for enforcement of the law.

socialist economies such as Hungary and Yugoslavia where bankruptcy laws are on the books and particular firms are clearly identified as nonviable, enforcement of liquidation procedures ranges from difficult to impossible. For example, as of January, 1988, only eight reconciliation procedures had occurred in Hungary. Only one of these ended in agreement between the creditors and debtor. Two of the remaining enterprises were liquidated, while five were permitted to be rehabilitated. The eight enterprises represented only 10% of the firms which reported uncovered losses in 1986; however, they accounted for 70% of the value of these losses (*Business Partner Hungary,* 1988). Meanwhile, reported losses of firms are growing and a liquidity crisis marked by extreme interenterprise indebtedness is developing. Losses reported by large Hungarian firms increased by 88 percent in 1989 relative to 1988. Losses rose in every branch of the economy with the exception of chemicals and metallurgy.[52] Total losses of large firms in 1989 (with sales revenues greater than 250 million forints) equalled 16,906 million forints, whereas losses totaled 9010 million forints in 1988. Moreover, forty firms reported losses exceeding 100 million forints in 1989. Only fifteen had reported losses of this magnitude in 1988. The problem of mutual enterprise indebtedness is referred to in Hungary as the "standing-in-line" phenomenon, since defaults on claims by some firms appear to be generating defaults by their enterprise creditors. The amount of long-term shortages of funds began in 1988 at around 14 billion forints. By October, the sum had risen to 92.5 billion forints.[53]

Evidence on the extent of enforcement of the Yugoslav bankruptcy law is presented in Tables 2 and 3. Although the number of liquidations appears to have increased in recent years, it is far from the number that would occur if the law were strictly enforced. Additional evidence of the significance of loss makers in Yugoslavia is illustrated by the following facts. One third of the labor force in Slovenia, the most productive Yugoslav republic, worked in firms reporting losses in 1989. Cumulative losses in the entire country in 1989 exceeded the amounts set aside for saving and capital formation. In other words, the aggregate capital stock shrank. As in Hungary, the extent of interenterprise

[52] JPRS, June 25, 1990.

[53] JPRS, "Illegal Interenterprise Forced Lending Increases Sixfold," March 9, 1990.

indebtedness is large and growing in Yugoslavia. The difference in the experiences of the two countries is that this problem has existed in Yugoslavia since the 1970s and has now spread to the banks. The latter institutions have resorted to using their legal reserve funds maintained with the National Bank of Yugoslavia and to borrowing to meet their daily needs for liquidity. One reason cited for the liquidity crisis among banks is the rising number of defaults by enterprises on bank debt. The banks themselves, however, have exacerbated the consequences of these defaults. Rather than aggressively seeking satisfaction of their claims in many instances, banks have actually attributed unpaid interest on debt to an increase in the principal owed to them by their debtors. The banks have, in effect, voluntarily rescheduled their loans in many instances.

There exist several potential, though perhaps not unrelated, explanations for the low rates of enforcement of bankruptcy laws in SEs and for the growing problems of illiquidity. One possible explanation for poor enforcement is that the "social welfare function" employed by lawmakers and/or decision makers may include an argument relating to the fate of workers of bankrupt firms. Once the costs to the workers or the costs to the government of providing for unemployed workers of liquidated firms are taken into account, the liquidation values of firms fall relative to their continuation values, and fewer firms are liquidated.

That concern about workers may enter the implicit social welfare function of socialist lawmakers may be considered as a natural extension of their historical concern with job rights. Indeed, to what extent policy makers will be willing to sacrifice this desideratum for the sake of market-oriented reform remains an open question with respect to the reforming SEs. Yet, as the discussion of Sections 2 and 3 indicates, concern for workers should not be associated solely with SEs. The description of the U.S. Congress' design of the reorganization phase of U.S. bankruptcy law includes the concern with problems, perhaps only local, of unemployment generated by liquidation of firms. An even stronger case for the concern with a firm's employees may be made in the case of France, whose bankruptcy law aims both at including a firm's employees in the bankruptcy bargaining process and at reserving liquidation for cases where the bankruptcy court determines that reorganization is financially infeasible. German policy makers have expressed similar concerns about the externalities imposed by liquidation of firms in their economy, and England has recently added a reorganization phase to its bankruptcy statutes. These observations lead to the following conjecture.

