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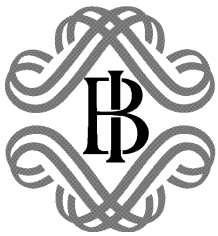
Quaderni di ricerca giuridica

della Consulenza legale

Bankruptcy Legislation in Belgium, Italy and the Netherlands

Brussels, 7 July 2000



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All'analisi economica e tecnica, sulla quale si basa l'azione che la Banca d'Italia svolge come banca centrale e organo di vigilanza, si accompagna, con crescente impegno, quella giuridica dei fenomeni creditizi e monetari e, più in generale, dei profili istituzionali dell'attività economica.

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I "Quaderni" riflettono esclusivamente le opinioni dei singoli autori e non intendono, quindi, rappresentare posizioni ufficiali della Banca d'Italia.

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The importance of efficient bankruptcy procedures is widely recognized. The awareness of the possible costs for an economy of inefficient procedures has induced several European countries to consider reforms of their systems.

On 7 July 2000 Banca d'Italia organized an international seminar on bankruptcy at its Brussels representative office. The aim of the seminar was to allow experts from Italy and the Benelux countries to meet and compare their experiences with their countries' legislations. We present here the text of the speeches delivered at the seminar, as well as a summary of the discussion that followed.

The participants were representatives of four central banks, lawyers, bankers and university professors who, in their different capacities, are involved in the study of bankruptcy legislation. The Dutch Ministry of Economic Affairs and the European Commission were represented as well. The former is in charge of designing the structural reform initiatives of the Dutch Government, the latter has promoted several initiatives in the field, among which the regulation on insolvency proceedings approved by the Council of the European Union on 29 May 2000.

Since the reform of bankruptcy procedures is also on the agenda in Italy, we believe that international comparisons of different legal frameworks provide useful elements for deepening the discussion on the main issues at stake.

This publication is also available at the Internet address: www.bancaditalia.it

CONTENTS

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OPENING REMARKS

Marco Evangelisti

Ladies and gentlemen,

I am very glad to welcome you at this seminar on bankruptcy legislation.

Banca d'Italia pays close attention to the debate on bankruptcy legislation both in Italy and in the industrialised world. The Governor and the other members of the Board of Directors have spoken in forums and Parliamentary Commissions and several Banca d'Italia officials have published scholarly papers in the Bank's Working Papers series. Recently, a study has been completed (with the contribution of Banca d'Italia's representative offices abroad) on the main features of bankruptcy legislation in the United States, Great Britain, Germany, France and the Benelux countries.

The Bank's interest in bankruptcy legislation is directly linked to its institutional role as supervisor of the banking system because of the important role of banks in financing economic enterprises. Efficient bankruptcy procedures mean a prompt liquidation crossing out of "bad" credits from banks' balance sheets, thus contributing to their stability.

More generally, bankruptcy law directly impacts the efficiency of the economic system since it extends not only to large businesses but also to small and medium enterprises. Any problems affecting large businesses are taken up by the media and have almost immediate echoes in public opinion since the livelihoods of employees at all levels and by fall-out the destiny of related contractors are at stake. Large businesses make up the backbone of any industrial system and Italy makes no exception to this.

In Europe, several countries have recently begun a reappraisal of their bankruptcy legislation. The economic recession in the 1970s and the consequent scale of business firms' financial and economic difficulties gave rise to the idea that rules and judicial interpretative criteria aimed at preventing the liquidation of ailing companies should be sought.

More recently, it has been recognised that legislation and jurisdictional practices biased in favour of the entrepreneur against their creditors inevitably discourage creditors from lending, and in the long run harm those very entrepreneurs they were designed to favour. Law and Economics publications through analyses of the economic consequences of bankruptcy legislation have drawn much attention to this problem, stressing the need for legislators to stand on the sidelines, allow the interaction between the parties to work itself out and to intervene only when this mechanism seems to be failing.

Liquidation

In many countries, the need is felt for a simplification of bankruptcy legislation for the liquidation of large enterprises (where the time required can be long) and of small and medium-sized enterprises where the procedural costs can be particularly high relative to the actual sums at stake.

The efficiency of Bankruptcy Law has an influence on lenders' willingness to finance economic activities. This willingness would be further enhanced were the procedures more user-friendly and creditors had possibility to have more voice in the liquidation proceedings.

On the side of the debtors, some countries have now introduced the so-called *Fresh Start*, that is, the possibility for the bankrupt entrepreneur to start a new economic activity some time after the liquidation of his previous enterprise. The assumption here is that success in business does not depend solely on honesty and competence, but also, and for an important part, on the erratic and inscrutable vagaries of markets. In these cases the law is called upon to perform an important task, namely, to balance the incentives to assume risks with the costs that are imposed on creditors. In the end, an adequate evaluation of the time before filing for a new bankruptcy is important for entrepreneurs as well, because it encourages creditors to lend money.

Financial restructuring

Practically everywhere in the industrialised world bankruptcy legislation comprises norms aimed at preventing the liquidation of enterprises in temporary financial difficulty. The law should allow public authorities to intervene at the earliest signs of ailing symptoms and prevent a scramble by creditors by granting a suspension or stay of the creditors' claims. This would create strong encouragement incentive for creditors to discuss reorganisation.

The underlying assumption is that there are obstacles to the adoption of such measures by creditors and entrepreneurs, and that the assistance of the law is required: it is assumed that shareholders' and creditors' control may be insufficient to guarantee the resolve of temporary difficulties of the enterprise. The Legislator's aim is to protect the general interest, since owners and creditors may not always be interested in preventing the bankruptcy of a sound enterprise.

On the other hand, legislators seem now aware of the necessity to prevent that the new law becomes a means for an artificial support to ailing firms and they now require that the court verifies the temporary character of the firm's financial difficulties.

Belgium, the Netherlands and Italy

In Belgium, a reform was passed in 1997 after much debate. The new legislation is aimed at simplifying existing procedures, avoiding the recourse to bankruptcy in case of temporary financial difficulty and giving the possibility to the individual entrepreneur to start a new economic activity after bankruptcy. Many doubts have been raised whether the reform has succeeded in its proposed aims. The evidence available on the first years of implementation shows that the new procedures are confronted with a more complex reality than was foreseen by the legislator. In any case, I think that the reform is moving along what appears to be the only possible direction.

As for the Netherlands, the Dutch Government is currently preparing a draft for a new bankruptcy law. According to available information, the main aim of the reform

should be to modify the existing procedure of financial restructuring in order to give entrepreneurs in financial difficulty more room to submit a financial plan to creditors.

In Italy, after the reform in 1999 of the so-called “Prodi Law” on the financial restructuring of large enterprises, the necessity for a general revision of bankruptcy legislation has recently gained the attention of scholars and experts. The Government should soon submit to the Parliament a reform of 1942 bankruptcy law. The position of Banca d’Italia is to create a legislative framework apt to allow dialogue between the entrepreneur and the other interested parties. Among other things, the law should allow for the liquidation only of enterprises in irreversible economic difficulty; in the absence of fraud, the penal sanctions against the bankrupt entrepreneur should be revised.

Conclusion

The debate on bankruptcy in the three countries seems to revolve around the same basic issues: to steer legislation away from past interpretation which aimed at keeping in existence ailing enterprises; to simplify the liquidation of bankrupt enterprises; to give bankrupt entrepreneurs the possibility of starting a new business activity even though they have not managed to pay all their debts, and to allow financial restructuring only if there is a conceivable possibility that the entrepreneur’s activity is economically sound.

We shall hear about the main features of the 1997 reform in Belgium as well as of the first results of its implementation; from the contribution of our Dutch and Italian speakers we shall be made acquainted with the main issues of the proposed reforms. Finally, we shall hear what is the contribution of the Law and Economics literature towards a deeper understanding of the role of legislation in improving the relationship between entrepreneurs and creditors.

As you can see from the programme, in the afternoon, at the end of the speakers’ presentations, we have left room for free discussion. I am sure that the reports of our speakers will prompt our qualified participants to volunteer comments on the implementation of existing laws and on the proposals for reform. We would particularly appreciate hearing from our Luxembourg guests on the proposals for reform in Luxembourg recently reported in the press. We have also the privilege to have among our participants representatives of the European institutions. We do hope to hear from them about the drafts of European legislation currently under scrutiny.

This seminar has been conceived as an opportunity to allow speakers from different countries to exchange their views on a subject that represents an important part of the so-called structural reforms in Europe. I hope that our initiative will contribute to bring light to an area where many issues still remain to be clarified and where the existing solutions still leave some unsolved problems.

Ladies and gentlemen, on behalf of Banca d’Italia and on my own behalf, I wish to thank you for your kind participation and I am sure that our seminar on bankruptcy law will be anything but bankrupt of ideas and points for discussion.

BANKRUPTCY AND LAW AND ECONOMICS

Paolo Santella (1)

1. An Unnecessary Duplication?

"A firm is said to be bankrupt if it cannot meet its debt obligations. In this case in most countries the bankruptcy legislation...specifies how to dispose of the firm's assets"(2).

Bankruptcy is characterized by being a collective procedure, in which all creditors must apprehend all the insolvent debtor's assets, normally through a person nominated by the court.

Bankruptcy may be seen as a duplication with regard to ordinary civil procedure law remedies, which allow unpaid creditors to seize the debtor's assets, sell them and take the proceeds in satisfaction of the debt.

European jurists normally explain the existence of bankruptcy by making recourse to an argument of justice: bankruptcy is to guarantee equal treatment to the insolvent firm's creditors. What remains to be explained is why practically everywhere bankruptcy legislation leaves contractual priorities untouched. More in general, justice arguments do not explain why the liquidation of the firm should follow different rules as those that govern the "normal" periods of its life.

A second possible way to analyse bankruptcy legislation consists in making recourse to the economic efficiency argument, following what has by now become the standard methodology for jurists in the United States. It is worth reminding that this methodology was originally introduced by Italian scholars. As early as in the 18th century, Cesare Beccaria based his analysis of criminal law on the assumption that people tend to behave (using today's economic jargon) in order to maximise their utility. In the 19th century, some among the most prominent Italian economists (for instance Maffeo Pantaleoni) were also jurists, and they conceived the law as an instrument through which individuals engage themselves to restrain their behaviour in order to increase the benefits from exchange (3).

2. The Theory of C*reditors' Bargain*

The main explanation for the existence of bankruptcy based on economic efficiency arguments has been proposed by those who hold that:

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(1) Banca d'Italia. e-mail:paolo.santella@libero.it.

(2) Adler, 1998, p. 145.

(3) Cfr. Romani, 1989.

(i) when the debtor's assets are less than his or her outstanding debt, ordinary creditors (as opposed to secured creditors) would engage a costly race to anticipate each other to recover their credits. In some cases the piecemeal liquidation could prevent selling the debtor's estate at its maximum value;

(ii) the creditors' race could determine the premature termination of a debtor's business.

As the argument goes, unsecured creditors as a group would take advantage on an agreement not to race, but, both because of their number and their temporal succession, they are bound to free ride one another. As is stated by cartel theory (from Maffeo Pantaleoni to Mancur Olson), as far as the single creditor is concerned, the benefits of negotiating an agreement can be inferior to the related transaction costs (4).

On the other hand, there is no free riding problem as far as secured creditors are concerned, since their credits are linked to specified debtor's assets in a specified order.

3. Is Bankruptcy Useless?

The main objection against the *creditors' bargain* argument is that in the majority of cases non priority creditors receive a minimum part, if any, of their credits (5). According to this interpretation, there would be no race to prevent; indeed, bankruptcy law would be aimed at solving a problem that does not exist.

According to Randal Picker, the insurgency of the common pool problem is prevented through the recourse to contractual priorities: "the existence or nonexistence of the unsecured common pool at the end of the firm's life depends on the design of the firm's capital structure at its inception"(6).

More in general, James Bowers (7) remarks that insolvent debtors themselves have a direct interest in distributing their assets to their creditors. The creditors' bargain argument assumes necessarily that the insolvent debtor be not interested in seeking an efficient liquidation of his or her assets. Bowers holds that (i) the debtor has an interest to control the liquidation of his or her assets; (ii) this liquidation maximises the assets' value.

Bowers starts from the assumption that every debtor enjoys a rent, since he values some of his assets more than their market price. When urged to sell some of his assets in order to satisfy the most pressing of his debts, he will minimize the impact of the losses by redoing his portfolios, selling assets with a lower rent in order to buy assets with higher rent. In such a framework, the grant of priority in the form of security is a means for the debtor to control the order of dismissal of his assets (8).

This process is judged efficient because the debtor has every interest to satisfy first those creditors who are better informed on his or her business (because they will probably

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(4) Cfr. Olson, 2000.

(5) Bowers 1990, p. 2098-9, and 1991, p. 29 quotes several studies in this sense.

(6) Picker, 1992, p. 679.

(7) Bowers, 1990.

(8) According to Bowers, this explains why the debtor is still interested in his assets even after insolvency: he is interested in keeping the highest rent in his remaining assets. Furthermore, he may always hope to escape from his difficulties.

be the first and the most pressing in asking for repayment) or those who are parts of specific contractual arrangements (because of the higher cost of replacing them).

On the other hand, to impose a collective procedure means giving up the information collected by creditors, financing the less efficient ones:

"Real vultures, like real debtors and creditors, in real cases know which vultures are strong and which are weak. The pro rata argument is intended to force them to behave as though they were ignorant. The information they have (but must disregard) as parties to a legislated pro rata creditors' or vultures' bargain, is socially valuable. Making life run as though people are ignorant wastes the value of the information which is likely to be substantial" (9).

4. The Relevance of Contractual Priority

As we have seen, both the argument in favour and against bankruptcy are based on the importance of contractual priority. The efficiency of contractual priorities has been contested by Alan Schwartz, who, starting from the Modigliani – Miller theorem of the irrelevance of capital structure, remarks that:

"...if all creditors are informed, the secured creditor will charge a lower interest rate because it is secured, whereas the unsecured creditors will charge higher interest rates because the pool of assets available to satisfy their claims has shrunk. The debtor's total interest bill is thus unaffected by the existence of security. Since the issuance of secured debt is costly, however, the debtor would be worse off with security than without it. Firms would never sell secured debt" (10).

In order to demonstrate the relevance of contractual priorities it is therefore necessary to show the existence of asymmetrical information among creditors. According to Jackson and Kronman, (11) the transfer of risk operated by contractual priorities is justified by creditors' different ability to evaluate credit risk. According to them, the cost of monitoring depends mainly (i) on the amount of the loan and (ii) on the length of the loan. Long-term debtors have more possibilities to deceive their creditors. Furthermore, in the long run there are higher probabilities that unforeseen events harm the entrepreneur's activity.

That should explain why banks make normally recourse to secured long-term credit:

"A secured creditor can focus his attention on the continued availability of his collateral and is largely free to disregard what the debtor does with the remainder of his estate" (12).

On the other hand, in the case of contractors, who normally make recourse to unsecured short-term credit, "quick turnover allows for changes in the credit terms in response to changes in the debtor's financial status" (13).

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(9) Bowers, 1990, p. 2111.

(10) Schwartz, 1981, p. 8.

(11) Jackson and Kronman, 1979.

(12) Jackson and Kronman 1979, p. 1153.

(13) Scott, 1977, quoted by Jackson and Kronman, 1979, p. 1159.

The main objection of Schwartz to Jackson and Kronman is that in many cases, in the United States, contractors do make recourse to secured credit. On the other hand, Schwartz is not able to demonstrate why secured credit is inefficient.

In the end, it is probably safe to say that since there is a widespread recourse to secured credit anywhere in the industrial world, legislators should be very cautious in modifying it, lest determine an increase in the cost of credit.

5. Protecting the Entrepreneur: the *Fresh Start*

The only fully convincing explanation for the existence of bankruptcy legislation seems to be the introduction of the Fresh Start, the possibility for bankrupt entrepreneurs of starting a new business activity even though they have not managed to pay all their debts. The purpose of bankruptcy would then be the protection of the debtor, rather than the creditors.

