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A New Impact of Insolvency Reforms on Business Survival and Recovery Perspectives

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Abstract: This conceptual article concentrates on the insolvency and recovery reforms and business survival. The aim of the research is an evaluation of the impact of insolvency law reforms on the increase of businesses' survival. The study focuses on a comparative analysis of insolvency reforms on EU level, including the advantages and disadvantages, with a special emphasis on the Polish case, which includes some similarities and differences to other EU countries' insolvency procedures. The article presents the concept of the most effective insolvency framework and its efficiency (as well as legal and financial framework) that gives the best results for companies to survive, to start recovery procedures and restructuring, not to go bankrupt, and not to become liquidated and eliminated from a competitive market. Taking a critical thinking approach, the article indicates the weaknesses of the existing insolvency procedures that should be improved and offers some recommendations for the future. The study covers, from a scientific point of view, the important issues that, in the face of complexity, a global, turbulent environment, and the global financial crisis, deserve an investigation. The findings and the implications are crucial not only for scientists, but also for insolvency practitioners, business and financial institutions' representatives, and policymakers.

Keywords: bankruptcy; insolvency; restructuring proceedings; business survival; recovery

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Introduction

The global financial crisis has pushed many businesses into insolvency. The annual number of failures still remains above the levels before the crisis in several EU member states, and some business leaders are struggling with distress and difficult choices about the future and their companies' survival prospects. Based on these, significant bankruptcy and insolvency reforms at national and EU level have been implemented. Economies around the world have undertaken reforms aimed at improving their insolvency systems. The majority of them have focused on introducing or strengthening reorganization mechanisms that help to continue business activity and to survive in a competitive market. Providing an effective and efficient framework for saving viable businesses is the main purpose of internationally-established good practices in the area of insolvency. All across the world, from 2009 to 2014, 60 economies implemented 87 reforms on resolving insolvency. Reforms in the area of corporate reorganization were the most common: 10 economies introduced a new reorganization proceeding, and 21 promoted reorganization or made improvements to their existing reorganization framework (World Bank Group, 2016, p. 104). Empirical evidence, however, on how these reforms affect the chances of business survival is limited; thus, the topic deserves an investigation that makes a contribution to the science and theory. According to World Bank Group (2016, p. 104), adequate financing to ensure the continued operation of distressed businesses has been identified as one of four critical components of turnaround success—along with competent management, a viable core operation, and a motivated labor force.

The aim of this article is to present the insolvency reforms that increase the business survival opportunities at selected EU countries and at Polish level. The article presents the conceptual framework in the area of insolvency reforms that are the most efficient for business survival. This study discusses the impact of insolvency reforms on chances of business survival. The topic is very topical and significant for insolvency practitioners, financial institutions, government representatives, leaders, and researchers.

Theoretical Framework

The main elements of the theoretical concept focus on institutional/governmental support, insolvency law changes, private and public aid and financial support of restructuring proceedings, early warning systems, second chance policy, and business survival (Figure 1). Insolvency is a culmination of a lack of financial means and the loss of solvency, which is not a temporary trend but develops into a permanent phenomenon. In legal terms, solvency is an institution whose purpose is to stop the accumulation of debts, and most frequently, it consists of the liquidation of the debtor's estate. Franc-Dąbrowska and Porada-Rochoń (2013, p. 1) indicated the need for a wider approach to the study of insolvency of small- and medium-sized companies due to a turbulent environment and difficulty for early identification of risk and, therefore, a short time (or lack thereof) to react and implement proper actions.

Schumpeter (1942) considered the bankruptcy of an enterprise as a necessary component of economic growth in macroeconomic terms ("creative destruction"). Unfavorable economic situations intensify the phenomenon of negative selection of inefficient entities, contributing to a change in the allocation of resources. Insolvency of an enterprise does not result from unfavorable external conditions but delayed adjustment to new market requirements or lack of such adjustment. This is the consequence of implementing innovations by the competitors. Alchian argued that competition between companies is not defined by the motive of maximizing profit but by "adjusting, imitating and based on the trial and error method search for the possibility to increase their profit." Therefore, "those, who obtain *positive profit* survive; and those who lose are eliminated from the market" (Alchian, 1950, pp. 211–13).