> *There exists a range of social welfare functions, differing in the weight placed upon the costs to liquidating firms' employees, that may be observed across capitalist economies and across socialist economies. The variation across capitalist economies is such that it is impossible to delineate the welfare functions in capitalist economies from those in socialist economies. The range of functions explains much of the difference in emphasis on reorganization in bankruptcy laws and the degree to which reorganization is invoked relative to liquidation.*

A question raised by this issue is under what circumstances costs to a liquidating firm's employees and the costs of other externalities created by bankruptcy constitute significant political costs. Certainly if labor is homogeneous, if capital is not industry or firm-specific, and if there is no unemployment in the economy, the only costs to the employees of liquidating firms are the costs of frictional unemployment. The higher is the unemployment rate and the more firm-specific is human capital, the greater will be the costs to the employees and to government budgets.

The protection of job rights in SEs presents one extreme in the range of concern for workers in that it prohibits complete functioning of labor markets. When firms are not allowed to adjust downward the size of their labor forces, then they will be forced to invoke bankruptcy more often than if adjustment were an option. In fact, it has been noted that bankruptcy in Yugoslavia is sometimes exploited in order to achieve a reduction of a firm's labor force by "dissolving" the firm and "recreating" a new one with fewer workers.[54]

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[54] It is alleged that U. S. firms also sometimes enter reorganization in order to renegotiate labor contracts. The bankruptcy of the Continental Bank occurred primarily to allow Frank Lorenzo to abrogate the collective bargaining agreement with labor and negotiate lower wages. I thank Michelle White for pointing this case out to me.

While differing implicit social welfare functions of decision makers may explain the varying importance of reorganization procedures in bankruptcy statutes, it may not explain so well the inadequate enforcement of liquidation provisions that seems to characterize socialist economies. A second possible explanation for the enforcement problem in SEs is that other social or political costs associated with liquidating particular firms or large numbers of firms may be large enough to deter decision makers from fully enforcing the laws. The extent of political costs entailed in liquidations may be in part a function of inadequate development of financial institutions, such as capital markets, that would facilitate the sale of a firm's assets. They are also likely attributable to the role of enterprises in providing social services to their employees. The greater the tie of social benefits to specific jobs, the greater will be the costs associated with unemployment. In all of the socialist countries significant social benefits are attached to the job. Housing, pensions, medical benefits, and daycare are often provided through the workplace. Dissolving a firm or some part of it, for example, may relinquish a worker's right to housing. A first step in reducing the political costs of bankruptcy should be to separate the allocation of social benefits from the allocation of employment.

Important social or political costs other than direct costs to workers include burdens on safety-net systems generated by large regional unemployment rates, disruption of services and increases in goods shortages, and social unrest. The greater are these costs, the less a bankruptcy law will be enforced. Tardos (1988) takes this argument even further: bankruptcy laws in SEs, if enforced, may cause more harm than good. Markets need to be developed and connected within the economy before passage of a bankruptcy law makes sense.

It is clear that a number of elementary changes in the reforming socialist economies could drastically reduce the costs associated with bankruptcy. These changes include allowing for market-clearing prices, increasing competition through breaking up large firms and encouraging creation of new firms, establishing well functioning labor markets, and passing uniform tax and subsidy laws that eliminate firm-specific bargaining. Nevertheless, whether or not a bankruptcy law should precede attainment of an economy with these features depends upon whether the proper functioning and use of markets requires rules such as those dictated by a bankruptcy statute. While it is true that the less well developed and connected are markets, the more often will a strictly enforced bankruptcy law have to be invoked, the absence of well defined procedures by which creditors (intentional or nonintentional in the form of enterprise suppliers) may recover their claims will perpetuate firm-specific bargaining with government officials and the pressure to bail firms out. There may exist no incentive in the absence of such rules for firms to abide by the "rules " of the developing markets.

A final explanation for sporadic enforcement of bankruptcy laws is that their design may allow interference by "local"-level officials, whereas officials higher in the government hierarchy might be inclined to enforce the laws. Costs associated with liquidation need not be large from the point of view of an entire economy. It is sufficient that their local effects (either in geographical or ministerial terms) be significant in order to initiate attempts to lessen their impact through reorganization instead of liquidation or through nonenforcement of a bankruptcy law. Cultural or legal barriers to labor mobility in socialist economies will obviously raise the regional costs of bankruptcy. The suggestion made above of removing the tie of employment to access to housing would also improve labor mobility and thereby reduce bankruptcy's "local" costs.

The design of a bankruptcy law can also determine the extent to which local interference constitutes an obstacle to enforcement. If bankruptcy proceedings are not intended to be initiated by bureaucratic officials and if these officials do not have a say in the possibility of reorganization, then their potential role in blocking liquidation diminishes. Yet, as I discuss below, it should be noted that relying solely on creditors to initiate bankruptcy proceedings at early stages of reform also creates the risk that bankruptcy will not be invoked as often as it should; the rise in interenterprise indebtedness in Yugoslavia and Hungary attests to this fact. Finally, the political structures existing in the socialist countries prior to November, 1989, fostered bureaucratic discretion in general law enforcement. Until a system is established in which there is widespread respect for the rule of law, no bankruptcy law, no matter how well designed, will be enforced. Dismantling the large bureaucracies will be the first step in creating a system that can function according to the rule of law.