With the introduction of the *fresh start* bankruptcy law gives the individual entrepreneur an insurance against the risk of insolvency that the market is not able to offer, probably owing to some sort of *adverse selection*, since such an insurance would be sought firstly by entrepreneurs in difficulty. Further, there is probably a *moral hazard* problem as well, since an insured entrepreneur would be fatally led to assume more risk.

6. Conclusion

Probably the main merit of the Law and Economics approach to the analysis of bankruptcy has been to single out that although

“bankruptcy is a solution to a problem...there is no consensus about what problem bankruptcy is supposed to fix. Without a clearer vision of the problem (or problems), it is difficult to evaluate either the effectiveness of bankruptcy as a tool to accomplish these ends or the legitimacy of the ends themselves” (14).

The indication for the legislator is not to tinker with the law, although we should be aware that “neither theoretical voids nor lack of information will inhibit experts from expressing opinions” (15).

(14) Warren and Gottlieb, 2000, p. 72.

(15) Bowers, 1990, p. 2099.

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INTRODUCTION TO THE BELGIAN BANKRUPTCY LAW REFORM

Wouter Bossu (16)

The present text intends to give a concise introduction to the so called "new" Belgian Bankruptcy Act from 8 August 1997 (17). This Act has replaced the "old" Bankruptcy Act dated from 18 April 1851. The scope of my intervention will be limited to the bankruptcy legislation stricto sensu; the new legislation on compulsory composition will not be discussed. It is neither the intention of the author to enter into an exhaustive and detailed discussion of the content of the new bankruptcy act, which will be discussed in length and in depth in the following lecture of Mr. Van den Haute. I trust he will also make the link with the equally new legislation on compulsory composition.

Firstly it will outline the main context, premises and objectives of the new bankruptcy legislation. Secondly, it will demonstrate how the latter objectives have been put into reality by some important legislative changes.

I. *CONTEXT, PREMISES AND OBJECTIVES OF THE BANKRUPTCY REFORM*

1. It should be noted from the beginning that it has never been the intention of the Federal Government to fundamentally – let alone revolutionary – rewrite Belgian bankruptcy legislation. The hereinafter mentioned objectives of bankruptcy reform are put into practise within the existing, albeit adapted and modernised legal framework, dating from 1851. The main source of inspiration for the new bankruptcy law is indeed the old one. The changes that have been made – and some of them are quite significant – have mainly found their roots in the abondant case law and the bankruptcy legislation of some foreign jurisdictions.

2. It is worthwhile noticing that the existing set of rules regarding **privileges and mortgages** has not been adapted or modernised by the new bankruptcy law. This is a pity, because it influences to a very large extent the eventual outcome of a bankruptcy procedure, which is indeed supposed to lead to the payment of the liquidation dividend to the creditors *according to their respective ranking*. In this respect, the possibly excessive proliferation of privileges and the lack of logic in their mutual relation is now the main deficiency of the law regarding the *concursus creditorum*.

3. Concerning the **socio-economic context** of bankruptcy, things have changed quite dramatically since 1851. Whereas the "old" Bankruptcy Act from 18 April 1851 was supposed to deal mainly if not exclusively with the bankruptcy of an individual businessman or merchant, the new bankruptcy law has adapted its content and wording to the fact that the individual businessmen have been substituted by corporations as the main economic agents in the modern industrial and postindustrial economy. The new bankruptcy act has accordingly introduced some important changes in the Belgian company law and in the company related penal law.

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(16) National Bank of Belgium.

(17) Faillissementswet/Loi sur les faillites, Belgian Official Gazette, 28 Ooctober 1997.

4. Furthermore, the present attitude of the lawmakers towards bankruptcy and the bankrupt differs quite radically from that of 1851. In the nineteenth century, bankruptcy was considered by the bourgeois society to be a shameful matter and the bankrupt was very often treated as a social outcast. Nowadays, bankruptcy is considered as necessary in economic life and very often the unfortunate consequence of a courageous enterpreneurial and thus laudable initiative.

5. The **basic premise** of the new legislation is the following:

- Enterprises which are temporarily in liquidity problems deserve a court controlled solution in order to safeguard the continuity of the business. Therefore, the lawmakers have adopted, simultaneously with the new Bankruptcy Act, an Act on Compulsory Composition (Gerechtelijk Akkoord/Concordat Judiciaire). Indeed, the almost non-existing application of the ancient legislation on the protection of enterprises in non mortal difficulties was arguably even a more painful problem than the deficiencies in the Bankruptcy Act of 1851.
- Enterprises whose situation is hopeless should be liquidated and removed from economic activity. However, the law should permit for livable parts of the enterprise to be transferred in order to guarantee at least their continuity.

6. In adapting the Belgian bankruptcy legislation, the lawmakers had mainly the following **two objectives** (18):

a) to create a quicker, cheaper and more flexible bankruptcy procedure;

b) to treat the bankruptcy of an enterprise as a "**stakeholders affair**", in which the interests of the creditors, the public authorities, the employees and the bankrupt should be reconciled equitably (19).

7. Whilst adapting and improving bankruptcy law, the following **core principles** of the existing Belgian bankruptcy legislation have not been touched:

a) the bankruptcy law is only applicable to commercial enterprises, i.e. the individual businessman or the incorporated commercial company; Parliament has however adopted a specific legislation to protect non-commercial debtors against excessive debt burdens.

b) the situation of bankruptcy is one where the bankrupt has

   1) permanent liquidity problems and

   2) does no longer enjoy credit with its creditors (20);

c) a by the court nominated and controlled, independent specialist (curator/curateur), herinafter refered to as "the liquidator," takes over the administration of the assets of the bankrupt, in order to liquidate them and to distribute the revenue of the liquidation to the creditors according to their respective ranking.

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(18) Introduction to the Bankruptcy Act, p. 2.

(19) Introduction to the Bankruptcy Act, p. 1.

(20) It has been tried to eliminate this condition during the legislative process, on the basis of Supreme Court caselaw (see case 17 June 1994). The Senate has however insisted to keep that condition in place, in order to protect the enterprise against too hasty a claim of one individual creditor.

II. *SIGNIFICATIVE MODIFICATIONS*

8. We will now briefly discuss some items of the new bankruptcy law that demonstrate strikingly the abovementioned changes and improvements.

A) A more efficient bankruptcy procedure

9. Since it is impossible to discuss all significant improvements of the bankruptcy proceedings, we will limit us to some significant issues.

10. A very important part in Belgian bankruptcy legislation is the repartition of competences between the liquidator and the supervising judge (rechter-commissaris/juge-commissaire). The new bankruptcy act defines for the first time the general competences of the latter: he supervises the administration of the bankruptcy, as well as the final liquidation, and he plays an intermediary role between the liquidator and the Court (21). New and sound is that the new bankruptcy act now contains the obligation for the liquidator to give, during the first year, every six months and later every year account to the supervising judge about the situation of the bankruptcy (22).

11. The new bankruptcy law also allows for the Court and the liquidator to consult and to cooperate with the bankrupt during the bankruptcy proceedings. This is the case with regards to aspects of bookkeeping, (23) the analysis of the causes of the bankruptcy, (24) etc. In case the liquidator chooses for keeping an enterprise in going concern, he can ask the bankrupt to run the business under the supervision of the liquidator (25). Moreover, the liquidator can ask the bankrupt to help him with or inform him about the administration of the enterprise (26).

12. The new bankruptcy act has fully embraced the possibility of the liquidator to keep the bankrupt enterprise, or parts of it, in going concern. If the interests of the creditors are not impeded by the going concern, every interested person or the liquidator can request the Court to continue the operations of the bankrupt under supervision of the liquidator (27).

B) Bankruptcy as a stakeholders affair

13. The new bankruptcy act has improved remarkably the position of the main stakeholders in a bankruptcy, namely (1) the bankrupt, (2) the creditors, (3) the employees and (4) the State.

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(21) Article 35 of the Bankruptcy Act.

(22) Article 34 of the Bankruptcy Act.

(23) Article 55 of the Bankruptcy Act.

(24) Ibid.

(25) Article 47 of the Bankruptcy Act.

(26) Article 59 of the Bankruptcy Act.

(27) Article 47 of the Bankruptcy Act.

B.1 *Improved protection of the bankrupt*

14. On the one hand, the new bankruptcy act has improved the protection of the fundamental rights of a bankrupt. On the other hand, the present Belgian bankruptcy legislation now contains the possibility to offer a fresh start to a bankrupt of good faith.

B.1.1 *Protection of the fundamental rights of the bankrupt*

15. Under the old bankruptcy legislation, the Courts could declare an enterprise in bankruptcy on their own initiative, without having heard the bankrupt. This practice has been heavily criticised by doctrine and has been considered legally unsound. Not only was there a lack of information towards the bankrupt, but the most fundamental rights of the bankrupt, stemming i.a.: from the European Treaty on Human Rights, might be infringed by a procedure of that kind. The new bankruptcy act has therefore abolished the possibility to declare a bankruptcy *ex officio*.

16. Moreover, whenever the interests of the bankrupt are at stake, the new bankruptcy act has given the bankrupt the right to be heard by the Court. This is for example the case with regards to the verification of the creditors' claims (28), the possibility to close summarily the bankruptcy proceedings for lack of assets (29), the closing of the bankruptcy proceedings (30), and the summoning of a general assembly of creditors (31).

B.1.2 *Excusability-fresh start*

17. The old bankruptcy act allowed for the Courts to declare the bankrupt excusable. The consequence of such a declaration was that the bankrupt was sheltered from imprisonment. These usefulness of these provisions became merely symbolical when the law of 27 July 1871 abolished imprisonment of defaulting debtors.

18. The new bankruptcy act has given a completely new and important meaning to the term "excusability". The bankrupt who has acted in good faith and whom can be expected to become (again) a reliable "economic agent" in the future, can be declared excusable by the Court (32). If the Court accepts the excusability of the bankruptcy, it offers to the latter the possibility of a "clean sheet" or "fresh start". Indeed, it will be impossible for the unpaid creditors to pursue payment of their claims after the closing of the bankruptcy procedures. In case the excusability is refused, each creditor regains, after the closure of the bankruptcy proceedings, the right to pursue individually his claim(s) against the debtor (33).

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(28) Article 70 of the Bankruptcy Act.

(29) Article 73 of the Bankruptcy Act.

(30) Article 75 of the Bankruptcy Act.

(31) Article 76 of the Bankruptcy Act.

(32) Article 80 of the Bankruptcy Law.

(33) Article 82 of the Bankruptcy Law.

19. An important new fall-out of excusability to company law can be found in the rule that a bankkrupt legal person, who has not been declared excusable, immediately ceases to exist and enters into liquidation (34).

B.2 *Improved involvement of the creditors*

20. The new bankruptcy act confirms the primary role of the creditors to keep watch over the creditworthiness of their debtors. The general way of introducing a bankruptcy demand vis-à-vis a particular enterprise stays indeed the demand by one or more of the creditors (35). However, the gap of time between the introduction of the bankruptcy demand and the decision of the Court offers to a *mala fide* debtor the possibility to take out or hide assets from his enterprise. The legislator has therefore offered the creditors a possibility to protect the integrity of the assets of the debtor preceding the introduction of the demand or pending the court decision. Any interested creditor can ask to the court to deprive the debtor totally or partly of the administration of their assets. In that case, the court shall appoint an **administrator-receiver**, who will administer the assets until the bankruptcy has been accepted or rejected (36).

21. The new bankruptcy act allows for the supervising judge to call at any moment for a **general assembly of creditors** or a specific group or category of creditors (37). The third year of the bankruptcy proceedings, this possibility becomes an obligation. At this general assembly, the liquidator has to give an account of the liquidation.

22. The new bankruptcy act has introduced the possibility for the creditors to ask to the Court to appoint a liquidator *ad hoc* in case they fear that their rights will be prejudiced by an intended sale of assets by the general liquidator. The liquidator *ad hoc* can ask the Court to prohibit the sale of that asset (38).

B.3. *Improved protection of the employees*

23. The old bankruptcy act did not include any protection of the employee's rights. Be it true that in practice, the workers were included in the bankruptcy procedures, the law has never been formally adapted to this important need.

24. Thus, also due to some famous cases of industrial bankruptcies, the following changes have been introduced in the new bankruptcy act itself:

a) If an enterprise demands its own bankruptcy, it has the duty to inform immediately the representation of the employees about that demand and the reasons for that demand (39).

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(34) Article 83 of the Bankruptcy Law.

(35) Article 6 of the Bankruptcy Act.

(36) Article 8 of the Bankruptcy Act.

(37) Article 76 of the Bankruptcy Act.

(38) Article 75, 3rd. paragraph, of the Bankruptcy Act.

(39) Article 9, 2nd paragraph, of the Bankruptcy Act.

b) If the curator decides to continue temporarily, completely or totally, the economic activity of the bankruptcy, the Court can only give its authorisation after having heard the opinion of the representation of employees (40).

c) Immediately after the bankruptcy order, the liquidator can, pending the above mentioned Court authorisation, continue the economic activity of the bankrupt enterprise, after consultation of the representative trade unions (41).

B.4 *Improved involvement of the State and its officials*

25. The new bankruptcy act has given to the Public Prosecutor (Openbaar Ministerie/Ministère Public) the right of initiative to demand for the opening of bankruptcy proceedings (42). Accordingly, the Public Prosecutor also has the right of initiative to demand for the appointment of an administrator-receiver (also see above).

26. This right of initiative constitutes indeed the counterpart for the abolition of the *ex officio* bankruptcy declaration by the Court itself (see above). The lawmakers wanted to assure that the possibility to introduce a demand of declaration of bankruptcy would not only be motivated by the individual interest of a particular (group of) creditors, but also by the general interest.

III. *CONCLUSIONS*

Although Belgian bankruptcy law has not been revolutionarised, it has undergone a significant modernisation. The lawmakers have tried to create a better, quicker and cheaper bankruptcy procedure. Time will show if they have succeeded. It seems however from the beginning that they have brought about a bankruptcy law that has a modern, equitable and balanced attitude towards bankruptcy, the bankrupt and the other stakeholders in the liquidation of a mortally ill enterprise.

(40) Article 47, 1st paragraph, of the Bankruptcy Act.

(41) Article 47, 2nd paragraph, of the Bankruptcy Act.

(42) Article 6 of the Bankruptcy Act.

BANKRUPTCY, COMPULSORY COMPOSITION AND VOLUNTARY LIQUIDATION UNDER BELGIAN LAW

Erik Van den Haute (43)

I. Essential features of the reform of the Belgian laws governing bankruptcy and compulsory composition (44)

1. Before examining links between bankruptcy, compulsory composition and voluntary liquidation, we propose to examine some of the essential features of the reform of the Belgian laws governing bankruptcy and compulsory composition, but without examining this reform in detail (45).

Unlike some other European countries, Belgium has maintained its traditional distinction between commercial and civil law, which means that a distinction has to be made between merchants and non-merchants (46). Merchants are defined by the law as those who engage in activities qualified by statute as commercial, as a regular business, whether it be their main profession or an auxiliary activity. The laws which will be examined under this contribution solely apply to merchants as defined above. The situation of non-merchants who are confronted with financial difficulties is governed by a separate law (47), which will not be discussed here, although we regret that the reform for the non-merchants has not been integrated in the reform of bankruptcy and compulsory composition, which would have enabled the legislator to have a systematic approach (48).

2. In order to understand the basic ideas behind bankruptcy and compulsory composition after the reform we have to go back to the main reasons for this reform. One of the main reasons for this reform is that compulsory composition did fail in 97% of the cases. Composition failed mostly because the conditions which had to be fulfilled

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(44) Law of July 17th, 1997 on compulsory composition, *M.B.*, October 28th; Law of August 8th, 1997 on bankruptcy, *M.B.*, October 28th.