Argenti (1976, p. 121) distinguished four stages that ultimately lead to bankruptcy:

(1) Problems in the operation of an enterprise start to arise, but they do not cause significant changes;
(2) All irregularities deepen, and mistakes are made;
(3) Significant irregularities concerning particularly the sphere of solvency appear;
(4) The bankruptcy of an enterprise follows.

The trajectory concept of Argenti (1976, p. 121) was confirmed by research carried out by Thornhill and Amit (2003). According to the results, there is a correlation between the age of enterprises and the number of bankruptcies. Young companies are heavily burdened with the risk of bankruptcy. The main objective of business activities in the initial phase of their existence is survival.

Figure 1 Key elements of implications of insolvency reforms to business practice. Source: Own study.

There is still no developed bankrupt economics—something that would demonstrate the processes and mechanisms of survival and insolvency of managing entities. There is a lack of one, consistent theory of bankruptcies, and its elements are the part of separate economic theories. Mączyńska et al. (2010, pp. 5, 10) drew attention to the development of economics and bankruptcy economics.

Djankov et al. (2008) collected information on the debt enforcement procedures for a hypothetical distressed firm in 80 countries around the world and related institutional features to efficient reallocation of assets. They found that the costs and time for recovery vary widely across countries and that richer countries are more efficient than poorer countries, although countries of French legal origin have the lowest level of efficiency of debt contracts, after controlling for income.

A number of theories, whose purpose was to explain the probability of the survival of business entities on the market, were developed in the economic literature. One of them is the liability of smallness concept, related to the liabilities of small enterprises. According to it, small companies have a smaller chance of survival. Preisendorfer and Voss (1990, pp. 107–29) claimed that smaller enterprises are frequently incapable of competing with bigger companies.

It is also worth indicating the liability of the newness concept concerning the liabilities of new enterprises. Research on the correlation between the duration of business entity activity on the market and survival plays an important role. According to this concept, young companies leave the market faster than the older companies. Competition that new enterprises must cope with is one of the underlying reasons behind this. Entering the market, enterprises compete with organizations with well-established positions, and they must gain a reputation in order to acquire clients, suppliers, and investors (Thornhill and Amit, 2003, pp. 7, 14–15).

According to the concept, which has its roots in industrial economics, only after entering the market are enterprises able to state if they can exist in it. The representatives of this approach search for the factors which will allow the enterprises to survive on the market and, in a broader sense, not only at the level of the company but also at the level of the whole economy—assuming that structural characteristics of industry, such as market entry and withdrawal barriers and the intensity of applying new technologies, exert a significant influence on the survival and the development of new enterprises on the market (Thornhill and Amit, 2003, pp. 7, 14–15).

Mas-verdú et al. (2015) analyzed the impact of business incubators on firm survival. Using a configurational comparative method, namely, fuzzy-set qualitative comparative analysis (fsQCA), they also examined whether the degree of business innovation, size, sector, and export activity affect firm survival. Results showed that when combined with other variables (i.e., sector, technology), business size is a sufficient condition for firm survival. Likewise, incubators alone cannot affect survival (Mas-verdú et al.).

Taking into account the scientific literature review, the authors note that legal factors' (e.g., insolvency law reforms) influence on business survival has not been frequently presented; thus, this article gives a significant, preliminary outlook that could support developing the issue during further research. The Results part of this study presents the comparison of insolvency reforms at EU level and the Polish insolvency reform case emphasizing restructuring actions and, finally, business survival.

Methodology

The sample covers EU countries. The scope of the study includes insolvency reforms across EU countries. The main methods include comparative analysis and a case study of Polish insolvency reform.