The form of Yugoslavia's bankruptcy law and problems with its enforcement may be understood in terms of the above explanations. The design of a reorganization phase through which all firms pass, hence a weakening of the goal that firms that should not survive do not, is consistent with a concern for workers, as illustrated by the codification of job rights in Yugoslavia. That a key party charged with enforcement of the bankruptcy law is local government explains much of the problem with enforcement of liquidation for those firms which have unsuccessfully attempted reorganization plans.

The design of the Hungarian bankruptcy law indicates an attempt to create an independent body charged with enforcement, thereby bypassing ministerial interference. Reorganization is only to be allowed in cases where perceived social costs of liquidation are high. Yet there is also the belief among several Hungarian analysts that rehabilitation procedures have been undertaken more often than was intended by the lawmakers. If so, then either the social costs of liquidation of particular enterprises have been too high or officials with direct interests in maintaining enterprises afloat have been able to influence the rehabilitation decision.

The portions of the Polish bankruptcy statutes discussed above would appear to be subject to the weaknesses of enforcement implied when bureacratic supervisors of firms are responsible for declaring bankruptcy, for determining the potential for rehabilitation, and for supervising the liquidation of firms under their purview. Moreover, the triggering of bankruptcy by the firm's inability to pay its dividend tax implies that firms may default on other debts in order to meet the tax payments. Only firms which cannot avoid defaulting on the dividend tax by postponing payment on other obligations will be forced into bankruptcy.

In both Hungary and Yugoslavia interenterprise indebtedness has become a severe problem despite the existence of bankruptcy statutes. Creditors in Hungary have not been aggressive in pushing their debtors into bankruptcy; therefore, too few firms have entered bankruptcy. Defaults on debt have thus multiplied. The recent amendment to the bankruptcy law obliging debtors to declare bankruptcy upon default indicates Hungarian lawmakers' acknowledgement of this fact. At the same time, mutual indebtedness has reached such a point that some enterprises have been forced to default on their debts as a result of defaults on claims owed to them. Hence, the most recent amendment to the Hungarian law absolves an indebted firm that forces another into bankruptcy from the obligation of declaring bankruptcy for itself if the total of its defaults on debts is less than its outstanding claims on the firm that it forces into bankruptcy. The new amendment, however, does not take into account a situation in which a firm's total default is less than the total amount owed to it from claims outstanding with multiple firms but greater than the amount outstanding for any one firm. An enterprise which finds itself in the latter situation will not want to push its creditors into bankruptcy for fear that it, too, will be forced to follow.

Default on debt in Yugoslavia has reached the point at which large numbers of banks are now in financial distress. Because of the illiquidity crisis of the banking sector the government has now decided that it must bail out or rehabilitate the banking system before it can successfully tackle the problem of enterprise default. That the Yugoslav bankruptcy law is automatically triggered when a firm cannot cover its losses would lead one to expect that there should be no problem with the number of firms commencing bankruptcy proceedings. Yet, it appears that the banks are unofficially rescheduling debt or allowing rehabilitation to "succeed" by simply not reporting the debt as a default. The significance of the problem and the extent to which it may go if unchecked are illustrated by the recently "discovered" insolvency of the Slovenian firm Elan, a firm making skis and outdoor equipment and one of Yugoslavia's largest and most respected exporters. Elan's debts are believed to have reached half a billion marks. Its defaults will destroy more than one bank and may well have a significant impact on the entire Slovenian economy.

The experiences of Hungary and Yugoslavia suggest that there is indeed a unique aspect to implementation of bankruptcy laws that relates to the beliefs of creditors in reforming socialist economies. Discussion in Section 4 mentioned a number of possible reasons for the passivity of creditors in reforming socialist economies, among them the belief that prospects for collecting in full will be greater if collection of claims is postponed. Given that the environment until very recently has been one in which bailout was virtually assured and given that everyone knows that the government cannot force every firm in the economy into bankruptcy, it may be rational for noone to initiate bankruptcy proceedings and for everyone to wait for bailout. This idea is contained in the following conjecture.

> *There may exist an equilibrium in a reforming socialist economy whereby no bankruptcies are declared and mutual indebtedness grows over time. This equilibrium is supported by the rational beliefs of creditors in virtually certain bailout by the government.*

The implication of the conjecture is that it may be difficult to make the initial transition from an economy with soft budget constraints to one with significantly "hardened" constraints. Once bankruptcy laws begin to be even moderately enforced, creditors will likely alter their beliefs and become more aggressive. The problem arises in making the initial leap from the starting point onto the path of financial discipline.