(45) On the new Belgian laws governing compulsory composition and bankruptcy, see: Dumon, Y., "La faillite et le concordat judiciaire : la réforme de 1997", *J.T.*, 1997, p 785; Stranart, H. and Dumon, Y., "Le concordat judiciaire", *J.T.*, 1997, p 849; Faillissement & Gerechtelijk akkoord, (Eds.) Byttebier, K. and R. Feltkamp, Maklu, 1998; Le nouveau droit du concordat judiciaire et de la faillite: les lois des 17 juillet et 8 août 1997, Centre Jean Renauld U.C.L., Bruxelles, Bruylant, 1997; Van Buggenhout, Ch., "Kanttekeningen bij de wetten betreffende het gerechtelijk akkoord en het faillissement", *R.W.*, 1997-1998, p. 449.

(46) On this distinction : see Verougstraete & Steenbergen, *J.C.B.*, 1978, p 535.

(47) Law of July 5th, 1998, *M.B.*, July 31st, 1998.

(48) On the law of July 5th, 1998, see : Van den Haute, E., Le règlement collectif de dettes et la possibilité de vente de gré à gré, Kluwer, Bruxelles, 1999; Collectieve schuldenregeling in de praktijk, (Eds.) Dirix, E. and Taelman, P., Intersentia Rechtswetenschappen, Antwerpen, 1999; Van den Eynde, P., "Cinq mois d'application de la loi relative au règlement collectif de dettes", *Rec.gén.enr.Not.*, 1999, p 321; Van den Haute, E., "Enkele knelpunten in de nieuwe wet betreffende de collectieve schuldenregeling", *Venn. & Fisc.*, 1999, p 298.

in order to have a composition granted were so severe that the entrepreneur who wanted to ask for a composition was mostly fulfilling the conditions of bankruptcy (49). It was only possible to have a compulsory composition granted when it was too late to cure the financial situation (50).

Now the reform of 1997 aims at drawing a clear distinction between bankruptcy and compulsory composition and, therefore, to differentiate the conditions of those two institutions.

The basic idea behind compulsory composition is the idea of going concern. There has been a lot of discussion on how to define going concern (51). In a general way, the basic concept of going concern can be defined as the idea that it is presumed that the enterprise will continue in operation for the foreseeable future, and that there is neither necessity nor intention to liquidate it (52). Compulsory composition supposes the intention to save the economic activity and to enable the company to go on with its business, even if there are temporary financial difficulties. This means that the basic idea behind a composition consists in trying to help a company which has temporary financial difficulties and requires for an intervention at a very early stage, because waiting too long could compromise the possibilities for the company of being saved.

On the other hand, the basic idea behind bankruptcy is one of interruption, because you have the statement that the legal person has ceased to exist (which does not necessarily mean that the business will be interrupted). The company still exists, but only on behalf of the liquidation and there are no more commercial activities, although it is possible to have interruption of the legal person (because of the declaration of bankruptcy) with a going concern of the business activities. : tThe receiver could deem useful to go on with the business for a certain time at least in order to maintain the goodwill attached to the business before selling or assigning the activities to a third party (the new law encourages the possibilities for a receiver to pursue the business of the bankrupt on behalf of the liquidation).

Because of these differences, the basic conditions to these two institutions have to be fundamentally different as well and the conditions of a compulsory composition should enable intervention at a very early stage (i.e. long before the conditions of bankruptcy are fulfilled).

II. Links between compulsory composition and bankruptcy

3. It is important to see which possibilities do exist to declare a merchant bankrupt within the composition proceedings and, in a more specific way, which are the risks

(49) Also see : Colle, Ph., "De nieuwe wetgeving betreffende het gerechtelijk akkoord" *in* Faillissement & Gerechtelijk akkoord, *loc.cit.*, p 199.

(50) Dumon, Y. and Stranart, H., *loc.cit.*, p 849.

(51) On this matter, we refer to Ondernemingsdiscontinuïteit – Discontinuité des entreprises, Kluwer, Antwerpen, 1983; Accountants International Study Group, *research paper*, Going concern problems-current practice in Canada, U.K. and U.S.A.. Going concern can be defined in quiet a lot of ways and the definitions will vary from one branch to another, although it is certain that there is a basic concept which underlies all principles and practices.

(52) A.I.S.G., Going concern problems-current practice in Canada, U.K. and U.S.A, § 2.

for a company to be declared bankrupt after having filed a request for composition to the court.

4. At the first stage, under the new laws governing compulsory composition and bankruptcy, it is clear that whenever a request for composition has been filed to the court, the debtor (who filed the request) cannot be declared bankrupt until a judgment has been rendered on this request (53). As the basic idea behind composition and bankruptcy is now fundamentally different and as the conditions to fulfill for those two institutions are different as well, it is logical that if a merchant fulfills the conditions of a compulsory composition, he does not (yet) fulfill the conditions of bankruptcy.

This rule raises the question whether the debtor cannot take advantage of the situation and file a request for composition in order to delay bankruptcy and, if he is mala fide, to hide some of his assets. The risk of abuse seems rather limited for different reasons.

The first reason is the fact that the delay would be very short, as the judgement on request for composition has to be rendered within 15 days (which supposes, of course, that this delay is respected by the courts). A second reason is the rule that states that, under the Belgian law, the debtor has the obligation to declare the state of bankruptcy within the delay of one month, as soon as he has drawn the conclusion that he is in a state of bankruptcy (54). Not doing this (or filing a request for composition instead of declaring the state of bankruptcy, for example) constitutes a criminal offence, so that this may add to the pressure not to exploit the situation. A third and more effective reason, is the so called *suspect period*. The court has the possibility to fix the date of cessation of payments (55), which means that all payments and some operations done after this date will be voidable vis-à-vis the beneficiary. This certainly limits some of the risks of abuse. Finally, the last reason consists in the possibility to deprive the debtor of the right to dispose of his assets (56), although this possibility appears to be rather theoretical at this stage, because the court has to be seized by one of the creditors. The problem is that most creditors will not know anything about a request in compulsory composition, since there is no publicity for the request in itself during the 15 days period. On the other hand, publicity at this stage would entail the risk of loss of confidence on the part of the debtor's business partners and the risk that the debtor's business - and therefore the possibility to cure his situation with a composition - collapses.

5. During the compulsory composition proceedings, there are four instances at which a debtor can be declared bankrupt :

- When the request for composition has been rejected, the court can declare the debtor bankrupt in the judgment rejecting the request for composition (57). This is logical, because when a request for composition has been rejected, this means that the debtor

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(53) L. July, 17th, 1997, art. 12.

(54) L. August, 8th, 1997, art. 9. See : Dumon, Y., *loc.cit.*, p 789.

(55) L. August, 8th, 1997, art. 12; If there are serious reasons which point out that payments have already ceased before the date of declaration of bankruptcy, the judge can declare officially the date of cessation of payments, which has to be within the last six months preceding the date of declaration of bankruptcy. See also, Caeymaex, J., "Les dessaisissements et la période suspecte" *in* Syllabus Journées d'études Skyroom Events, September 25th, 1997, p 269.

(56) L. August 8th, 1997, art. 8. See : Bossu, W., "Introduction to the Belgian bankruptcy law reform".

(57) L. July 17th, 1997, art. 15, § 2.

does not fulfill the conditions for a composition, in most cases because his situation has deteriorated in such a way that it cannot be cured anymore within a reasonable period of time so that the debtor in fact fulfills the conditions of bankruptcy. It is important to note that the debtor has to be heard on the fulfilment of the conditions of bankruptcy.

- Secondly, when the composition is accepted the court gives the debtor a time period the so-called *moratorium*, during which the debtor will have to elaborate some proposals together with a person (*commissaire au sursis*) appointed by the court in order to assist the debtor. During this period, if the conditions for compulsory composition are not fulfilled anymore and the debtor is in a state of bankruptcy, the court can declare the debtor (who has to be heard specifically on this matter) bankrupt (58).
- When the proposals are made, they will be submitted to the court again and the creditors, debtors and the *commissaire au sursis* will be heard about these proposals, at which stage a permanent arrangement containing all or some of these proposals can be accepted. It is also possible that a permanent arrangement is immediately rejected because the judge concludes that the proposals made in the permanent arrangement are not realistic, for instance that there is no possibility for going concern and in that case he can again declare the company bankrupt if the conditions of bankruptcy are fulfilled (59). The debtor has to be heard specifically about the fulfilment or not of the conditions of bankruptcy.
- Finally, when the permanent arrangement is withdrawn during its performance (for instance, if it is not performed correctly by the debtor) it is possible to declare the debtor (who has to be heard specifically on this matter) bankrupt (60).

6. If, at some stage of the proceedings of composition, the debtor has been declared bankrupt, some practical issues may arise.

First, it is important to define the status of debts contracted during the proceedings of compulsory composition. It is of course vital for the chances of success of compulsory composition proceedings to encourage business partners, potential business partners and creditors to go on with the business, which has to be the main aim of the procedure. That is why the debts contracted during the compulsory composition will be considered as preferred, but only if they were *"authorized"* by the referee appointed by the court (*commissaire au sursis*). As the legal terms are not very clear (61) the question to know what is to be understood by *"authorized"* remains controversial.

Secondly, what will be the status of all payments made during the compulsory composition ? Still based on the going concern philosophy of a compulsory composition and in order to encourage all business partners and creditors to go on operating as usual during the proceedings, it has to be admitted that all payments made during the

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(58) L. July 17th, 1997, art. 24.

(59) L. July 17th, 1997, art. 33.

(60) L. July 17th, 1997, art. 37, § 3.

(61) The terms used by the law are *"medewerking, machtiging of bijstand"* in Dutch and *"la collaboration, l'autorisation ou l'assistance"* in French and can be interpreted in many different ways. See: Verougstraete, I., Manuel de la faillite et du concordat, 1998, p 58 and p 215; Ernst, Ph., "Verbanden tussen het gerechtelijk akkoord, het faillissement en de vereffening van vennootschappen na 1 januari 1998", *Venn.&Fisc.*, 1998, p 193.

composition proceedings can be held against the group of creditors in bankruptcy (estate) (62). But here again, the payments have to be *"authorized"* by the referee appointed by the court (*commissaire au sursis*).

Finally, the rights of creditors who have accepted an arrangement within the framework of compulsory composition remain untouched. But this rule raises the question as to know whether creditors who have accepted to discount their claims and to grant a partial debt relief within the framework of a compulsory composition can now claim (in the bankruptcy proceedings) again the entire value of their credits or if they are bound by the debt clearances granted during the composition proceedings ? The idea prevailing is that the rights of such creditors remain totally valid and what was previously granted within the framework of a compulsory composition is not relevant anymore for the bankruptcy proceedings (63).

7. Finally, some difficulties may arise when the debtor has been declared bankrupt *after* the composition proceedings. This can mean that the debtor is declared bankrupt after having fully performed the permanent arrangement, or that the permanent arrangement which has been granted has been withdrawn at a certain point.

8. If a permanent arrangement has been fully performed, and the compulsory composition proceedings are finished, there is a sort of debts clearance for all debts concerned by the arrangement (idea of the *fresh start*). These debts will of course not be concerned by the bankruptcy proceedings.

On the other hand the bankruptcy proceedings will apply to all other debts which again brings up the question of the status of the debts contracted during the composition. Here, the same rule as the above mentioned rule, will apply : in order to encourage the creditors and the future business partners, these debts will be preferred in the bankruptcy procedure if they have been *"authorized"* by the referee appointed by the court (see also n° 6) (64).

9. If the permanent arrangement has been withdrawn, the proceedings of compulsory composition are also over. In this case, the consequences of bankruptcy will be identical to those of a bankruptcy declared during the compulsory composition proceedings and the rights of the creditors will remain entire (65).

III. Links between compulsory composition and voluntary liquidation

10. Before examining the existing links between compulsory composition and voluntary liquidation, it has to be stressed that under Belgian law, these two institutions have different aims: compulsory composition is defined by the basic concept of going

(62) L. July 17th, 1997, art. 44.

(63) Verougstraete, I., *loc.cit.*, p 215-216, n° 318; Ernst, Ph., *loc.cit.*, p 191, n° 19. The main idea is that, unless stated differently by the law (such as for example art. 43, L. July 17th, 1997 concerning the assignment of business activities) all consequences from the compulsory composition disappear.

(64) L. July, 17th, 1997, art. 44.

(65) Ernst, Ph., *loc.cit.*, p 196, nr. 35.

concern whereas voluntary liquidation is dominated by the idea of disruption of the legal person which ceases to exist (the legal person will only exist on behalf of the liquidation) and which most of the times, is accompanied by an interruption of business activities – or at least an assignment of those activities. Voluntary liquidation does not tend to prevent, as does compulsory composition, bankruptcy. Voluntary liquidation can therefore not be seen as an alternative for compulsory composition.

11. First, the law states implicitly that any legal person has the right to choose between voluntary liquidation and compulsory composition. Even if the company fulfills the conditions of compulsory composition, it can still decide to stop all activities and go into liquidation. The relevant article says indeed that this choice *remains* intact even if the proceedings of compulsory composition are initiated by the public prosecutor (66).

This existing choice seems strange when reading art. 12 L. July 17th, 1997, which says that it is not possible for a company to be liquidated when a request for compulsory composition has been filed to the court. This seems contradictory to the right of choice as explained before.

One acceptable explanation, combining art. 11, § 2 and art. 12 L. July 17th, 1997, is to admit that although it is possible during the concerned period (15 days) for the general meeting to take the decision to go into liquidation, the company cannot yet be liquidated and the liquidator appointed by the general meeting will have to wait until there is a judgement on the conditions of compulsory composition before undertaking any action (67). It can of course be objected it is not very logical for a company first to ask for compulsory composition (in order to try to save its business in going concern), and then to decide to go into liquidation (and thus interrupting or assigning its business activities).

Another possible explanation considers that article 11, § 2 (right of choice between compulsory composition and voluntary liquidation) is limited to the cases where it is not the company itself that files a request for compulsory composition but the public prosecutor (68).

On the other hand, we don't think that it is acceptable to give full priority to article 12 (which would mean that as soon as a the proceedings of compulsory composition have been initiated, it would not be possible anymore for the company to go into liquidation) (69). It will indeed not be very useful to proceed with compulsory composition if the debtor is no longer interested in pursuing his activities and just wants to stop everything and go into liquidation.

As these discussions tend to show, even if there is some discussion on the question to know if a company can decide to go into liquidation or not after a request for composition has been filed to the court and before the court has rendered a judgement

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(66) L. July 17th, 1997, art. 11 § 2.

(67) Ernst, Ph., *loc.cit.*, p 199, n° 54.

(68) Ernst, Ph., *loc.cit.*, p 200, n° 56.

(69) Contra : Windey, J., "Les conditions d'obtention du concordat et le déroulement de la procédure" *in* Syllabus Journée d'études Skyroom Events, September 25th, 1997, p 37, nr. 48; Wymeersch, E., "De invloed van de Faillissementswet en de Wet Gerechtelijk Akkoord op het vennootschapsrecht" *in* Faillissement en Gerechtelijk akkoord : het nieuwe recht, (Eds.) Braeckmans, H., Dirix, E. and Wymeersch, E., Antwerpen, Kluwer, 1998, n° 27.

on this request, it seems almost certain that there is no possibility for a company to be liquidated within this period. This means that even if a company takes the decision to go into liquidation during this period, it has to wait the judgement on the request for composition before it can undertake anything regarding the liquidation.

12. However, a company can go into liquidation and be liquidated during the *moratorium.* There may be a lot of reasons why a company would want to go into liquidation during this period, as this is precisely the period where the company is examining all the possibilities together with its accountants and the experts or referees nominated by the court. On the other hand, there are no reasons why it should not be possible for a company to decide to go into liquidation during this period and to do effectively so.