Results and Discussion

Comparison of Insolvency Reforms at EU Level

Despite the fact that Europe is a "single market", insolvency processes differ significantly among its member nations. Each country adopts its own law for insolvency procedures, and there are considerable differences in the number and types of insolvency and restructuring proceedings, time limits for filing, the right of creditors and other stakeholders, and their priority (PWC, 2009). The number of proceedings varies from a simple system with only one proceeding (Bulgaria) to a more complex one with up to eight (Italy, France). In most countries, these proceedings are classified into two groups, including pre-insolvency and post-insolvency. However, Germany has a different system, with preliminary proceedings and main proceedings. Due to the absence of pre-insolvency proceedings in German law, German companies may encounter difficulties in arranging a rescue deal or sale. Thus, this may adversely affect the company value. In terms of the time limit for filing, while there is no clear prescribed time limit but a risk of director's liability in case of late filing in Italy and the Netherlands, other countries set specific time limit, such as 3 weeks in Germany, 1 month in Luxembourg, 45 days in France, 3 months in Spain, and so on (Deloitte Legal, 2017). All of these divergent insolvency regulations can make a significant difference in the prospects of saving the business or the return obtained by creditors. In fact, this legal discrepancy discourages cross-border investment and the timely restructuring of viable companies in financial distress, increases uncertainty amongst issuers, investors, and other stakeholders, and puts small and medium enterprises (SMEs) at a competitive disadvantage. Generally speaking, it reduces the efficiency of the EU capital market.

Facing this reality, the Council of the European Union adopted the EC Regulation on insolvency proceedings in 2000, which came into effect in 2002. In all EU member states except Denmark, this Regulation takes precedence over domestic policy and applies in cases when a debtor has assets in more than one EU member country. In simple terms, the Regulation assigns the member state where the debtor has its center of main interests (COMI) to be the jurisdiction whose laws around insolvency proceedings are conducted under and provides "automatic" recognition of those proceedings in other member states. Despite the efforts to facilitate cross-border insolvency proceedings, the Regulation still has weaknesses, such as the lack of rules concerning the opening up of proceedings and groups of companies, the exclusion of pre-insolvency and hybrid proceedings, and so forth. These shortcomings were recently amended by improving the COMI determination. Along with the amendment, the Commission also provides "the Recommendation on a new approach to business failure and insolvency", which aims to shift the focus of insolvency proceedings from liquidation to pre-insolvency restructuring, thus enabling viable companies to return to going concern status. In detail, the Recommendation supports the permission for the debtors to retain control of the business and provides lenders with various protections to provide new financing to assist with the restructuring plan.

In line with the reform at EU level and the Recommendation issued by the Commission, some EU member states have undertaken the reform in their insolvency proceedings. For example, Slovenia is introducing a preventive restructuring procedure; Spain, Hungary, and Romania have improved their personal insolvency regime; Croatia has done the same in both personal and corporate restructuring regimes; and the Netherlands is undertaking a reform process in order to improve the existing preventive restructuring procedure.

In order to increase the efficiency of restructuring procedures, the EC Recommendation (Association for Financial Markets in Europe, 2016) focuses on six conditions as follows:

- Possibility to file early with the objective of avoiding insolvency;
- Position of the debtor;
- Possibility of a stay on individual enforcement actions;
- Adoption of the restructuring plans by creditors;
- Protection for new finance granted in restructuring procedures;
- Involvement of courts when third party rights could be affected.

Differences can be found among how EU member states deal with these conditions. While Austria and Germany set very strict access conditions, though still offering debtors the possibility to restructure before they are insolvent, Bulgaria, among others, does not allow debtors to have access to any type of structured procedure to restructure their debts with their creditors before they are actually insolvent. France and the Netherlands are the two countries where a debtor may lose certain powers of control over the business during preventive restructuring procedures; meanwhile, in most other countries, the debtor is still left in position along with an appointed insolvency practitioner. In terms of possibility of a stay on individual enforcement actions, there is no possibility to extend the stay period in Germany, Spain, Poland, and Greece, while it is possible to do so in most other member states.

In addition, providing a second chance for entrepreneurs is another focus of the Recommendation. In fact, it is recommended for member states to allow a reasonable discharge period of a maximum of three years from the opening of liquidation of assets proceedings. However, there is still huge divergence in this type of period. While there is no possibility to discharge in Bulgaria and Hungary, the discharge period is too long in some other countries, such as 5 yeas in the Czech Republic or Sweden, 7 years in Austria and Belgium or even 10 years in Greece (Directorate-General Justice and Consumers of the European Commission 2015).