Anecdotal evidence suggests that in both Hungary and Yugoslavia larger firms are able to escape liquidation, whereas smaller firms may not. This observation is consistent with the discussion of the social costs of bankruptcy and/or of local intervention, and it has direct implications for the disciplinary impact of bankruptcy laws. It is curious to compare this observation with that cited in Section 2 that larger U.S. firms tend to succeed in adopting reorganization plans more often than smaller ones. The explanation offered by Franks and Torrous (1988) for this result is that larger firms are generally better able to bear the costs of a prolonged reorganization procedure; therefore, they are better able to sustain the bargaining process with creditors until a plan is adopted. In one sense their size, and hence their liquidity position, increases their bargaining power relative to that of small firms. In Hungary and Yugoslavia the size of the firm also seems to influence its bargaining power, although for different reasons.

Appropriate capitalist analogies to the bailout of Yugoslav and Hungarian firms nevertheless exist and suggest that the phenomenon of bailout for firms whose sizes render them of regional importance is not a distinctly socialist phenomenon. Examples of large bailouts, which took place outside of the official bankruptcy procedures and for which the firms were regional giants, include the U. S. bailouts of Conrail, Chrysler, and Continental Bank, the German bailout of AEG-Telefunken, A. G., the Japanese bailout of Toyo Kogo, and the English bailout of British Leyland.[55]

The role of reorganization is a critical factor in the bankruptcy process. On the one hand, it may be used to allow survival of firms that should fail, or to avoid liquidation. On the other hand, it may allow survival of firms that should survive but which otherwise would not if contracts were not renegotiated. Yet, the outcome of reorganization appears to depend critically upon the composition of the parties participating in the bargaining process and the distribution of bargaining powers. Improving the efficiency of contracts through renegotiation requires that each bargaining party be able to implement its threat point. The experience with Hungarian and Yugoslav bankruptcy would suggest that either creditors are unable to implement their threat points of liquidation or that existing economic relationships make the possibility of bailout plausible and desirable for both debtors and their creditors.

[55] See Reich (1985) for an excellent analysis of the bailouts of Chrysler, AEG-Telefunken, Toyo Kogo, and British Leyland.

7. Conclusion

In this paper I consider the role of bankruptcy in reforming socialist economies. I identify the general goals that a bankruptcy law in any economy might be expected to perform, and I concentrate on the goal that the law forces liquidation of firms that should be not survive and allows rescue of firms that should survive. I then examine in detail the U. S. bankruptcy law and describe major differences in bankruptcy laws across industrialized capitalist economies. I discuss features that one would expect to observe in bankruptcy laws in socialist economies, compare the laws of Hungary, Poland, and Yugoslavia with those of the capitalist economies, and analyze problems of enforcement of bankruptcy in the socialist economics. I argue that differences in bankruptcy laws across economies reflect differences in property rights of firm owners and in the development of markets. This implies that bankruptcy laws that may be appropriate for socialist economies in the initial stages of reform may not work when financial markets are more developed.

How the bankruptcy law is triggered, who evaluates the petition for bankruptcy, and the role of reorganization in the bankruptcy process are key components that are likely to change as reform in socialist economies progresses. Yet, it appears that political preferences for the security of workers are a significant determinant of the place that reorganization occupies in bankruptcy. Since these preferences differ even across capitalist economies, it is hard to draw a distinction between the roles of reorganization in capitalist and socialist economic systems.

It is well known that enforcement of bankruptcy statutes in socialist economies is a significant problem. Reasons for poor enforcement include concern for the fate of workers of liquidated firms, the existence of externalities, or social and political costs, associated with liquidation of large firms or large numbers of firms, and the ability of regional or ministerial officials with vested interests in a firm to prevent liquidation. Several measures could be taken to reduce the political costs of bankruptcy. These include introducing market-clearing prices, increasing competition, and implementing taxation and subsidization policies that are applied uniformly to firms. Separating the provision of social benefits from the workplace could also simultaneously reduce costs associated with unemployment and enhance labor mobility. These observations raise the question of whether passage of bankruptcy laws should await introduction of the above measures. I argue that bankruptcy is a crucial element in the process of reform, and that markets, especially financial markets, cannot operate properly without a system of well defined property rights, of which a bankruptcy law is a part.

Yet, because the history of operation of the socialist economies has influenced creditors' and debtors' beliefs about the probability of bailout, bankruptcy laws that rely on aggressiveness of creditors or even upon accurate reporting of unsatisfied claims may be extremely difficult to implement in the initial stages of reform. It may be a dominant strategy for all creditors to delay seeking satisfaction of their claims, thereby forcing the government to bail out loss-making firms. This problem is unique to the situation of the reforming socialist economies, since no well functioning financial markets have existed in these economies in the past and governments are trying to convert from one type of behavior to another.