13. The problem which arises is of course that liquidation could cause some inconveniences to the creditors, because the debts against business partners contracted during these proceedings would not be preferred (which makes this situation different from the one where the debtor is declared bankrupt during the proceedings). We would prefer a solution where no difference would be made between bankruptcy and voluntary liquidation whenever they occur during the compulsory composition proceedings. Otherwise the system (which is based on the idea that is vital to encourage all business partners and creditors to go on dealing with the debtor during the composition proceedings) will collapse (how can business partners or creditors know in advance if the debtor is more likely to be declared bankrupt during the composition proceedings or if he is more likely to decide to go into liquidation...?). These inconsistencies tend to show that that voluntary liquidation had to be reformed together with bankruptcy and compulsory composition.

14. Can voluntary liquidation be seen as an alternative for bankruptcy? We are convinced that it can under Belgian law, as the law governing compulsory composition tends to show. In all European countries lawmakers want to simplify the proceedings and liquidation is a simpler procedure than bankruptcy, the cost is less important and it is possible to act more quickly, which can be very important when one needs selling the company's business to another company, while in bankruptcy the receiver has always to go back to the referee and ask the authorization. On the other hand, the philosophy behind the new bankruptcy law is different, there is the fresh start philosophy and the idea that being bankrupt should not be considered negative as before; but bankruptcy still creates a negative publicity which is not attached to voluntary liquidation.

Finally, voluntary liquidation can be seen as an alternative to bankruptcy, especially when you see that the law on composition allows the judge in three out of four cases to choose whether to declare the company bankrupt or to order to the *commissaire au sursis* to call a general meeting to decide upon liquidation, even when the conditions for bankruptcy are fulfilled (art. 45 Law July 17th, 1997).

IV. Links between bankruptcy and voluntary liquidation

IV.1 *Principle*

15. The principle has been established by the Supreme Court of Belgium in a decision rendered on June 17th, 1994 (70). In this decision the Supreme Court of Belgium (*Cour de cassation*) admits first that a company in liquidation, which does only exist on behalf of the liquidation, has still to be considered as a *merchant.* It can therefore be declared bankrupt as soon as the conditions of bankruptcy are fulfilled. This principle has been confirmed in the new law governing bankruptcy: art. 2 states that a any legal person which has been dissolved (i.e. gone into liquidation) can be declared bankrupt even during a period of six months after the closing of the liquidation. It seems therefore that, today, there is no doubt anymore about this question (71).

Even if the principle seems clear today (it is now beyond any doubt that a company in liquidation can still be declared bankrupt), the discussion remains on how to appreciate the conditions of bankruptcy whenever the debtor has gone into voluntary liquidation.

IV.2 *Cessation of payments*

16. The first condition, which supposes that the debtor has ceased to pay his creditors, raises a problem in the sense that the liquidation creates a situation of *concurrence* between all creditors. The consequence is that the liquidator is not allowed by the law to do any payments anymore. Does this automatically mean that there is cessation of payments as meant by art. 2 of the Law governing bankruptcy?

We believe that the simple fact that a liquidator decides (because he has to, according to the law and to his tasks) to suspend all payments to the creditors is not enough to fulfill the first of the conditions of bankruptcy. It has to be stressed that liquidation is in fact, in the long term, a kind of payment, because it involves the sale of the company's assets in order to satisfy (= to pay) the creditors, which means that all proceedings of the liquidator have but one aim: to pay the creditors as much as possible (even if the creditors have to wait a certain lapse of time and if there are some legal restraints) (72).

17. Does this mean that the above does not apply to a liquidation where the assets are not important enough to satisfy all creditors ? In other words, do we have to admit that whenever the liquidation of a company does not allow to satisfy the non-privileged

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(70) Cass., June 17th, 1994, *T.R.V.*, 1994, p 598.

(71) Before the decision rendered by the Supreme Court, some authors stated that a company in liquidation cannot be a *merchant* because it has stopped operating and it does not do anymore business (Grégoire, M., Comment on Comm. Brussels, april 2nd , 1991, *R.D.C.*, 1991, p 627; Geinger, H., Colle, Ph. and Van Buggenhout, Ch., "Overzicht van rechtspraak (1975-1989) - Het faillissement en het gerechtelijk akkoord", *T.P.R.*, 1991, p 428) whereas others rejected this opinion (Coppens, P., "Examen de jurisprudence (1965-1968) - Les faillites et les concordats", *R.C.J.B.*, 1969, p 367, n° 4; Geens, K. and Laga, H., "Overzicht van rechtspraak (1986-1991) - Vennootschappen", *T.P.R.*, 1993, p 1166 - 1168; Kevers, Y., "La mise en faillite d'une société en liquidation", *J.T.*, 1988, p 637-640; Termote, P., "Het faillissement van de vennootschap in vereffening en de derogerende werking van de samenloop", *T.R.V.*, 1994, p 602-603).

(72) Grégoire, M., Théorie générale du concours des créanciers en droit belge, Bruylant, Brussels, 1992, p 357; Termote, P., *loc.cit.*, p 603

creditors, the decision to liquidate the company leads automatically to bankruptcy ? It seems clear to us that the fact that the company's assets are not important enough to satisfy all creditors should not necessarily be seen as the fulfilment of the first condition of the state of bankruptcy. We believe indeed, here again, that the Courts should be flexible in appreciating the condition of cessation of payments and should take account of the fact that the company has gone into liquidation and that a worthy and independent liquidator is trying to make the best of it. Our view on this point is confirmed by the preliminary works to the reform because an amendment, according to which a liquidator would have to declare the state of bankruptcy of the company in liquidation, as soon as it appeared that the company's assets were not sufficient to satisfy all creditors, has been rejected (73). We may therefore infer that it should be possible to have a voluntary liquidation instead of a bankruptcy, even when a company's assets are not important enough (74).

IV.3 *Lack of credit*

18. The second condition of bankruptcy is also very difficult to appreciate because the situation of a company in liquidation cannot be compared to the situation of a company in going concern. A company which goes on operating needs the credit of its business partners, whereas a company which has gone into liquidation has ceased to operate and does not need the same kind of credit any longer.

One convincing way is to consider that the credit of a company in liquidation, which has undoubtedly to be appreciated differently, can be measured in the trustworthiness of the liquidator. If the company has appointed a trustworthy and independent liquidator who is doing rather well and who receives the credit of all or most of the creditors (which is the case as long as they accept the suspension of payment and await the outcome of the liquidation without filing any proceedings against the company in liquidation), the second condition of bankruptcy is not fulfilled (75). This opinion is acceptable, we believe, as far as the Courts show some flexibility (the demand of one creditor tending to get the company declared bankrupt would not be sufficient to admit a breach of trust). The Court has to examine how the liquidator does his work, if he is independent and trustworthy, and if other creditors do trust his work regarding the proceedings of liquidation.

IV.4 *Can voluntary liquidation be seen as an alternative to bankruptcy?*

19. At the heart of the above discussion is the question whether voluntary liquidation is an acceptable alternative to bankruptcy. We do believe that voluntary liquidation is a serious alternative to bankruptcy. But, even if this is admitted by the Belgian law from a technical point of view, the idea itself is not yet widely accepted (76).

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(73) Report Hatry-Vandenberghe, June 20th, 1997, Senate, *Doc.Parl.*, 1996-1997, nr. 1-498/11.

(74) Ernst, Ph., *loc.cit.*, n° 106.

(75) On this opinion, see: Grégoire, M., *loc.cit.*, p 358-359, who underlines the fact that the conditions of bankruptcy do not fit very well for a situation of voluntary liquidation: the two situations cannot be compared.

(76) See also, above n° 14.

V. Conclusions

20. One of the main goals of the Belgian reform was to have compulsory composition as a general rule, and to limit bankruptcy to the desperate cases. However, the latest available figures show that bankruptcies outnumber largely the few cases of compulsory composition (in 1999, more than 7000 Belgian companies were declared bankrupt, whereas only 163 compulsory compositions were filed to the courts - of which only four where fully applied) (77).

We believe that one of the main reasons of this failure is the fact that most debtors realize too late how bad their financial situation is and that, even now with clearly distinctive conditions to bankruptcy and to compulsory composition, compulsory composition is still considered as something very negative which in the end, will lead to bankruptcy. Most business partners are therefore afraid to go on dealing with a debtor who filed a request for compulsory composition. It seems therefore important to stress the differences between compulsory composition and bankruptcy (78) and to enable and to encourage debtors to file a request for compulsory composition at a very early stage (and not to wait until it is too late).

On the other hand, it is important to maintain a certain flexibility, even when it appears that the financial situation of the debtor cannot be cured anymore within a reasonable period of time: bankruptcy is one possibility, but regarding the cost of the proceedings it should be limited to the cases where the supervision by the court appears to be necessary (for instance, when there is an important risk of abuse). In all other cases, voluntary liquidation (or semi-voluntary liquidation) should be accepted as a serious alternative (the Belgian law governing compulsory composition admits this from a technical point of view, although the idea itself is not yet very much accepted).

Finally, bridges should be built in by the law between compulsory composition and bankruptcy on one hand, and between compulsory composition and voluntary liquidation on the other hand. And, before considering the idea of voluntary liquidation as an alternative to bankruptcy, it is, of course, important to create links between these two institutions (in order to enable creditors who are not satisfied with the way the liquidation

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(77) Figures released by Echo de la Bourse, January 19th, 2000, "Deux tiers des concordats débouchent sur la faillite", also available on http://www.echonet.be

(78) For the same reason, and because of the fact that the aim of a compulsory composition (trying to save the business in *going-concern*) is totally different from the aim of bankruptcy (liquidating the assets in order to pay the creditors), we do believe that compulsory composition does not create – under Belgian law – a situation of concurrence (*concursus*) between all creditors (even if some rules governing compulsory composition are not very different from some of the consequences of a typical situation of concurrence, such as bankruptcy or voluntary liquidation). This opinion, although very much debated in Belgium, seems to be confirmed from a technical point of view. On this debate: see also: Van Buggenhout, Ch., "Gerechtelijk akkoord en samenloop", *R.D.C.*, 1999, p 157; Grégoire, M., Théorie générale du concours des créanciers en droit belge, Bruylant, Brussels, 1992, n° 405; Van den Haute, E., *loc.cit.*, p 23, n° 28; Poelmans, O., "Le concordat et le concours après la loi du 17 juillet 1997", *R.D.C.*, 1999, p 144; Dieux, X. and Windey, J., "Nouvelles observations sur la théorie générale du concours entre les créanciers à la lumière de la loi du 17 juillet 1997 sur le concordat judiciaire et de ses premières applications" *in* Mélanges offerts à Pierre Van Ommeslaghe, Bruylant, Brussels, 2000, p 378.

is being dealt with to file a request to the court to declare the debtor bankrupt) and to build in some guarantees for the creditors (79).

The law governing bankruptcy, compulsory composition and voluntary liquidation do not only have to strike a delicate balance between these three institutions, but – the most difficult part of all – also a balance between the rights of the debtor (who should not get away with his assets, but who should nevertheless benefit from a *fresh start*), the rights of the creditors (who should be protected against the debtor, but also against each other) and the powers of supervision (receiver, liquidator, *commissaire au sursis*, courts). The perfect balance between all these does probably not exist...but it's worth a try at least!

(79) For instance, the law should state that only professional liquidators who can offer some guarantees regarding their independence (such as for example lawyers) can be appointed to liquidate a company. See: Grégoire, M., *loc.cit., R.D.C.*, 1991, p 627.

ITALIAN CRISIS PROCEDURES FOR ENTERPRISES: AN OVERVIEW

Roberto Cercone (80)

1. The legal basis for dealing with enterprises in difficulties in Italy is the Insolvency Act, of 1942 (Royal Decree n. 267). This provides for five different procedures for general application in cases of enterprises in distress.

Other procedures were introduced by specific statutory provisions at the end of the seventies and in the nineties; one is an administrative procedure to deal with large companies, special administration (*amministrazione straordinaria)*, provided by Law n. 95 of 3.4.1979, the so-called "Prodi Law", and reformed by Law n. 270 of 8.7.1999; others were conceived for specific situations of crisis (the most important being that provided by Law n. 33 of 17.2.1993, for the liquidation of EFIM, a State-owned holding company).

2. A general distinction between administrative and judicial procedures is helpful. The main differences are the following:

- the role of the judicial authorities; in judicial proceedings, the authorities perform functions of both supervision and management on the one hand and of dispute resolution on the other; in administrative proceedings, they are likely to act only as judges in lawsuitsperform only the latter, since management responsibilities are entrusted either to a government institution (Ministry) or to an independent authority (such as the banking or insurance supervisory authorities);
- the procedures for initiating and pursuing proceedings: judicial proceedings are generally initiated and pursued on the initiative of the debtor or creditors; administrative proceedings are implemented by the competent authority *ex officio*, regardless of specific requests from the debtor or creditors;
- starting requirements: judicial proceedings deal solely with economic crises (insolvency or financial difficulties); administrative proceedings can also address management pathologies (management irregularities or violations of laws or regulations).

Peculiarities of the administrative proceedings depend on the specific public interest in resolving the crises. In this case the supervisory authority is not neutral – as is a judge, who applies the law to resolve a dispute – but has a particular interest in monitoring the evolution of crises and, eventuallyin case, the exit of the distressed firms from the market. Administrative procedures are therefore aimed at firms which are subject to special regulations and controls on account of the need to protect general interests involved in such activities as banking, insurance, public sector concerns or co-operatives. Such distinctive characteristics of administrative procedures are without prejudice to judicial review in the event of complaint by interested parties.

3. The original architecture of crisis regulations, as envisaged in the 1942 Insolvency Act, provided for:

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- two procedures for the liquidation of firms, one judicial (bankruptcy), the other administrative (compulsory administrative liquidation);
- one procedure, a scheme of arrangement between the debtor and creditors, which can be concluded during bankruptcy (composition in bankruptcy – *concordato fallimentare*) or compulsory administrative liquidation (liquidation arrangement – *concordato di liquidazione*);
- two procedures aimed at the reorganisation of distressed enterprises: the deed of arrangement (*concordato preventivo)* and the moratorium (*amministrazione controllata*), so-called *minor procedures*.

All these procedures apply only to commercial enterprises, as defined in the Italian civil code, i.e. any company or individual enterprise whose main activity consists in the production of or trade in goods or services. Small entrepreneurs, as defined in the Italian civil code, are exempt; they are dealt with through normal procedures for default of payment.

Some firms, such as banks and insurance companies, are subject to administrative procedures under special laws.

I should like to focus my attention on judicial procedures, which applies to all commercial enterprises).

4. Bankruptcy procedures are initiated when an enterprise is deemed to be insolvent. Insolvency is not precisely defined. Nevertheless, the law indicates some symptoms of insolvency that must be present before proceedings can be initiated: they must show that the company is no longer able to settle its obligations regularly.

It is not sufficient for a debtor to default on payments: detailed analysis is required to check if defaults are effectively a symptom of a firm's general inability to meet its obligations.

The procedure is initiated by order of a specialised court (bankruptcy court) on the basis of a petition from the enterprise concerned, from a creditor or public prosecutor (who has specific powers in civil and commercial law under Italian legal system); the court can issue a notice of bankruptcy *ex officio,* without any kind of petition, if it has relevant information concerning a debtor's situation, although this is fairly uncommon.

The bankruptcy order issued by the court also appoints the bankruptcy officials: a judge (*giudice delegato*), with supervisory powers and a receiver / trustee in bankruptcy (*curatore fallimentare*), who directs the procedure.

The treatment of the bankrupt is inspired by the principle that failure is not a normal event in a risky activity like business, but is a reprehensible fault on the part of the enterprise. The debtor is subject to:

- divestment: the bankrupt is deprived of his right to manage his business and to dispose of assets; he is divested of any corporate authority;
- temporary loss of certain civil rights – such as passport or privacy of correspondence – and powers – such as the possibility of managing a business again after the proceedings have been concluded (*fresh start*);
- criminal prosecution not only in cases of fraud (*fraudulent bankruptcy*), but even if the business failure occurred as a consequence of mere negligence (*simple bankruptcy*).