Along with the Recommendation by the European Commission, Nagham and Boughanmi (2017) recognized some innovative ways to resolve distress which are good practices found in different countries. These include the auction approach, debt equity swaps, empowering creditors by expanding their rights under bankruptcy, qualifications, training, and fee regulation for insolvency practitioners, speeding up court procedures, promoting out-of-court workouts and prepacks, encouraging early filings and providing easy accessibility, allowing floating charges, and use of the internet and authenticated professional platforms to sell assets or post decisions.

In brief, there have been quite auspicious reforms in EU member states in order to comply with the Recommendation of the Commission. However, differences in the implementation and insolvency proceeding reform among member states still represent a big gap to fill, since they have been causing legal uncertainty and additional costs for investors and hurdles for viable companies to restructure efficiently (World Bank Group, 2016).

There are two main features of an efficient bankruptcy court. The first is that it should maximize the ex post value of the firm, while the second is that it should ensure that the bonding role of debt is preserved. The latter means that the bankruptcy procedure should not create incentives for debtors to resort to bankruptcy. Maximizing the ex post value of the firm may be interpreted as a restructuring (and possible commitment by the country to an economic adjustment program) to maximize the value of repayments to the creditors. To be sure, such restructuring may also be in the interests of the country (Thomas, 2004).

Polish Insolvency Reform Case at the Background of EU Countries

This part of the article presents bankruptcy and insolvency law reforms in Poland that strongly support restructuring procedures. The main advantage is that they give the opportunity for a second chance and increase of business survival and allow taking proper restructuring actions in advance and in the right course. Poland is one out of seven EU countries (Denmark, Germany, Belgium, Italy, Poland, Greece, and Spain) participating in the Early Warning Europe program. The Early Warning Poland program helps businesses and the government to build mutual trust, protect companies and jobs, and protect the creditors rights. Poland follows the Danish experience, namely, with 10 years of program existence, 5000 companies supported, and an effective network of pro publico bono mentors. The Polish Ministry of Development supports business survival in many ways, especially through the second chance policy, the introduction of new legislation, and legal and financial support. This financial aid, namely, loans, is for the purpose of regaining financial liquidity for companies in the period of restructuring plan preparation. Poland receives the financial support from EU sources of 765 million PLN for the period of 2016–2020. The annual budget constitutes approximately 153 million PLN, which includes 53 million PLN for public liabilities restructuring.

Polish insolvency legislation includes two types of proceeding for businesses in financial distress: bankruptcy and restructuring. These two types of procedures that were entered into force on 1 January 2016 have different statutes: 1. Bankruptcy Law (Dz.U. from 2015, position 233), and 2. The new act on the Restructuring Law (Dz.U. from 2015, position 978). This new act on the Restructuring Law is a new legal framework for pre-insolvency/restructuring/hybrid proceedings. The following four restructuring proceedings are available:

1. Arrangement approval proceedings;
2. Accelerated arrangement proceedings;
3. Arrangement proceedings;
4. Remedial proceedings.

Apart from these procedures, bankruptcy proceedings also exist.

All restructuring proceedings may be entered into if the debtor is insolvent within the meaning of the Bankruptcy Law or at risk of insolvency (their economic situation indicates that they may soon become insolvent). According to Table 1, the essential component of restructuring proceedings is an arrangement: The legal act is similar to a court settlement, containing terms of restructuring.