Whereas the beliefs of creditors will play a role in the economy's ability to move onto the path of financial discipline, the financial institutions created in the reforming socialist economies will also influence the progress along the path. The fact that the banks in Yugoslavia are owned by firms and that it is primarily to the founding firms that the banks lend is likely a significant factor in explaining the banks' behavior. As part of the rehabilitation of the banking sector, the Yugoslav government plans to convert at least some of the most poorly performing banks to private ownership. Whether or not banks are publicly or privately owned, the proportion of bank lending in investment finance, and the extent to which banks may own firms are all factors that will influence the design and impact of bankruptcy laws. Although discussion of these factors is beyond the scope of this paper, it is a subject of my ongoing research.

Appendix

This appendix summarizes major features of the bankruptcy laws of France, Germany, Japan and the United Kingdom according to the criteria mentioned in Section 3.

France

The French bankruptcy law, passed in 1985, was intended to define a single bankruptcy procedure for liquidation and reorganization. The primary goal of the lawmakers was "first and foremost to save the debtor's ailing enterprise and the employment attached thereto."[1]

Declaration. Any debtor who fails to repay claims that come due must inform the Commercial Court of this fact within fifteen days of the default. Bankruptcy proceedings may also begin at the behest of the creditors, the Commercial Court, or the public prosecutor.

Liquidation vs. reorganization. Since the procedure for bankruptcy is a unified one, the debtor does not have to decide whether to file for liquidation or for reorganization. All firms officially enter bankruptcy in a period of rehabilitation. The bankruptcy proceeding begins with an observation phase, during which an administrator appointed by the court explores the possibilities for avoiding liquidation and may either supervise the operation of or actually operate the firm. The administrator, with the help of the debtor, prepares a report outlining the economic and employment situation of the firm. If the administrator decides that reorganization is unwarranted, then liquidation proceedings are recommended. Moreover, liquidation of the firm may not commence before an observation period has been undertaken. If the administrator judges that rehabilitation of the firm is possible, then his report describes a proposed reorganization plan, in which proposals for writing off or rescheduling of debt, among other suggestions, are contained. The plan is sent to the debtor, the workers representative committee and to the creditors' representative (appointed by the court),[2] who circulates it to all

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[1] Simeon et al, p. 18A-9, who make reference to the bankruptcy law, Law No. 85-98, passed on January 25, 1985.

[2] In contrast to the previous law the court now appoints a creditors' representative in addition to the bankruptcy administrator. The intention is to avoid any conflicts of interest arising when one official represents both the debtor and creditors. Reasons for court appointment of the creditors' representative as opposed to election by the creditors are not provided.

creditors. Each party is expected to respond to the plan. If no response is received, then acceptance is assumed.

Reorganization. Once the administrator has submitted a reorganization plan and the period for obtaining comments has expired, the court holds a hearing during which all relevant parties may inform the court of their views regarding the plan. It is significant that the basis for adoption of the plan is approval by the court. In contrast to the previous law, which required a certain percentage of creditors to ratify the reorganization plan, the current law specifies that the court may approve a plan to which one or even all of the parties object. The plan may involve continuing to operate the firm in its totality, selling some portions of the firm, or transferring the firm to new owners. Transfers of any parts of the firm are based on offers received for those parts from potential purchasers during the observation period. The court is required to accept the offer "best ensuring the maintenance of employment levels and the repayment of creditors." Once a rehabilitation program has begun, the court has the right, "upon a showing of just cause," to replace members of the firm's management or to assign shareholder voting rights held by management to a court-appointed attorney. All transfers of shares by management after the firm's declaration of bankruptcy are regulated by the court.

Priorities of creditors. The lawmakers' concern for employees in designing the French bankruptcy law is evident from the priorities established for repayment of creditors. Employees have the right to receive six months of back pay, payable before any unsecured creditor is compensated. Further, payment for the last sixty days of work must be made by the administrator within ten days of the announcement of bankruptcy, and this payment is made before any secured or unsecured creditor's claims are satisfied.[3] Creditors who extend credit after bankruptcy has been declared enjoy the highest priority among creditors in the satisfaction of claims, once the payment of the last sixty days of salaries is made. In contrast to the previous law, secured creditors may not file for payment through the sale of designated collateral once bankruptcy proceedings have begun.

[3] All employers are required to purchase insurance guaranteeing salary payments; therefore, if the firm's assets are insufficient to make the salary payments within the required time limit, the insurance policy is exercised.