With regard to creditors, no individual legal action may be taken against a bankrupt enterprise and no individual payment of credits is allowed; claims must be met according to the principle of equal treatment, on the basis of proportional distribution of the firm's assets.

Business is interrupted; contracts in force with other contractors are affected in different ways: some are interrupted automatically as soon as the proceedings is initiated; some, such as employment contracts, are not affected by bankruptcy; for others, the law allows the *curatore fallimentare* to choose whether to continue or interrupt business.

The bankruptcy officials identify the debtor's assets and liquidate them; they draw up a list of creditors' claims, in order to verify all the debtor's liabilities; finally, they distribute proceeds of the liquidation among the creditors.

The order of distribution is the following:

- expenses for proceedings and other expenses incurred in the continuation of business, when this is authorised by the court (first-priority claims);
- privileged and secured claims (priority claims);
- unsecured claims.

Distribution is made on the basis of equal treatment within each category: credits with the same level of priority are paid in proportion to the amount of each.

Assets in excess are returned to the debtor.

One way to end a bankruptcy proceeding is to agree to a settlement with creditors (composition in bankruptcy). In this case, the debtor offers all creditors a pre-defined percentage of payment, indicating dates and guarantees for fulfilling these commitments. Guarantees can take the form of the debtor's assets or be given by a third party, which acquires all the debtor's assets.

The scheme of arrangement can benefit both creditors, who thereby receive a larger share of their claims more quickly, and the debtor, who may thus achieve a speedy closure of the proceedings and also avoid the disqualification and criminal prosecution deriving from insolvency. The third party also has an advantage in guaranteeing the debtor's obligations, as he obtains his assets in exchange.

5. The scheme of arrangement (*concordato preventivo*) presupposes the debtor's insolvency, which is the same condition required for initiating bankruptcy proceedings.

The scheme of arrangement comprises a settlement between the debtor and the creditors, which is reached under judicial supervision.

The procedure is very similar to the composition in bankruptcy; but in this case, the court does not declare the debtor to be bankrupt and requires that a minimum level of payments be made, which is not requested for the composition in bankruptcy. The debtor must offer to settle his debts, giving creditors and the court assurances that 100% of all privileged and secured claims will be settled and at least 40% of unsecured claims met. Sufficient evidence that these commitments can be met must be provided.

The debtor has two main options under statutory provisions:

- to offer real or personal guarantees that the above amounts of debt will be paid (deed of arrangement with guarantee);

- to offer all his assets to the creditors, who are responsible for liquidating them, satisfying their own claims and returning excess assets to the debtor (deed of arrangement with transfer of goods to creditors).

The courts may allow the parties to set up mixed schemes. One important scheme invented by debtors and creditors provides for the debtor to nominate a third party, who acquires the debtor's assets and, in exchange, guarantees his commitments in favour of the creditors (the above mentioned minimum level of payments).

The scheme of arrangement is initiated by a petition from the debtor; the debtor is the only person who may request this procedure; creditors have no such power.

The debtor's demand is evaluated by the court in order to check that all the legal conditions are fulfilled (minimum level of payments and sufficient guarantees). If the assessment is positive, the court orders the opening of proceedings; it appoints a *giudice delegato* and a commissioner. The latter supervises the evolution of the proceedings, verifies the consistency of the conditions with the debtor's circumstances and indicated guarantees and, if the debtor's proposal has been approved by creditors and recorded by the court, monitors performance. Contrary to bankruptcy, the debtor usually remains in business, but under the supervision of the court.

As a consequence of the opening of the proceedings, creditors may not initiate legal actions against the debtor in order to enforce their claims, which are paid according to the condition of the arrangement, if this is approved, or as provided in the bankruptcy proceedings. The law provides for no interruption of business transactions.

The conditions of the agreement, proposed by the debtor, must be accepted by unsecured creditors at a meeting at which they vote; each vote has the same weight as all the others; the creditors are not ranked in importance; the debtor's proposal is approved if it obtains as many votes as are necessary to reach the absolute majority of creditors and a two-thirds majority of the total amount of claims.

No approval is required of secured creditors, since they are expected to receive the total payment of their claims; as I said before, this is a statutory requisite for this kind of procedure.

After the creditors have expressed their approval, the court orders deed of arrangement to be recorded and the procedure ends when the arrangement is fully complied with. If the debtor's proposal is not approved or if, after approval, the debtor fails to meet his obligations to creditors, the court initiates proceedings for bankruptcy.

6. The moratorium (*amministrazione controllata*) is a kind of special administration: it aims to overcome a transitory situation of distress in the life of an enterprise. It presumes that the debtor's difficulty in meeting his obligations is momentary and that the situation can return to normal.

The meaning of momentary distress has been variously interpreted:

- as a situation of financial difficulty, such as a momentary mismatching between financial revenues and outgoings (in a condition of balanced assets and liabilities); in other words as a momentary liquidity problem;
- as indicative of a more serious situation of economic losses and shortage of assets, due to poor business performance.

The second interpretation leads to wide recourse to the moratorium, allowing its use in cases of more severe economic pathology than simple illiquidity. The important point to stress is that statutory provisions require that the enterprise show prospects of returning to normal.

The initiation of this procedure is conditional on the completion of a thorough study of the debtor enterprise's prospects.

The moratorium has some features in common with the scheme of arrangement:

- it is initiated on the order of a judge in response to a petition by the debtor; it is open only to debtors, not to creditors;
- the court appoints a *giudice delegato* and a commissioner; their duty is to control corporate management and verify the chances of overcoming the difficulties;
- the debtor can continue to manage the business but the judge may at any time entrust the management to the commissioner;
- a statutory effect of the moratorium is the suspension of all legal proceedings initiated by creditors to enforce their claims; this measure gives the enterprise a period of respite during which it can start to reorganize;
- business is not suspended and funds can still be borrowed from creditors.

7. The Italian legislation for dealing with enterprises in distress is based on simple assumptions:

- financial distress and, in particular, insolvency, are negative events, which are the consequence of inappropriate behaviour, which must be sanctioned on different levels;
- consequently, the procedures are envisaged to protect creditors from the unfair behaviour of debtors; statutory provisions do not consider a crisis to be physiological, even in a risky activity such as business, and a normal effect of competition;
- the proceedings consist in the compulsory sale of a debtor's assets with no proper regard for the firm as a producer and no specific provision for the protection of its productive potential. The moratorium allows for some scope to keep the business as a going concern, but it was originally conceived to address minor, temporary, problems that could be ultimately solved by the entrepreneurs' own means, rather than more critical situations requiring more decisive measures such as the sale of a firm, new partnerships, mergers, etc.

The above describes the original crisis regulations as conceived in the forties. Their actual enforcement changed in the following decades. Deviations from the original scheme were more frequent during periods of economic depression, when insolvency procedures are usually more common.

Economic distress causes a rise in the number of troubled firms and in the severity of their difficulties; the increased weakness of the productive system sharply highlights all critical aspects of the regulations.

With regard to the Italian system, the most important deviation from the original view occurred in the seventies and in the nineties. The approach to corporate difficulties was profoundly reconsidered.

In particular, in the seventies Italian enterprises were affected by structural imbalances and the need for reorganisation in order to increase their efficiency. It was

of priority importance to ensure that this process could take place in a context of continuity of economic activities. This approach was thought to be essential in order to safeguard national productive capacity and social peace by maintaining high employment levels.

8. An answer to these needs was provided, firstly, by the bankruptcy courts and, later, by Parliament. The courts began to give a new interpretation of some essential rules in order to find a new way of applying procedures to specific situations: this approach was called "*alternative use of proceedings*", to distinguish it from the original approach.

Briefly, the aim of this re-interpretation was to avoid bankruptcy and business interruption for as long as possible. This goal was achieved by extending the scope of application of certain proceedings, principally the moratorium. This was used even when there was no serious prospect of restructuring the business. The result was to assure continuity of business, the preservation of manufacturing facilities and the maintenance of employment levels, postponing the definitive exit of the enterprise from the market, which nonetheless remained the inevitable conclusion of these procedures.

The continuation of business was made possible using financial resources available to the enterprise, to the detriment of other creditors. In fact, after a moratorium order by the court, firms may borrow funds fairly easily, because credits arising during the moratorium are classified as first-priority claims; they must be paid before any other secured or unsecured claims, even if the latter predate the moratorium.

Legislation was not very different. During the seventies a number of laws were approved to support specific manufacturing sectors, by offering a government guarantee for new credits granted to distressed firms; once again, support was generalised, rather than specifically addressed to concerns assessed as creditworthy on the basis of a technical evaluation of their chances of overcoming their economic difficulties.

We may conclude that the need for a different approach to the crisis was satisfied by re-interpreting existing procedures, which had not been created to meet new needs, and by improvising State intervention.

9. At the end of the seventies, the legislative process culminated in approval of the first general regulation of insolvency after the bankruptcy law of 1942. This new law of 1979, supplementary to 1942 law and reformed in the 1999, (81) was intended to manage crises of large companies and groups.

Statutory provisions introduced a procedure called special administration (*amministrazione straordinaria delle grandi imprese*), which can be initiated in cases of insolvency, as an alternative to bankruptcy. The procedure aims to reorganise insolvent corporations rather than to liquidate their assets; this objective is achieved by restructuring business or transferring assets to others companies as going concerns.

It was also the first Italian bankruptcy law to provide for the insolvency of group; special administration may be extended to the holding company and subsidiaries of an insolvent company. But even if several companies belong to the same group, proceedings

(81) See the following contribution by Monica Marcucci, *The Inefficiency of Current Italian Insolvency Legislation and the Prospects of a Reform*, p. 49-50.

must be pursued separately, each company maintaining its own assets and liabilities separated from those of all the other group's members submitted to the special administration; the Italian system does not recognise a consolidated approach of crisis management.

The Ministry of Industry and Trade appoints a commissioner and supervises the special administration proceedings. The commissioner has to verify the conditions of the firm and draw up a restructuring plan, containing detailed indications of the operation needed to rescue the company or companies: mergers, divisions, transfers, or, if there is no hope for a successful restructuring, liquidation.

The results of this law have not been encouraging; in the first decade of its application (eighties), the special administration failed to restore firms to health, basically because the procedure was used as a last resort, when there was already no chance of success. In the second ten years (nineties), there were some signs of improvement. The most critical aspect proved to be the liquidation stage, because the option of continuing business and protecting employment levels was preferred to the liquidation of assets and the payment of creditors, even in the most hopeless cases.

10. The nineties brought increased awareness of the inadequacy and inefficiency of crisis regulations, as a new wave of economic difficulties highlighted the chronic problems inherent in the procedures: excessive recovery costs for creditors, too much time needed between the initiation of a procedure and recovery and failure to restore firms to health.

A survey by Banca d'Italia in 1993 illustrated this phenomenon; the survey also pointed out another phenomenon, which was totally new. A response to the need for more effective procedures came from private parties. Those years witnessed the diffusion of agreements between debtors and creditors (*extrajudicial arrangement*) aimed at solving crises without the intervention of the authorities.

Private agreements may envisage a simple debt restructuring operation or a more complex rescue package comprising every measure thought necessary to restore an enterprise to health, including stock transactions, internal restructuring, definition of new strategies and so on.

They may also include the constitution of a committee of representatives from the largest creditors, with a wide range of powers and functions: checking the exact fulfilment of the enterprise's commitments, controlling key business transactions or approving strategic decisions such as mergers, changes in the type of business, capital increases, entering new markets, etc.

Extrajudicial agreements are highly flexible, they are agreed by the interested parties, may not be subject to a court decision, can be set up without the intervention of the administrative authorities and are not governed by specific statutory rules.

The private regulation of crisis management has proved to be more efficient than procedures prescribed by law; statistical data show they can ensure higher rate of recovered credits in much less time.

A general evaluation of these practices is not easy: on the one hand, they provide a clear evidence of the interest of private parties in looking for new way of dealing with crises efficiently; on the other hand, they reduce the scope of legal proceedings, shifting crisis management to an area without sufficient regulation.

Commentators highlighted the failure of extrajudicial arrangements to solve crucial issues such as dissent among creditors (agreements are successful only if all the creditors approve the restructuring plan, but not otherwise). This problem becomes even more complicated if the creditors are both professional intermediaries and small creditors, which are less amenable to self co-ordination and are generally less interested in safeguarding the business.

Other problems arise from the failure of restructuring plans: in this case, transactions carried out according to the plan's provisions, such as payments to creditors or the borrowing of funds, can be swept away by bankruptcy officials as a consequence of the application of statutory provisions regarding acts detrimental to creditors (*revocatorie*).

To conclude, we can say that the Italian bankruptcy system is quite inadequate in satisfying the expectations of both firms and their creditors. The experience of recent years has provided some suggestions for a reform of statutory regulations, such as the importance of self-regulation through private agreements. These suggestions will be addressed in the debate about renewing the bankruptcy law.

THE INEFFICIENCY OF CURRENT ITALIAN INSOLVENCY LEGISLATION AND THE PROSPECTS OF A REFORM

Monica Marcucci

1. The inefficiency of current insolvency legislation

The need for a change in current Italian insolvency law is unanimously acknowledged. The main legislative source, the Insolvency Act, dates back to 1942 and has proved unable to resolve the problems of distressed firms in the modern economic context.

The demand for reform thus arises from the perceived inefficiency of current bankruptcy procedures, the main limits being the following:

- scant consideration for the objective of protecting the value of the firm;
- harsh punishment for debtors, reducing the incentives to initiate the procedure in good time;
- lack of provisions permitting the transfer of bankrupt firms as going concerns;
- complexity, excessive length and high costs of the proceedings.

Most of these shortcomings are a consequence of the limited scope of current bankruptcy legislation, which is essentially intended – as specified in the Insolvency Act's official Report – as a means to wind up the enterprises and to expel them from the market.

Consistent with that aim, the primary concerns of the bankruptcy process are the punishment of the inefficient debtor and the protection of the interests of creditors (i. e. satisfaction of their claims). In this context, the interests of the debtor are not taken into account, while the creditors are merely participants in a compulsory proceeding, in which they play a marginal role. On top of this comes the paradox that at the end of the proceedings the creditors normally see only a very small percentage of their claims reimbursed.

2. Alternative procedures to liquidation

At the moment, the only way to avoid the liquidation of a firm's assets once insolvency procedure has been initiated, is to submit to the court an offer of settlement (the so-called *concordato fallimentare*).

The usefulness of this instrument is limited by the fact that the only person entitled to propose it is the debtor himself, in other words, a person who has been divested of control over the firm and is not, therefore, well placed to value the real chances of rehabilitation. In any case, the additional requirements of full payment of secured and priority claims and absolute compliance with the principle of *pari passu* for general creditors, effectively render recourse to this alternative procedure both difficult and infrequent.

Furthermore, the other two alternative insolvency proceedings available, i.e. the deed of arrangement (*concordato preventivo*) and the moratorium (*amministrazione controllata*) also suffer from major shortcomings.

With regard to the **deed of arrangement**, its effectiveness is substantially hampered by the provision requiring the debtor to guarantee payment of at least 40% of all unsecured claims, with no possibility of avoiding liquidation by offering to pay a smaller percentage, even if the latter is more than they would receive in the event of liquidation.

As to the **moratorium**, the first obstacle to this procedure is the provision requiring evidence of the possibility of reorganizing the enterprise to be given soon after the beginning of the proceeding, when it is still difficult for the court to value the concrete prospects of rescuing the firm. Another problem arises from the provision requiring debtors to make full payment by the end of the procedure, with no possibility of rescuing the firm through agreements with creditors, under the supervision of the competent authorities.

Two more elements must be considered when analyzing the inefficiencies of current legislation. First of all, it is important to mention the major distortions caused by the gradual narrowing of the courts' role in extraordinary legislative measures adopted in recent years (in the 1990s) to overcome crises in large Italian industrial companies (e.g. the Efim law and other emergency measures).