Specification	Bankruptcy Law	The new act on Restructuring Law proceedings			
	Bankruptcy proceedings	**Arrangement approval**	**Accelerated arrangement**	**Arrangement**	**Remedial**
Initiation of the procedure	Debtor or by any debtor's personal creditor.	Only the debtor by entering into a contract with a licensed restructuring counselor chosen by the debtor.	Only the debtor by filling an application to the court.	Only the debtor by filling an application to the court.	Personal creditor of the debtor or by the debtor himself.
Main criteria to benefit from the proceedings	Bankruptcy may be declared in the case of a debtor who becomes insolvent.	The total disputed claims that give the right to vote on an arrangement not exceeding 15% of the total claims, giving the right to vote on the arrangement.	The total disputed claims that give the right to vote on an arrangement not exceeding 15% of the total claims, giving the right to vote on the arrangement.	The total disputed claims that give the right to vote on an arrangement exceeding 15% of the total claims, giving the right to vote on the arrangement. The debtor has to cover the cost of the proceedings and the liabilities arising after its opening.	The debtor has to cover the cost of the proceedings and the liabilities arising after its opening.
Purposes	Main aim is to satisfy the claims of the creditors to the maximum extent possible and, if feasible, for the existing business of the debtor to continue operating on the market.	The debtor is entitled to negotiate the terms of the arrangement without court involvement.	Restructuring proceedings combined with a court supervision when the debtor is not able to successfully negotiate terms of the arrangement without court involvement.	Restructuring proceedings combined with court supervision. The proceedings require greater involvement of court supervision than an accelerated arrangement.	Entered into when ordinary proceedings are not effective.
Possible outcomes	A bankruptcy proceeding usually leads to the liquidation of the debtor's assets, but it is also permissible to: 1. approve a prepack application appended to the bankruptcy petition; 2. conclude an arrangement between the creditors and the debtor aimed at restructuring of liabilities by an agreement with the creditors and maintaining the operation of the debtor's business.	The arrangement is concluded as a result of collecting creditors' votes by the debtor themselves, without involvement of the court. The debtor is allowed to manage all of their assets without limitations.	Pending execution proceedings concerning a receivable debt covered by the arrangement are suspended by operation of law on the day when the proceedings are opened. The arrangement is reached on the meeting of creditors convened by the judge-commissioner. The debtor is allowed to manage their assets, but they cannot perform activities which fall beyond the scope of ordinary business activities. Such activities require consent of the court supervisor.	Pending execution proceedings concerning a receivable debt covered by the arrangement are suspended by operation of law on the day when arrangement proceedings are opened. The debtor is allowed to manage their assets, but they cannot perform activities which fall beyond the scope of ordinary business activities. Such activities require consent of the court supervisor. The arrangement is reached on the meeting of creditors convened by the judge-commissioner.	After the opening of the proceedings, the debtor loses the authority to manage their assets (as a rule) and the court appoints the receiver, who is authorized to manage the debtor's assets. The arrangement is reached on the meeting of creditors convened by the judge-commissioner. The debtor can manage their assets only in special circumstances and only under the court's permit.

Source: Own study based on Deloitte Legal (2017). A Guide to Pre-Insolvency and Insolvency Proceedings across Europe. pp. 45–47. Available online: https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Legal/dttl-legal-deloitte-europe-insolvency-proceedings-guide.pdf (accessed on 21 July 2017).

Table 1 Comparison of Polish bankruptcy and insolvency proceedings.

The arrangement requires court approval. Accelerated arrangement proceedings include arrangement proposals, a preliminary restructuring plan, an up-to-date inventory of the assets, with the estimated valuation of component parts and the list of creditors (containing the amount of receivable debts owed to each of them). Arrangement proceedings concentrate on arrangement proposals, a preliminary restructuring plan, and the list of creditors (containing the amount of receivable debts owed to each of them).

Research Limitations

Objective data on business rescue are difficult to establish, and elements contributing to successful results are difficult to isolate.

Conclusions and Recommendations

Young enterprises are more vulnerable to the risk of bankruptcy. The entities which are best adjusted to the market conditions survive in it. The issue addressed in the article becomes increasingly important from the point of view of the entities whose aim in the initial phase of their functioning is, first and foremost, survival. The topic is very fresh not only for practitioners but also for scientists and policymakers.

The purpose of the Bankruptcy Law is to equally satisfy all creditors of a debtor, who is not able to satisfy each creditor separately. Bankruptcy should prevent carrying out enforcement against a debtor only by some creditors (in the event where the others do not have the enforcement title yet, e.g., when their claims have not been paid yet) and in cases when there is a priority system in enforcement proceedings. This means that the fact of bankruptcy is established judicially on the basis of the request either from a debtor, or from some of creditors or a few creditors. Bankruptcy and liquidation processes generate a lot of private and public costs (*externalities*). Restructuring proceedings are intended to provide an opportunity for a debtor to avoid declaration of bankruptcy through enabling them to start restructuring. This approach focuses on debt recovery that allows a business to have a second life, to continue business activity in the future and survive in the market, which is beneficial for many stakeholders.

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