In addition to the bankruptcy provisions outlined above, the bankruptcy law of 1985 specifies measures that a firm may take to avoid declaring bankruptcy. The purpose of these measures strongly resembles the idea behind pre-rehabilitation in the Yugoslav bankruptcy law, with the difference that pre-rehabilitation is a legal obligation for the firms meeting the conditions giving rise to the need for it. In France, measures to prevent bankruptcy are designed to provide expert assistance to the financially troubled firm before it reaches the point of defaulting on debts and to provide a bargaining framework for conciliation with some or all of the firm's creditors. Each company may belong to an Approved Counseling Organization, which provides analyses of financial and accounting data provided to it by the firm. The firm may thus obtain assistance and recommendations before it declares bankruptcy. Second, when a firm anticipates the need for financial resources exceeding those that will be available in capital markets, it may file a report with the Commercial Court, requesting the appointment of a conciliator. The latter's role is to negotiate an agreement between the debtor and some subset of creditors regarding rescheduling or writing off of debt.

Germany

The current German bankruptcy provisions are heavily biased toward liquidation. In the view of Klasmeyer and Kubler (1988) the laws were written in a period when it was believed that bankruptcy was the last step in the evolutionary process in a market economy by which weak enterprises were eliminated from the marketplace. The current laws are scheduled for reform. One of the major reform recommendations made by the Commission for Insolvency Law in 1984, after six years of study, was the creation of a uniform bankruptcy procedure that would allow for reorganization in much the way that Chapter 11 of the U. S. bankruptcy law does.

Declaration. Bankruptcy may be filed by the debtor firm or by its unsecured creditors. Secured creditors are required to settle their claims outside of bankruptcy, since the collective nature of bankruptcy proceedings does not facilitate the collection of secured claims. The debtor is required to file for bankruptcy within three weeks of the time at which it exhibits either the inability to repay debts or insolvency.

Liquidation vs. reorganization. The debtor has the option of initiating a bankruptcy (liquidation) or a composition proceeding, each regulated by separate laws. Although these alternative procedures exist, less than one percent of insolvencies in the early to mid eighties were resolved through composition. This is due to strict requirements on the value of assets necessary to undertake composition. Namely, the debtor must offer to satisfy at least thirty-five percent of total claims of creditors. This amount must be offered in cash, and the composition must treat all creditors equally.

Reorganization/Composition. Assuming that the debtor can meet the minimum requirement of satisfying at least thirty-five percent of unsecured claims with cash, then the debtor proposes a plan of postponement and waivers of the remainder of claims. A meeting of the creditors is called for voting on the composition proposal. A majority of creditors who together account for three-fourths of the total unsecured claims is required for approval of the plan. Bankruptcy (liquidation) proceedings automatically commence if the composition proposal is rejected.

A commonly employed alternative to the judicial composition is the out-of-court composition, since it does not require the immediate satisfaction of thirty-five percent of outstanding claims. Although an official estimate on the percentage of insolvencies is unavailable, the belief is that this percentage is nonnegligible, though probably not exceeding thirty percent.

Priorities of creditors. Once a bankruptcy petition is filed, the court renders a decision as to its admissibility. If the court deems that the firm's assets are insufficient to cover the procedural costs of bankruptcy, then the bankruptcy petition will be denied.[4] In general, non-preferred creditors receive none or only a very small proportion of their claims in bankruptcy cases. Creditors who have acquired a lien on assets prior to initiation of bankruptcy may ask the bankruptcy trustee appointed by the court for satisfaction of their claims. Next in the list of priorities are procedural costs. Finally, the law allows for a ranking of preferred creditors. Among the preferred creditors are employees' claims for

[4] The proportion of bankruptcy applications which are denied is significant. In 1982 approximately 15,000 petitions for bankruptcy were filed; however, only approximately 4000 were granted. (Verbrugg (1986))

three months of salaries prior to the adjudication of bankruptcy. Other preferred creditors include social security institutions, the Federal Labor Institution and tax organizations.

The majority of creditors in Germany appear to secure their debts through a variety of means. The prevalence of this practice explains why so many petitions for bankruptcy are denied due to lack of funds for covering procedural costs. That most claims are secured is most likely a defensive response to the bias in the German bankruptcy laws toward liquidation. (Verbrugg (1986))

As already mentioned, German bankruptcy laws are likely to be amended in coming years. In addition to the recommendation of a unified bankruptcy procedure, the suggestions for bankruptcy reform include rescinding the right of secured creditors to exercise their claims on secured assets once the firm declares bankruptcy; abolition of bankruptcy priority rights, such as the priority of tax authorities, social security authorities, and employees in satisfaction of outstanding claims; and according to the bankruptcy trustee the right to exercise liability claims that are presently exercised by individual creditors.