It is also important to recall the excessively limited role of voluntary out-of-court insolvency arrangements in our system. In fact, the out-of-court solution of crises is hindered by the risk that bankruptcy will be declared when partial payments have already been made or the crisis has deepened, with the consequent risk of criminal liability (for example, for complicity in fraudulent bankruptcy).

3. Economic effects of the inadequacy of the current legislation

The above-mentioned limits of current insolvency procedures have serious effects on the Italian economy: our productive structure, comprising a very large number of small firms, is particularly open to the risks arising from inefficient insolvency legislation.

Small firms have high birth/death rate and are consequently fairly likely to be involved in insolvency proceedings. Another factor is the inefficiency of market for reallocating ownership of small firms, due to typical information problems. Moreover, an inadequate insolvency law has significant effects on financing costs, which are normally higher for small firms.

More generally, recent surveys have shown that the current inadequacies in Italian legislation generate high direct legal costs (more than 20% of bankruptcy assets), excessively lengthy liquidation proceedings (more than five years), huge losses to creditors (80% of claims on average), and the termination of a large number of procedures on account of insufficient assets.

4. The need for change and past attempts at reform

The preceding analysis shows how great is the need to design new solutions for the special problems posed by insolvency.

The inadequacy of current legislation has been discussed for many years, not only in the academic world (among scholars), but also in Government Committees appointed to draft reform proposals.

Especially worthy of note is the proposal of the so called “Pajardi Committee”, submitted in 1989, but never adopted by Parliament. This proposal had as its primary objectives the shortening of the length of the proceedings and the preservation of the firm as a going concern, compatibly with the protection of creditors’ rights. The committee also suggested setting up a two-stage procedure; the first stage for the declaration of insolvency and the second for the opening of bankruptcy or, alternatively, reorganization proceedings.

Apart from these issues, the proposal would not have substantially affected the basic structure of the current law and its essential bias in favor to the protection of creditors’ interests. Therefore, it seems of only limited help in the current discussion on reform.

More recently, in 1996 the “Libonati Committee” was appointed by the Ministry of Justice to draft a new proposal, but it was dissolved before completing its work.

5. The new Italian special administration of companies

In the meantime, in the absence of a general reform of insolvency procedures, some isolated measures have been taken to simplify the current system.

The first is the reform of the Italian law on **special administration** of large enterprises (commonly known as the “Prodi law”), adopted as Legislative Decree 270/1999.

By expanding the role of the Court in the special administration procedure, this law seems to signal a shift in bankruptcy (policy) provisions for large companies, previously marked by the granting of wide powers to the administrative Authorities.

The previous procedure, created by law 95/1979, was much criticized during the intervening years, due mainly to the poor results achieved in practice. But the true impulse for change must be attributed to the strong objections raised by the E.U., which perceived it to be harmful to the principles of competition. As a matter of fact, the support provided by the Italian State over the years to businesses subject to special administration was aimed more at protecting employment than at rescuing businesses, which were therefore able to continue operating even when the chances of rehabilitation were slim or totally lacking.

There was also another consideration that called for an urgent revision of the procedure. This was the serious damage suffered by most creditors of companies placed under special administration, due to the exponential increase in priority claims and the lack, in the original Prodi law, of either a precise timetable for concluding the proceedings or the means by which creditors could demand foreclosure for non-profitability.

The main novelties in the reform can be summarized as follows:

1) a new basic requirement for eligibility for the procedure, namely the “concrete prospect of recovering the economic equilibrium of the business activity”; further condition for eligibility are: a) the insolvency of the company; b) a number of

employees of not less than 200 for at least one year; c) debts amounting of a figure that is not less than 2/3 of the total of the balance sheet value and the revenue for the last financial year;

2) express mention of the scope of the proceeding, which is indicated as the "maintenance of the firm as a going concern", to be pursued by means of "the continuation, reopening, reorganization or transfer of the business activity";

3) the attribution of broader decision-making powers to the Court, in relation to both the commencement and termination of special administration (it is important to recall that the Court has discretionary power to appoint the administrator of the business during the period of special administration, as well as to evaluate the requisites (including the prospect of reorganization, for admitting the business to the new procedure);

4) the principle of the conversion of special administration to liquidation if there is no prospect of rescue; the procedure, in fact, is divided into two stages, the first opens with the declaration of insolvency and is devoted to evaluating the admission conditions; the second (whose commencement is possible but not automatic) is supervised by the supervision of the Ministry for Industry, which appoints the authorities for the proceeding and approves the reorganization plan. But the Court can make its presence felt even in this phase: it has the power to verify whether if successful rehabilitation is likely and, if not, to convert the special administration into liquidation.

6. The Code of practice of the Italian Bankers' Association

An additional measure intended to fill the gaps in the current insolvency legislation is the recent Code of practice issued by the Italian Bankers' Association (ABI) to the commercial banks.

The Code consists of a series of non-binding guidelines intended to promote the restructuring of enterprises through out-of-court negotiations with their creditors. Under the Code, which borrows from the "London Approach" (a system of principles issued by the Bank of England to commercial banks), banks are urged to take a supportive attitude toward debtors in financial difficulties (the procedure outlined by the Code applies to firms that owe the banking system at least 30 billion lire).

According to the guidelines, decisions about the debtor's long-term future should only be made on the basis of comprehensive information, which is shared among all the banks concerned. Interim financing is facilitated by a standstill and subordination agreement, and the banks work together to reach a collective view on whether and on what terms a company can be restructured.

This self-regulation approach is based on the correct assumption that, in crises, the positive effects of sharing information among all the creditors of distressed firms are higher than the benefits that each creditor can obtain individually using his own information, which is inevitably partial. Comprehensive and shared information about the economic situation of the enterprise affords a timely perception of the crisis by the creditors and thereby allows for more effective remedial measures.

The model designed by ABI nevertheless is seriously hampered by the current legislative framework, which does not provide the necessary protection for agreements

reached in compliance with Code of practice (if the firm becomes bankrupt after a restructuring agreement has been reached, any payments made in accordance with the plan risk being revoked, while the banks may be charged with criminal conduct, for granting financing, despite being aware of a situation of insolvency).

7. The present state of the debate. The prospects for a general reform

The need for a general reform is again under discussion. It has become a highly topical issue on the agenda of the present Italian government. The Ministry of Justice has recently appointed a Committee of experts with the task of drafting an "enabling law" (*legge delega*) for a global reform of Insolvency legislation. If this law is approved (82), the Government will be empowered to issue the new rules governing insolvency, in accordance with the principles established by the enabling law.

This reform is part of the process of reviewing of company law that initiated with the 1998 Consolidated Law on Financial Intermediation and is linked with the proposal for a general reform of Company law drafted by the "Mirone committee" and recently approved by the Government.

It is important to recall that another incentive to establish new rules for insolvency is the need to increase the competitiveness of the Italian legal system within Europe, since all major European countries have recently adopted or proposed new bankruptcy/insolvency laws.

In these countries, one of the major aims of the new laws is to shift the focus of bankruptcy law away from an exclusive protection of creditors' interests and towards a balance between protecting creditors and saving distressed firms. Consistent with this objective, the most recent reforms seem to reflect an underlying "pro-debtor" approach, in the sense that their effects on debtors are less harsh, in order to encourage them to initiate the proceedings in good time (i.e. before their financial difficulties become too severe), thereby improving the prospects of rehabilitating the enterprise.

Some international bodies have also pointed out, in their economic analyses, the importance of adopting efficient insolvency procedures. The IMF, in its 1999 report entitled "Orderly and Effective Insolvency Procedures", discusses the major policy choices to be addressed by all countries (irrespective of the different stages of their development) when designing an insolvency system. The IMF report stresses, among other things, the need for structured insolvency procedures, which should take place within a formal framework, under the supervision of the court. An orderly and effective procedure, according to the IMF, addresses the inter-creditor problem by setting in motion a collective proceeding that seeks to achieve equitable treatment among creditors and to maximize the assets to be distributed to them. Moreover, the very existence of an orderly and effective insolvency system creates incentives for negotiations between debtors and their creditors, which may lead to out-of-court agreements being reached "in the shadow" of the law.

As many authors have underlined, the reform of Italian insolvency laws should take into account, first of all, the features of the Italian productive system. It should pursue

(82) On 27 November 2000 the draft of enabling law proposed by the Ministry of Justice has been approved by the Government and submitted to the Parliament.

the primary objective of maximizing the value of enterprises, promoting amicable settlements and always encouraging adoption of the best solution to achieve that objective: the rescue of the firm under the control of the debtor; the transfer of the business activity to another entrepreneur; the liquidation of the debtor's assets piecemeal or as an economic unit.

Each of these solutions should, in turn, be capable of being carried out rapidly and according to economic criteria, in order to achieve the objective of maximizing the value of the firm.

This objective does not clash with the interests of creditors, as they benefit from a procedure that maximizes the value of the debtor's assets and, therefore, the value of the creditors' unsecured claims. Nevertheless, the reform should bring further (specific) protection to creditors, in order to reduce the risks inherent in lending and, thereby, to increase the availability of credit and the propensity to invest in general. Consistently with that aim, the risks arising from a firm's insolvency should be allocated in a *predictable*, *equitable* and *transparent* way. Predictability implies that the relevant risk allocation rules should be clearly specified in the law and should be consistently applied by the individuals and institutions charged with implementing them; *equitably* relates to the collective nature of all insolvency procedures, which requires the law to provide a mechanism ensuring the equitable treatment of all creditors; *transparency* implies that all interested participants must be given sufficient information for them to make adequate and efficient decisions.

The pursuit of the objective of protecting and maximizing the value of the enterprise requires, first of all, the provision of incentives for the early initiation of bankruptcy proceedings.

In general, the earlier firms enter bankruptcy, the less financially distressed they are. From an efficiency standpoint, early bankruptcy for distressed firms is therefore desirable, both because it minimizes creditors' losses if the firm is liquidated and because it maximizes the likelihood of saving the firm if an attempt is made to reorganize it.

Early filing for bankruptcy can be encouraged by mitigating the punitive effects of initiation of the procedure and by leaving the debtor in control of the business. Therefore, the focus of the law should move away from an "insolvency of the entrepreneur approach" (on which the current discipline is based), towards a more objective "crisis of the enterprise approach". Debtors would suffer punitive effects only in cases of fraudulent conduct.

Moreover, the preservation of a firm's value requires that an attempt to reorganize it should be made only if the firm has a real chance of recovery. It is therefore important to provide mechanism to ensure adequate assessment of the effective economic and financial situation of the firm, on which the reorganization plan must be based.

This aim can be achieved, as the recent German reform suggests, within a "unitary" proceeding, which is initially conducted under the same rules and, for an initial pre-defined period, makes assumption as to whether the enterprise will be rehabilitated or liquidated. The proceeding (which takes place under the supervision of the court, which monitors observance of the rules), only becomes either a liquidation proceeding or a rehabilitation proceeding once the debtor, with the consent of the creditors, has determined whether rehabilitation is, in fact, possible. In such a context, rules must be drawn to facilitate negotiated settlements of bankruptcy by promoting the freedom of contract of the interested parties. At the same time it is important to enable the courts

to play an active role “binding in” creditors, by making the plan enforceable on a class of creditors if they have not approved the plan. All this should ensure the adoption of efficient solutions to the crisis.

The attribution of broader powers to the court, which in some circumstances might even replace the will of the parties, requires that the proceedings should be conducted under the authority of courts composed of judges with particularly high professional standards. It is therefore important, when drafting the reform, to take into account the provisions of the proposed general reform of company law, which already place insolvency disputes under the jurisdiction of the specialized commercial courts to be created as part of that reform.

BANKRUPTCY REFORM IN THE NETHERLANDS: REMOVING THE STIGMA ON FAILURE

Pieter M. Waasdorp (83)

1. Introduction

Bankruptcy Reform forms part of a broader policy aimed at strengthening the entrepreneurial capacity of the Dutch economy. The growing interest in entrepreneurship should be seen against the background of developments such as fiercer national and international competition, European integration, technological advances and progressive individualization. The economic structure is changing: traditional economic activities are becoming less important, and economic activity is shifting towards advanced knowledge-based activities. The application of new information technologies gives rise to new combinations of products and activities. This paves the way for the development of small-scale activities, via the provision of services on the internet for instance. In the future small scale firms will have the advantage.

The economic landscape shows a dynamic panorama of starting, fusing, splitting and stopping businesses. There are clear indications that in the '"new economy"' the level of business dynamics will increase permanently. For instance, information goods are characterized by high up front investments, low reproduction costs and network effects. This leads to a 'winner "winner takes all"' economy, where fewer companies temporarily reap higher benefits and an increasing number of companies drop out (84). The information economy provides tremendous opportunities for entrepeneurs and needs entrepeneurs to reap economic and social opportunities. On the other hand, business failure will have to be openly recognized as a social and economic fact of life. Many in the Netherlands see that there is a stigma on failure, which serves not only as a barrier to stop insolvent firms in time, but also works as deterrent to restart a business. This is contrasted with experiences in the US where business failure is also viewed as an important learning experience and an accepted fact in the life of an entrepreneur. As can be seen from figure 1 the number of entrepreneurs who start again after bankruptcy is considerably higher in the US than in The Netherlands. In fact the Netherlands is not unique in this respect with the European Union.

The net effect is that this culture leads to an untapped supply of entrepreneurial talent which if released could have a beneficial effect in fighting unemployment and a robust rate of economic growth. "Entrepreneurial societies will be those that learn to prosper from failure by picking people up from a business failure and getting them to try again" (85).

Entrepreneurship is a source of economic and social dynamism: entrepreneurship ensures flexibility and innovation, acts as a jobs engine, enhances personal development, and encourages emancipation and integration. Furthermore, business and industry can make a positive contribution to solving social issues and problems.

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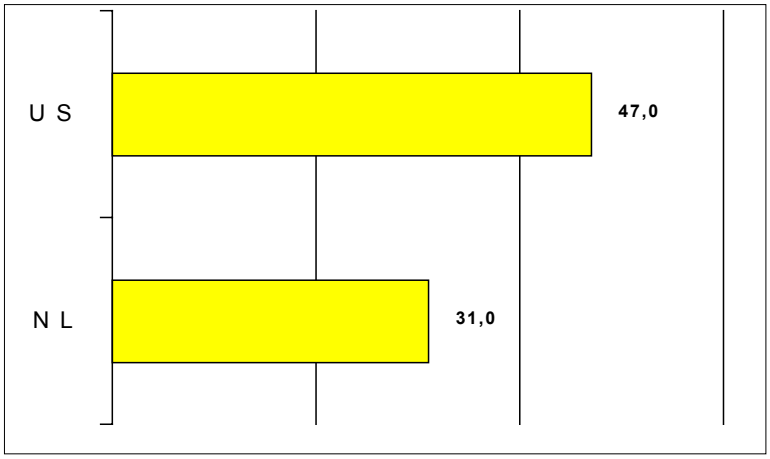
(84) G. Ybema en S.H. Baljé (1999), Snel groeien in de informatie-economie, *Economisch Statistische Berichten* (in Dutch).

(85) C. Leadbeater (1999), *Living on thin air. The new economy*, Londen.

Figure 1

Stigma on failure
(percentage of entrepreneurs who start again after bankruptcy)



The objective of government policy is to pave the way for a more entrepreneurial society by creating more opportunities for and removing impediments to entrepreneurship. This policy objective has been stated in a recent policy paper on entrepreneurship: *The Entrepreneurial Society. More opportunities and fewer obstacles for entrepreneurship* (86).

Lowering barriers to entry and exit of firms is at the heart of entrepreneurial policy. Barriers to entry have already been lowered via the gradual abolition of establishment regulations. Combined with a tougher Competition Act this will highten competition between firms. Inefficient firms will face stronger competition and go under sooner. This will release scarce production factors which can be used for new activities. An increase in the number of business closures and bankruptcies over the coming years is therefore quite possible. This has prompted an assessment of whether the existing Bankruptcy Act is suited to deal with such a development. The Netherlands does not stand alone here: bankruptcy and insolvency legislation has already been overhauled in Germany, France, Belgium, the United States and other countries, and a reform of the Insolvency Act is under consideration in the United Kingdom.

2. The Functioning of the Bankruptcy Law

The core of the Bankruptcy Act dates from 1893. The most sweeping change since then has been the introduction of the Natural Persons Debt Restructuring Act (WSNP) on 1 December 1998. This law ends the principle of unlimited personal liability for debts. This is particularly important for single-person businesses and general partnerships. This Act however is not relevant for other types of businesses.

(86) http://info30.minez.nl/cgi-bin/pu2-retrieve.pl?11R26A.

The main problem with the Bankruptcy Law is the inefficiency of the suspension of payments scheme. Originally intended to provide an opportunity for reorganization of insolvent firms it turns out that around two third of the businesses granted a suspension of payments eventually still go bankrupt. Another aspect of the inefficiency of the current system are the low recovery rates for non-secured creditors (87). Table 1 presents some international data. Although international comparisons of recovery rates are extremely difficult due to different definitions and research periods it gives some kind of indication.

Table 1

Recovery rates non-secured creditors
(percentage of debt reclaimed)

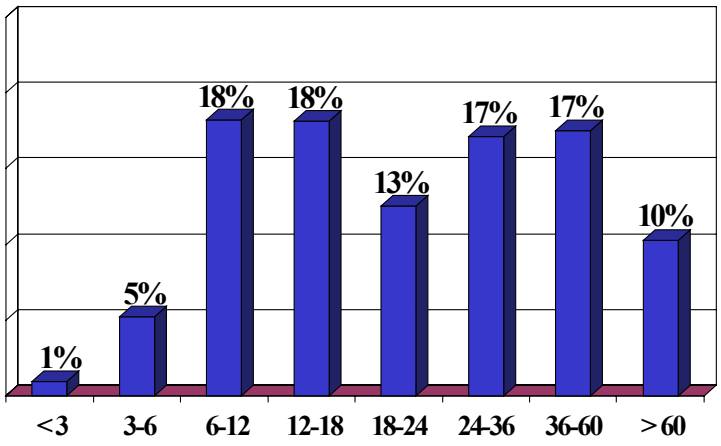
NL	US	Finland	Sweden
2-12%	34-53% 4% for chapter 7	35%	35%

Source: A.W.A.Boot and J.E. Ligterink (2000), "De efficiëntie van de Nederlandse faillissementswetgeving", University of Amsterdam.

Finally the Dutch Bankruptcy Law is characterised by its slow process (see figure 2). In more than 75% of the cases the bankruptcy process takes more than 1 year. In more than 25% of the cases even more than three years.

Figure 2

Duration of bankruptcies
(in months)



(87) A.W.A. Boot and J.E. Ligterink (2000), "De efficiëntie van de Nederlandse faillissementswetgeving", University of Amsterdam.

The deficient reorganizing capacity of the suspension of payments scheme may mean that firms are either reorganized too late or not at all. A delay may even close off any prospects for reorganization altogether. The deficient reorganizing capacity of the suspension of payments scheme is related to the way in which the Bankruptcy Act is structured. Thus there may not be enough time to prepare and execute a reorganization plan. The receiver may not have enough instruments at his/her disposal to come to an agreement with the creditors, for instance because some groups of creditors have preferential positions. Another possibility is that the bankruptcy option is chosen to sideline the official receiver. And it is also possible that a reorganization is delayed until the bankruptcy, so that the insolvent enterprise can then shed staff without further obligations.

The Bankruptcy Act should not lead to the destruction of capital or the demise of viable firms. But seeking to balance the interests of debtors and creditors is a delicate matter. Thus an improvement in the reorganization and restart possibilities for firms (to the advantage of debtors) can lead to excessive compulsory depreciation of loans for financiers (to the detriment of creditors). And this could make financiers more reluctant to extend credit, also to solvent firms. Striking a careful balance is called for.

Box 2.1: Bankruptcy legislation in the Netherlands and the United States

Does bankruptcy legislation punish or stimulate risk taking? The Dutch Bankruptcy Act seems to be most concerned with protecting the creditors' interests. This can encourage financiers to provide capital, but it may also deter people from taking risks and starting a business.

The Dutch Bankruptcy Act offers little scope for the reorganization of ailing firms. Originally the suspension of payments was intended to achieve this, but this instrument does not seem to function very well in the Netherlands. This is striking in a comparison with the United States for instance. The number of suspensions that lead to bankruptcy seems to be smaller in the United States than in the Netherlands. Although a comparison of legal systems is difficult, there are a number of notable differences between the US and Dutch bankruptcy laws. The US bankruptcy system is aimed at achieving a reorganization and is strongly geared to protecting the debtor's interests. Through the '"chapter 11' 11" provisions the US law offers extensive reorganization options for ailing firms. Thus the debtor has 120 days to prepare a reorganization plan, utility companies are obliged to continue supplies during this period, and the banks are also obliged to cooperate with reorganization efforts. And the courts can force unwilling creditors to cooperate on a restructuring plan. The Dutch Bankruptcy Act does not have these features.

3. How is the reform organized?

Bankruptcy reform takes place within the framework of the Market Forces, Deregulation and Quality of Legislation Project (MDW). This project was started in

1994 and is aimed at removing impediments to competition arising from obsolete or inadequate rules and regulations. The MDW operation has proved its value in the previous cabinet period. Each year a number of projects are undertaken and fields of regulation are thoroughly scrutinized. The project is co-hosted by the ministries of Economic Affairs and Justice and depending on the specific topic other ministries are involved as well.

Bankruptcy reform takes place in two stages. In stage 1 a number of relatively simple and uncontroversial amendments on the Law will be put forward. This new Law, which is only reformed in a slight way, will most likely sent to parliament summer 2000. Amendments include the introduction of an objective criterion for the suspension of payments period, an extension of the moratorium and more tools for the receiver to restructure companies.

In stage 2 more fundamental possibilities for reform will be examined. This stage will probably be finalized in autumn 2000.

SIGNIFICANCE FOR THE BANKS OF THE POSSIBLE REFORM OF THE COOLING-OFF PERIOD RULES

Manon A.A. Sevenheck (88)

Introductory remarks:

The Ministry of Justice is currently working on a proposal to amend the Dutch Insolvency Act. This Bill aims to provide greater scope within the Insolvency Act to facilitate the restart of businesses that are still viable even though they have fallen into financial difficulties. In so doing, the Dutch legislative process is following a tendency within Europe to give (national) Insolvency Acts more of the character of a company financial reconstruction act.

Various means to this end are proposed:

First of all, it is proposed to apply more stringent rules to admission to the moratorium procedure. It is the intention that the moratorium procedure should thus be able to be used for its original purpose again, that is to say, to give the debtor (/business) the opportunity to survive the period of financial difficulties. The rules applying to admission to the moratorium procedure are being tightened by proposing that, when a petition to be granted a moratorium is filed, in addition to a statement of assets supported by adequate documents and records, a statement also be submitted which shows that it will be possible for the business run by the debtor to continue trading, together with a draft financial reconstruction plan. In the financial reconstruction plan the debtor will have to declare what measures he or she intends to take to make the business successful again: e.g. reorganization of the corporate structure and/or change of market strategies. The intention is that tightening the rules governing admission to the moratorium procedure will allow only debtors (/businesses) with serious expectations of survival to pass through the moratorium procedure.

At this point it should be noted that the Bill is not expected to be a great success on this score. This is due to the fact that research has shown that, more often than not, the reason why businesses fail is inadequate business skills (89). Conversely, greater success can be expected from replacing the debtor.

In addition to the foregoing, the Bill involves a reform of the cooling-off period rules. In the paper that follows I shall concentrate on this part of the Bill. For that reason, a brief account of the cooling-off period is required first:

The cooling-off period forms part of the moratorium or insolvency procedure. Notice of this period may be given by the relevant bankruptcy court judge immediately after moratorium or insolvency proceedings have been opened upon application from any interested party or in his own official capacity. During the cooling-off period, which may not exceed two months, third parties may not recover any of the effects that form

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(89) See: Blom, R.J., *Failliet! Het Onderzoek!* (Insolvency! The research!), Graydon Nederland BV, 1996, p. 133 et seq.

part of the insolvent debtor's net assets. "Third parties" are taken to include: pledgees and mortgagees; persons with a reservation of title; persons who may invoke a right of recovery; persons who have granted the debtor a right of use; and the Collector of Taxes.

The position of the business vis-à-vis these creditors is frozen. During the cooling-off period the Official Receiver can form an impression of the insolvent debtor's net assets. For the banks, being given notice of the cooling-off period means that during this period they are not allowed to realize their collateral, – or in other words: the banks may not exercise their secured rights.

The reform of the cooling-off period rules will have major repercussions for the banks.

In order to put the significance of the reform of the cooling-off period rules for the banks into perspective, the following two questions need to be answered:

1) What does the proposal to reform the cooling-off period rules imply for the banks?

2) What purpose is the reform of the cooling-off period rules intended to serve?

3) What does the proposal to reform the cooling-off period rules imply for the banks?

1. What does the proposal to reform the cooling-off period rules imply for the banks?

The starting premise of the cooling-off period remains the same: during the cooling-off period third parties may not recover any effects that form part of the insolvent debtor's net assets. Under the terms of the Bill, the relevant bankruptcy court judge may, however, award the third party reasonable compensation for this. The claim to the compensation also constitutes a liability of the insolvent debtor. Furthermore, it is proposed that the maximum length of the cooling-off period be extended from two months to a maximum of four months.

What is new is that during this period the Official Receiver will be authorized to use, consume and dispose of the effects that form part of the insolvent debtor's net assets. Upon so doing, the Official Receiver would offer compensation to make up for this, which could be entered as a liability of the insolvent debtor. This would be conditional upon the debtor having been authorized to dispose of these effects and the insolvent debtor's net assets being sufficient to pay the reasonable compensation awarded to the beneficiary. Furthermore, the Official Receiver should no longer give greatest priority to the interests of the joint creditors alone but should also take more social considerations into account, such as the continuity of the business and preserving jobs, when forming his judgment (90). This vision also befits a society that promotes entrepreneurship (91).

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(90) As was also the decision of the Supreme Court in the Sigmacon II judgment of 24 February 1995 (NJ 1996, 472).

(91) See: Huls, N.J.H., *Een nieuwe kans voor particulieren en voor ondernemers (A new opportunity for private individuals and for entrepreneurs)*, Ministry of Economic Affairs, p. 97.

2. What purpose is the reform of the cooling-off period rules intended to serve?

During this amended cooling-off period the Official Receiver should have more legal opportunities than he already has to hand over the business as a going concern (92). If a business in financial difficulties has some parts that are viable, it has proved to be the case in practice that hiving off these viable parts produces the highest return for the net assets of the business in question (93). Although current practice is as described above, the present Insolvency Act offers no scope for it. For that reason, terms such as “technical” or “improper” insolvencies are used.

The Bill aims to put an end to this improper completion of insolvency proceedings . Particularly because the Official Receiver will have the ability during the (possible) amended cooling-off period to use, consume and dispose of effects that form part of the insolvent debtor’s net assets, the chances of the Official Receiver being able to hand the business over as a going concern will be that much greater. This also applies to the assets that have been assigned to the banks as security. The Official Receiver should offer reasonable compensation to make up for this. During the cooling-off period the receiver and the debtor/trader have equal powers.

3. What does the proposal to reform the cooling-off period rules imply for the banks?

There is generally a close relationship between businesses and banks. At the heart of this relationship lies the fact that the banks are providers of credit to the business. In their capacity as providers of credit the banks keep a close eye on the liquidity and solvency position of the business/client. If a business threatens to get into financial difficulties, the business’s credit position will generally already be being dealt with by the “Non-performing Loans” department of the bank in question. It is this department that decides whether to realize some or all of the collateral put up by the business in question by selling up the assets concerned.

The banks are, however, afraid that their policy will be thwarted if revised cooling-off period rules come into effect, since the banks will no longer be able to realize their collateral on their own initiative during the cooling-off period. The Official Receiver assumes control. There is also uncertainty concerning the possible proceeds that the Official Receiver will realize upon the sale under execution of the assets that have been put up as security. The reason for this is that the realizable sale value is frequently time and place-related. If it anticipates that the proceeds from the sale of the asset in question under execution may be lower, the bank may decide at an early stage – i.e. before the question of moratorium or insolvency proceedings arises – to proceed to sell off the asset on its own initiative. The bank thinks it can maximize the sale

(92) In most cases the alternative of a legal division of the business runs into practical difficulties, such as over-long and laborious procedures which fail to result in the sort of debt restructuring that is advisable anyway.

(93) See: Oosthout, H.B., *De doorstart van een insolvente onderneming (Restarting an insolvent business)*, 1998 Kluwer, Deventer.

proceeds by acting in this way. On top of that, the bank may also decide to adopt a more cautious attitude to extending credit to businesses in future (94).

The question is whether the banks' fears are justified. For the reform of the cooling-off period rules might also be expected to have some positive effects. First of all, the revised cooling-off period rules offer a procedure hedged round with statutory safeguards which enables a business to be handed over as a going concern. As far as transparency is concerned, more can be expected from this than is the case with the way in which so-called "improper" insolvency proceedings are currently wound up. In addition, following a successful cooling-off period a business can be sold as a going concern, free of secured rights. In favour of this, it has already been argued that the going concern value of a business is higher than that of a business in an insolvency or moratorium situation. This represents a considerable benefit as far as the proceeds realized by debtor's assets are concerned. Furthermore, there seems no possibility (logically) that any assets that have been put as collateral which are essential to the business as a going concern would come under the regime of the cooling-off period.

My conclusion is that the success of the institution of the reform of the cooling-off period rules will depend on the confidence that the banks have in it. This confidence will also be determined by their own experience of it and the experience of foreign banks with similar institutions.

(94) See: Damkot, H.J. and Timmermans, J.H.S.G.K. on behalf of the Dutch Bankers' Association, *De toekomst van de Faillissementswet (The future of the Insolvency Act), Tijdschrift voor Insolventierecht (Insolvency Law Review)* 2000/1, pp. 12-15.

DISCUSSION

Joseph De Wolf:

We have a representative from the EC among the participants. I think we should seize this opportunity to ask him to give us a view from behind the curtain of how the EC is looking at bankruptcy.

Marc Vereecken:

There are currently five initiatives at the European level. There is the insolvency convention, which, since the entry into force of the Amsterdam Treaty, has become a regulation. It was adopted at the end of May 2000. It covers commercial enterprises but it excludes the financial sector. Banks, UCITS, investment firms and insurance undertakings are all excluded from the scope of that regulation. The regulation also allows for secondary proceedings, so that there is not a principle of unity of the proceedings.

Given that the financial sector is excluded from its scope, we have specific directives on banks on the one hand, and a directive on the reorganization and winding up of insurance undertakings. Contrary to the insolvency regulation, the principle in this case is universality and unity of the proceedings. The procedure must be opened in the home state of the institution and the proceedings cover all assets and branches abroad.

Both are mutual recognition directives. They do not include material rules on insolvency proceedings but simply are international private law directives, because they are aimed at establishing the applicable national law. On both these issues there has been major progress very recently. Both of them have been subject to political agreement just at the end of May 2000.

Another initiative is the settlement finality directive that was adopted in May 1998. It covers payments systems and security settlement systems. Among other things, it provides for the recognition of netting in order to insulate the collateral from insolvency proceedings — collateral posted to central banks or to either payments systems or security settlement systems. It also provides for participants' obligations to be ruled by the insolvency law of the member state.