Japan

Separate bankruptcy statutes for liquidation and reorganization exist in Japan as in Germany. Liquidation is to be invoked in cases of illiquidity, whereby it becomes obvious that the firm will be unable to repay its debts, in cases of actual suspension of debt payments, or of insolvency, where total liabilities exceed total assets.

Declaration and Liquidation vs. Reorganzation. Bankruptcy proceedings may commence at the initiation of a court, or an application to commence bankruptcy proceedings may be activated by any creditor or by the debtor firm. The directors of a corporation are legally obliged to file a petition for liquidation when the firm meets one of the above conditions. Any creditor who files an application for bankruptcy must advance the administrative costs of the bankruptcy proceedings as determined by the court. If the creditor does not pay in advance, the bankruptcy petition may be denied. The court examines relevant documents, may hold hearings with the creditor and debtor, and decides whether to accept the bankruptcy petition. The court may also order various measure that are designed to preserve the value of the firm's assets until a decision on acceptance of the bankruptcy petition is rendered.

Parties with the right to file for reorganization are a corporation's board of directors, individual creditors holding more than one tenth of the firm's total capital, or shareholders holding more than one tenth of the total issued shares. In addition, any company engaged in liquidation proceedings may file an application for reorganization. This application, however, must be approved by two-thirds of capital held.[5] As in the case of liquidation, administrative costs for the reorganization proceedings must be provided in cash in advance in order for the reorganization application to be accepted.

Reorganization. The purpose of Japanese reorganization is stated in Article 1 of the Corporate Reorganization Act of 1952. It is "the bringing of the sustenance and regeneration of the business of a stock company of which, despite its financial difficulty, there is prospect of rehabilitation, through adjustment of the interests of its obligees, shareholders, and other interested persons."[6] The reorganization statute covers obligations and rights of secured creditors and of shareholders. It also specifies that a reorganization plan must by "fair and equitable." Order of repayment of claims in reorganization is to proceed with tax debts and "other obligations for the common benefit" receiving top priority, followed by secured creditors, unsecured creditors, and shareholders. Upon receipt of a petition for reorganization, the court interviews the chief executives of the company and may ask the leading creditors to designate a representative. It also reviews documents pertaining to the financial status of the firm. After possible discussions with the executives, with creditors, and with employees, the court renders its decision regarding acceptance of the petition. The court considers the following factors in arriving at its decision: (i) profitability of the firm – funds sufficient to cover overhead costs

[5] The description of the Japanese reorganization law provided by Matsuo (1982) is unclear as to whether the two-thirds majority pertains to the creditors, shareholders, or both.

[6] Quoted in Matsuo (198?)

and make debt repayments; (ii) likelihood of obtaining the consent for a reorganization plan by a majority of creditors; (iii) assurance of the existence of a suitable trustee for the firm.

The court confers all powers of operation and management of the firm to the reorganization trustee. The trustee may, with the apporval of the creditors, delegate some of these management powers to a director. The trustee drafts a reorganization plan after a meeting with all of the interested parties. The court then calls an informal meeting of the interested parties. A formal meeting of the interested parties to discuss the plan , but not to vote on it, then takes place. The court then makes final changes to the plan, and it is voted upon at a third meeting of the firm's claimants. Secured creditors must ratify the plan by a majority (in terms of value) of four-fifths, and two thirds of the unsecured creditors must accept the plan. Recent practice has tended to exclude the shareholders from the list of claimants; therefore, they are generally unable to vote on the plan. If the creditors do not ratify the plan, then liquidation proceedings begin.

Priorities of creditors. The following priorites of creditors are usually stipulated in reorganization plans: preferred obligation rights, such as expenses for the common benefit, employees' salaries up to six months prior to reorganization, and tax claims; secured creditors, who may expect full repayment of claims, albeit without interest; unsecured creditors, of which small creditors are generally favored over larger ones; deferred claims, such as interest accruing subsequent to commencement of reorganization. According to Matsuo, unsecured creditors receive on average no more than fifty percent of their claims.

Secured creditors in liquidation proceedings enjoy the right of separation: they may exercise their claims outside of the bankruptcy procedure. If the security is insufficient to cover the value of the claim, the remainder enters as a claim on the bankruptcy estate. Creditors also enjoy the right of set-off, whereby if they owed an amount to the bankrupt at the time of declaration of bankruptcy, they may write off this amount of the bankrupt's claims to them outside of the bankruptcy proceeding. Preferred claims in the actual distribution of the proceeds from liquidation include court expenses and other expenses for the common benefit and wages of employees. Once the firm's assets are liquidated, the court distributes them in an order that is established by law.