Finally, there is a new initiative, at present at a very early stage, which is currently being examined by the Commission concerning the cross-border provision of collateral. At the current stage of thinking, it would provide for the recognition of title transfer collateral, not only pledge but also title transfer repos. The Commission is expected to make a proposal by the end of this year.

De Wolf:

We also have the pleasure to have Ms. Françoise Pfeiffer from the Central Bank of Luxembourg. We ask Ms. Pfeiffer for a few comments on the project of bankruptcy reform currently under discussion in Luxembourg that we have read about in the press.

Françoise Pfeiffer:

In Luxembourg the Ministry of Justice is presently working to establish a draft bankruptcy reform. The legislative reform is still at a very preparatory stage, though, and no official

documents which highlight the main points of the reform are available at the moment. According to the scant information available, two texts will be elaborated. The first one will amend the present "gestion contrôlée" procedure and provide for better conditions to save companies for which remedies may be found. The reform will be inspired by the French and Belgian laws in this field. A first draft has been sent to the Ministry of Finance by the ministerial working group.

The second text will modify certain aspects of the current insolvency proceedings in order to accelerate the liquidation of insolvent companies which cannot be saved. This text, however, is at a very early stage of completion.

De Wolf:

The floor is now open to the other participants, who can interrogate our speakers. I think there are two main points of interest. The first concerns the fresh start and the second concerns the financial restructuring procedure.

Fiscal Issues

Marco Evangelisti:

I would first ask our President about the fiscal aspects of bankruptcy: are there any fiscal facilities given to the curator? Does the law adopt any fiscal measures in order to facilitate the recovery of the enterprise?

De Wolf:

There are, first of all, aspects of tax provisions; typically the tax administration in Belgium has always been very reluctant to see provisions becoming deductible, in particular concerning developing countries, where credits may be highly at risk. There is of course a protocol and a procedure with the Commission Bancaire et Financière which can in a number of cases allow for some deductions. Even in this case there is always the danger to allow for very easy applications of tax deductions. For these reason the tax administration in Belgium has always been very careful in allowing for fiscal deduction, even when there is the necessity to help enterprises in difficulty.

Wouter Bossu:

I would like to make a reference to the bridge between fresh starts and tax claims. During the legislative process of the Belgian bankruptcy reform the issue was very hotly debated. In particular, I believe, in the Senate there was a lively discussion whether to extend the fresh start provisions also to fiscal debts. I believe the tax administration eventually had to accept that even fiscal credits cease to exist in case of fresh starts.

Erik Van den Haute:

The same question was debated again with reference to the law concerning financial difficulties of non merchants, which was approved by the Belgian Parliament on 5 July 1998. At first it was proposed to consider tax debts among those excluded from debt clearance. But then, after a very lively debate, it was decided to extend debt clearance to

tax debts, which is very important to guarantee the fresh start idea, because tax debts are among the most important when a firm is in financial difficulties. From a practical point of view, the implementation of this measure is not yet undisputed. According to the tax administration, this provision is against the constitutional principle of equal treatment of all citizens.

Manon Sevenheck:

Speaking about the Netherlands, the law allows natural persons, after being declared bankrupt and having liquidated all their assets and distributed the sums to their creditors, to get rid of all the remaining debts. Further, with a view to stimulating entrepreneurship, the law provides for immediate compensation for fiscal claims for new enterprises. This represents a significant benefit with respect to the treatment allowed to entrepreneurs who have been in business for more than five years.

Roberto Cercone:

In our country we have no fiscal incentives for the debtors, but we have special treatment for losses on credits. Creditors are allowed to deduct losses on credits from their annual income without limits and at the beginning of the bankruptcy of the debtors.

Going Concern

Vereecken:

This morning it was mentioned that in Belgium it is possible to have, following bankruptcy, interruption of the legal person although some of the business activities can continue. I imagine that parts of the assets, both material and immaterial, the *fonds de commerce* for instance, can be attributed to the business activity. What remains in the estate for the creditors and what goes in the new activity?

Bossu:

Actually, it is not possible to have an enterprise activity in a legal person that no longer exists. On the one hand, when the liquidator decides to keep a part or the entire enterprise as a going concern, this is a temporary measure in order to liquidate the company's assets at their maximum value. On the other hand, when the court declares the excusability of a corporate bankrupt entrepreneur, the legal person will exist but it will normally no longer have an enterprise.

Van den Haute:

The main idea is that whenever the business should go on after bankruptcy, it is only with a view to liquidating its assets, as Wouter said. When you have a big company it may be very expensive to stop production; furthermore, when you stop production and you do not have any more activities you lose all the goodwill. That is why the first decision the receiver has to make is whether or not to go on with the business. The going-concern idea stems from the necessity of preventing depreciation of the firm's assets. In the case of compulsory composition, you have either the going concern of business activities or the going concern of the legal person.

Bossu:

Except when the excusability has been granted to a corporation, because in that case you will have an empty shell.

De Wolf:

In Belgium empty shells used to be very attractive, especially when they could carry losses because the acquirer could deduct these losses. Legislation has recently tried to prevent these abuses, although the problem is still not completely solved.

Compulsory Composition

Vereecken:

Mr. Van den Haute at the end of his presentation this morning gave some empirical evidence for 1999. He mentioned 7,000 cases of bankruptcy and only 70 cases of compulsory compensation. That seems to suggest that what everybody agrees the law should do, namely to allow the liquidator to save whatever can be saved, does not really work. On the other hand, maybe creditors and debtors normally settle out of court. Maybe the success of the law is that it has not been used.

Van den Haute:

It is one of the main problems of compulsory composition. As I understand it, the problem seems to be the same everywhere, that is to determine at which stage you can intervene. On the one hand, you have a company that is always very optimistic about its business prospects. The more so if you think that the great majority of the companies that go bankrupt are small companies, with just one or two managers, mostly with brilliant ideas but few notions about management. They do not realize when they have to take action. Pieter Waasdorp expressed a very interesting idea when he said that in the Netherlands they are trying to give managers incentives to go to the court and ask for composition. On the other hand, the problem is that there is a psychological barrier, because managers are afraid that creditors may believe their enterprise is bankrupt. I do not think the law by itself can change this mentality. Furthermore, drawing up a restructuring plan takes a lot of time and money. The upshot is that managers take action too late. That is why I agree with Pieter that it is necessary to introduce incentives for managers to address their company's problems earlier.

Paolo Santella:

Why should the creditors not be interested in drawing up a rescue plan for their clients? After all, it is their money that is at stake.

Van den Haute:

We have to distinguish between two kinds of creditors. On the one hand, banks have often a lot at stake and they usually try to work out a business plan. The problem is that the entrepreneur has to go on with his own business, and also to deal with his other business partners. If the latter do not want to work with you, then you have a problem. You can propose an interesting business plan to the bank, but if the other business partners do not follow you, you will never be able to perform your business plan.

Santella:

If I understand well, you are saying that the administrative costs of such rescue plans are too high.

Van den Haute:

Yes, I think so.

Santella:
So maybe the law should provide some reduction in transaction costs, otherwise we should allow enterprises to fail, because the costs of this kind of rescue plan may be higher than the benefits.

Van den Haute:

When you are dealing with small enterprises, effectively the costs are too high. You cannot afford a rescue plan without any proceedings. You cannot do it on a voluntary basis. You have to have all the creditors and business partners sit around the table, explain to them what is happening. But from a practical point of view, creditors and business partners tend to work on rumours. My experience is that as soon as there is the slightest possibility of a problem, they stop, because they do not want to take too much risk: when dealing with small enterprises, creditors and business partners do not want to put too much money and time in putting the business back on its feet. But when you are dealing with a big company which has some interesting possibilities, it is possible to come up with a rescue plan.

Cercone:

At the basis of banks' behaviour there are also other interests, namely the amount of the credits versus the ailing firm and the possibility of developing the relationship with such debtor once it has been rescued, because such relationships are a source of income for the bank. Therefore banks have a specific interest in steering enterprises towards a rescue plan.

Bossu:

Suppliers have an interest as well in keeping their client.

Cercone:

Yes, but the amount of information incorporated in a relationship between an enterprise and a financial intermediary is higher than the information incorporated in a relationship between the entrepreneur and a business partner. The loss of a credit relationship has a higher cost than the loss of a normal business relationship with a non-financial business partner.

Van den Haute:

There is also the fact that suppliers can more easily go elsewhere. Banks cannot do the same if the outstanding amount is too important. According to my experience, banks generally do well in trying to find a solution.

Vereecken:

One conclusion I would draw is that out-of-court settlements seem to work. Further, compulsory composition entails high administrative and reputational costs. Would it not

be simpler to say, let's forget about compulsory compensation, let's have quick and speedy bankruptcy proceedings followed by the rehabilitation of the bankrupt partner?

Santella:

I think there is another argument in support of Marc's, namely that any settlement involves an economic evaluation, which can be properly made only by the parties, which are the only people in a position to evaluate costs and rewards. On the other hand, for an administrative authority it is far more difficult to make such an evaluation.

Van den Haute:

I am still convinced that it is useful to maintain a form of compulsory composition, provided mentalities change, since at present creditors generally do not see any difference between bankruptcy and compulsory composition. In certain cases there is admittedly a risk of abuse. Concerning the economic evaluation of economic settlement, this is one of the improvements of the Belgian reform: the law now provides for the economic evaluation to be made by the actors. It is the debtor who presents a proposal to the creditors for an arrangement. The court will organize hearings, with the creditors, the debtor, and the person appointed by the court (*commissaire au sursis*). Integrating these elements in the permanent arrangement gives you an economic evaluation which is nearly the same as what you would have on a voluntary basis. The cost is higher of course.

Marcucci:

I agree with Erik on the possibility of reaching an evaluation in formal proceedings. The problem is how to set up these proceedings. It is important to give the debtor a role in the assessment of the economic situation so that creditors can find a way to draw up a reorganization scheme. For large companies information problems are less important. Furthermore an efficient bankruptcy legislation has important *ex ante* effects on the incentives the entrepreneur has to assume risks. If the entrepreneur knows what would happen in the event of failure, he can create a better financial structure for his business. That is why the risk allocation rules must be clearly defined by the law, so as to make the consequences of the firm's difficulty predictable. This also gives incentives for efficient out-of-court agreements. Of course, all this is much more difficult for small firms, because of bigger information and coordination problems.

Van den Haute:

My experience on voluntary settlements is that the risks of bankruptcy are the same in voluntary settlement as in compulsory composition. The important thing is to ensure timely intervention.

Santella:

The problem is that the function of compulsory composition is to force some creditors to accept an agreement they do not want.

Van den Haute:

But the cost of the proceedings provides a counterweight. For instance, the rights of privileged creditors are suspended, which allows the business to continue. Otherwise they would leave and put all the creditors in trouble. Naturally the cost factor is important.

Santella:

The problem is to justify such a breach of the principle of freedom of contracts. Why should the debtor be given the possibility to make recourse to the law in order to avoid respecting a contract he has willingly signed?

Van den Haute:

The idea is that in compulsory composition the company can be saved and it is necessary to keep it as a going concern while the rescue plan is worked on. Allowing creditors to claim their credits may jeopardize this possibility.

Santella:

But if the creditor does not collect his credit, there is also the possibility that he would incur financial difficulty as well. So why favour one at the expense of the other?

Van den Haute:

In compulsory composition the idea is to try to save the business, so that the position of the debtor should be central.

Bossu:

One of the advantages of being a central bank is that we consider banks not as our creditors but as our debtors. Most of the contractual framework between a central bank and banks concerns the automatic event of contractual termination. I am fairly sure that in every country that has a system of compulsory composition, the latter is one of the automatic events of termination. You add that to the principle that assumes that as soon as compulsory compensation occurs, there is the so called *close-out* of the contractual relations between the central bank and the bank and the ensuing netting. Furthermore, the settlement finality directive and the proposal on collateral directive contain the principle that creditors should always be able to sell their collateral immediately, whatever a court may decide. Once it is known in the financial market that a bank has entered into compulsory composition, the bank is going to fail at once.

De Wolf:

I do not think you made the point for Paolo in this case, because what central banks are talking about is the problem of contamination, which is not the case in the crises of commercial firms. Once you step down in ordinary life, you should give some oxygen to the debtor that still has a chance.

Cercone:

Free negotiations between creditors and debtors are possible only if you have a simple liability structure, such as in the case of a firm with one or two creditors. But when we have a large number of creditors this becomes very difficult. It would be much more difficult, for instance, for creditors to agree to a securitization transaction. In fact, we are speaking about rules that can be changed only on a voluntary basis and it is not possible is to change these rules without hurting the interests of any creditor.

De Wolf:

It is true that people go bankrupt because they cannot recover their credits from other people. It is a sort of contamination problem.

Contractual and Legal priorities

Marcucci:

I think there is a reason to disrupt the civil law order of precedence.

Van den Haute:

Priorities, contractual as well as legal ones, should be dealt with at the same time, but I am afraid the problem has turned out to be much too complex until now.

Santella:

The problem is that there does not exist a convincing theory of legal priorities.

Bossu:

Ten years ago most interbank loans were unsecured loans, in Belgium as well in other countries, such as Italy and the Netherlands. Now interbank loan activity has almost completely been substituted by the repo market, where banks make loans to each other through repos. This confirms the tendency to use property as the final security. In Belgium we accepted transfer of title as a security; today repos are completely protected.

Santella:

Does it mean that there is a tendency to make use of financing techniques that allow the creditor not to be involved in bankruptcy procedures?

Bossu:

In any case, this helps to reduce the number of ordinary creditors in a bankruptcy procedure.

Van den Haute:

Indeed, property can be seen as the best security. The privileges established by the law are not so effective, so people tend to make use of property, which leads to the fact that under Belgian law, since you can give property as a guarantee, we are approaching a system of trusts, that is the separation of the economic and legal aspects of property. It is regrettable that these new techniques are introducing a fair degree of uncertainty into our system.

Santella:

Maybe this is a reaction to the excessive complication of our juridical systems; maybe there are too many laws.

Van den Haute:

Indeed, nobody nowadays knows how legal priorities work. People are probably trying to find out alternative means, property for instance, but this gives rise to uncertainties as well, since these new techniques are not explicitly recognized by the law, at least as far as Belgium is concerned. Even the Supreme Court is not very clear on this point. I think what we need is a global reform of priorities. It is regrettable that the long debate that preceded the 1997 bankruptcy reform in Belgium did not produce such a reform.

Geert Vandenabeele:

I believe the reason why the property clause has not been generally accepted as a privilege under Belgian law is the intention to guarantee priority to fiscal and social security credits. Further, the legislator of the 1997 reform wanted to guarantee the protection of the weaker economic factors. It was thought that recognizing property would have protected the stronger economic factors.

Bankruptcy

Bossu:

Are ordinary creditors served by a bankruptcy procedure? Would it not be better for them to be able to pursue their rights unilaterally? Suppose a company is incurring financial problems and is not paying some of its suppliers. I think it might be better for them to pursue the company individually, so that it could convince its bank to advance payments.

Van den Haute:

It must be recognized that ordinary creditors receive very little of their credits in the event of bankruptcy.

Sevenheck:

Maybe the real function of bankruptcy as far as unsecured creditors are concerned is as a negotiating ploy in order to induce the debtor to pay.

Bossu:

The point that should be stressed is that bankruptcy was conceived by the Belgian legislator as a punishment to the debtor, while its real function is to help the debtor to get rid of the debts deriving from an unfortunate business enterprise.

Van den Haute:

Failure in economic life is an entirely normal event. Further, once a bankrupt entrepreneur is given the possibility to start again, it is likely that he will be able to profit from his past experience. On the other hand, the law should help entrepreneurs to stay in business as much as possible.

De Wolf:

Perhaps we need a double type of legislation. One for start up companies, in which case creditors may be treated as stockholders: if the business fails, they just take their losses. On the other hand a different kind of legislation should apply once the enterprise has passed the state of experiment. However, I do not know whether this is a realistic approach.

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