England

Bankruptcy laws that significantly altered existing ones were passed in England in 1985 and 1986. One of the principal changes was the introduction of a possible reorganization phase of bankruptcy, termed administration. Previously, only liquidation in bankruptcy was possible. Bankruptcy in England actually comprises three possible phases: administration (reorganization); liquidation; and administrative receivership. The most common grounds for liquidation of a firm is inability to pay its debts. Inability to pay debts occurs when any one of the following conditions holds: (i) the firm has failed to satisfy a creditor's claims within three weeks of being served notice; (ii) a judgement in favor of a creditor has not been honored; (iii) the court deems that the value of the firm's liabilities exceed the value of its assets.

Declaration. The director of a firm or any creditor may file a petition to the bankruptcy court for administration. Similarly, either may file a petition for liquidation, although it is usual for a creditor to file such a petition. A firm that is in liquidation, however, may not file a petition for administration.

Reorganization/Administration. Once a petition has been filed, the court issues an administrative order if it finds that one of the following goals would be achived: (i) the survival of the firm or any part of it as a going concern; (ii) approval of a voluntary agreement (composition) between the firm and its creditors; (iii) the sanctioning of an agreement; (iv) "a more advantageous realization of the [firm's] assets" then would be achieved through liquidation. During the period in which an administrative order is operative the court appoints an administrator who takes control of the firm's property and who retains the power of management and operation of the firm. The administrator may also dispose of the property of a company even if it has been secured or is subject to a floating charge.[7]

[7] A floating charge is a type of security over all or a category of the firm's assets, whose precise composition may be left unspecified or may change over time. The floating charge is "crystallized" by certain events, such as default on debt, at which point it becomes a fixed charge, or a security over the relevant assets.

The administrator examines the financial affairs of the firm and must submit within three months a set of proposals for meeting the goals outlined in the administrative order. The administrator then summons a creditors' meeting at the creditors vote upon the proposals. Acceptance requires an affirmative vote by creditors representing more than one half of the value of outstanding claims. Even if the proposals are rejected, the court possesses the power to carry out the administrative order in a manner that it deems appropriate.

It should be noted that the firm may in effect formulate its own plan for debt composition or reorganization to be executed under the supervision of a qualified insolvency practitioner. The process by which the firm proposes this plan is called voluntary administration. The firm essentially proposes a plan and a nominee for executing it. The nominee then calls a meeting of the creditors and debtors. The conduct of the meeting is subject to a wide degree of flexibility and leaves open the possiblity of modifications to the firm's proposal. Acceptance of the proposed plan is subject to similar requirements as for the case of (nonvoluntary) administration. In the case of rejection of the plan the nominee may apply for an administrative order or for liquidation. It is interesting to note that a firm may propose voluntary administration at any point in an adminstration or liquidation proceeding.

Priorities of creditors. The usual ordering of priority in distributing the assets from liquidation are the expenses of the liquidator, creditors with a fixed charge, preferential creditors, creditors with a floating charge, ordinary unsecured creditors, and shareholders. Preferential creditors include the Inland Revenue Service, tax and sociali security administrations, contributions to pension schemes, and debts relating to the salaries of employees.

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Table 1
Sources for Covering Losses During Rehabilitation Period (%'s)*

	Nonreimbursable		Reimbursable		Total	
	1984	1985	1984	1985	1984	1985
Assets from BOALs linked by SMAs	26.6	35.2	21.1	41.9	22.7	41.1
Funds from SPCs	6.2	5.5	47.9	17.0	35.2	15.7
Postponement or lowering of taxes and other contributions	64.0	47.0	6.3	9.1	23.9	13.4
Writing off of claims	3.2	12.3	–	–	1.0	1.4
Assets from banks	–	–	24.7	32.0	17.2	28.4
Total	100	100	100	100	100	100

* The percentage of covered losses accounted for by reimbursable assets was 69.6 and 88.5 in 1984 and 1985, respectively.

Source: Zakošek (1987), p. 1957.

Table 2

Data for BOALs Not Covering All of Uncovered Losses

Reported in Previous Year

	1980	1981	1982	1983	1984	1985
No. of BOALs	82	174	178	235	254	201
No. of Employed	19,944	49,496	49,059	56,968	76,432	n.a.
% Uncovered Loss from previous yr. remaining uncovered	6.2	22.5	26.5	32.3	16.1	19.8

Source: Zakošek (1987)

Table 3

Bankruptcies - Yugoslavia

	1981	1982	1983	1984	1985[a]
No. of BOALs	20	13	n.a.	22	59
No. of Employed	1,944	1,246	802	1,916	8,801

[a] Covers 1985 and the first quarter of 1986.

Source: Zakošek (1987)