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The Spanish Law of Suspension of Payments: An Economic Analysis From Empirical Evidence

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THE SPANISH LAW OF SUSPENSION OF PAYMENTS: AN ECONOMIC ANALYSIS FROM EMPIRICAL EVIDENCE.

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Abstract

Spanish legal restructuring law has been studied from an economic efficiency perspective by analysing 92 cases filed with the Barcelona courts for the period of 1984 to 1992. Legal mechanisms to establish the value of the firm do not reduce the asymmetry of information and do not allow the evaluation of its resource generating (cash flow) potential. Proceedings reserved to preferred creditors allow them to grab important part of assets, reducing the firm's going concern value. Junior creditors often accept restructuring schemes that entail the loss of a major part of their credits to the debtor, who in addition and normally maintains management control of the firm.

1- Introduction

The perspective of the Economic Monetary Union has stimulated recent structural reforms in order to improve the efficiency of the markets and the competitivity of Spanish firms. Their purpose is to facilitate efficiency in resource assignment. This environment appears to create the appropriate conditions for a reform of the Spanish bankruptcy system.

Since the black box has been opened, economists have a better knowledge of the way a firm's production is organized and of why the relationship with the different suppliers of the productive factors take certain contractual forms and not others. There is a better understanding of the purposes of the contracting parts, of the obstacles that interfere in the negotiation, of the difficulties in carrying out the contracts and of the different ways of breaking contracts. This is why the area known as institutional economy, transaction costs economy or even contractual perspective of economy provides the legislator with elements so as to appropriately identify the problems and take the correct decisions about the mechanisms that could help to solve them.

Most of the firms' transactions are established by incomplete contracts, that is, contracts in which the parts do not consider all the future contingencies. The existence of uncertainty is one of the elements that generates transaction costs. Another element that generates transaction costs derives from the fact that, in any incomplete contract, there is a margin to break it.

Bankruptcy law is a basic piece in the economic system because it influences the agents' possibilities to reach agreements that benefit them and that create wealth. The way the original terms of contracts are protected as well as the capacity to prevent opportunistic behaviors in financial distress (when, for example, some agents grab prematurely the firm's assets) affect the prospective results in the transactions. The greater the uncertainty associated with these transactions, the more obstacles are perceived by the agents. All this highlights that the effects of bankruptcy law extend beyond the judiciary phase, acting from the very moment in which the agents consider

the possibility of carrying out a transaction. The bankruptcy system helps to complete contracts when the firm is not able to meet its liabilities. This is why a theory explaining the way in which contracts are incomplete has been considered essential when considering the optimal bankruptcy system[1].

When the suppliers, financial institutions or the workers contract with the company, they cannot foresee what it is going to happen in the case of a crisis: neither is it possible to decide ex ante whether the company should reorganize or should be liquidated, nor it is possible to determine how the costs of the crisis should be distributed. These difficulties increase with an additional fact: the firm continuously acquires and cancels commitments, and therefore the number and nature of the agents and, more concretely, the structure of rights affecting the assets, changes each moment. This is why it is affirmed that one of the advantages of the bankruptcy procedure is that it makes the decision process easier under unfavourable circumstances.

In fact and in spite of the potential benefits associated with bankruptcy laws, there is a wide dissatisfaction with the way obligations are canceled and the way resources are reassigned. Bankruptcy laws generate important direct (administrative) costs [2] and indirect costs (loss of business opportunities), they allow non-compliance of contracts (thus generating transaction costs) and, in many cases, they facilitate the premature liquidation of the company or, on the contrary, they permit a firm's inefficient continuity. Any change of the legislation that improves the efficiency in the assignment of resources is justified. However this is not easy, since the bankruptcy system not only affects the economy but also has political and social consequences. In fact, when designing a bankruptcy system not only economic outcomes are considered. For example, the tendency in many systems is to favour a firm's continuity: legislators are particularly sensitive to social costs associated with firm's liquidation (for instance loss of jobs): these costs are perceived as very important and they are more evident and immediate than the costs associated with the continuity of an inefficient firm[3].

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[1] Hart, 1995 (Ch.7, p.158)
[2] Unfortunately, data related with bankruptcy costs are not available in Spanish court records.
[3] White (1994, p. 293)

The purpose of the this study is to analyze the legal restructuring procedure (Suspension of Payments Law, 1922 July 26, form now on L.S.P.) from an economic efficiency perspective, by analyzing 92 cases filed with the Barcelona courts for the period of 1984 to 1992. There is also a liquidation procedure, but it has not been studied because under this procedure the company's assets are usually sold piecemeal. L.S.P. is the only procedure designed for the approval of an agreement in order to avoid liquidation. In practice the options of legal restructuring are observed only in suspension of payments. However, this procedure is not very successful and it is generally considered as a way to delay the firm's liquidation.

The analysis is organized as follows: first, some efficiency elements outlined in bankruptcy literature are commented; secondly the basic aspects of L.S.P. are analyzed. Next, empirical results are shown, focusing first on the stage of evaluation, and then analyzing the stage of negotiation. Finally, the main implications of the study are pointed out.

2- Efficiency evaluation of the Bankruptcy System

Far from being the only ones, the analysis is centered on three aspects that can be considered in the evaluation of the efficiency of the legal restructuring systems. The first one is related with the mechanisms of evaluation of the resources that enter in the system. The second aspect refers to the effects on the reassignment of the productive resources (specifically, if the firm is going to continue its operations or not). The third one is related with distributive results of the procedure in terms of the allocation of property rights and the control between the various agents contractually related with the firm.

As for the first question, in many countries the entry into the procedure has the effect of revealing a certain type of information: insolvency laws establish mechanisms as to evaluate resources and determine the structure of existing rights; the results of this valuation is known by all participant agents. These mechanisms are established in order

to overcome the information problems existing between the conflicting parts and respond to the legislator's purpose of facilitating the decision relative to the firm's continuity or liquidation. In practice, owners and managers have more information on the firm's resource generating possibilities than creditors. This asymmetry of information reduces the possibilities of finding an efficient agreement, since they offer more opportunities to the most informed agents allowing them to take non-cooperative actions in the negotiation, of which the purpose is to determine just how the firm's resources have to be reallocated[4].

Concerning the second question, it is desirable from the economic efficiency point of view to maximize the firm's resources value. The bankruptcy systems may generate ex post inefficiencies when efficient companies are liquidated or when non-viable firms continue their operations[5]. This last circumstance takes place particularly in those systems that protect management's or debtor's interests in order to facilitate the firm's continuity[6]. However, in many cases the best solution is the firm's exit from the market. The problem is that throughout the firm's life an asymmetry between the stages of growth and those of contraction is observed: the existing rights structure represents an obstacle to exit, delaying necessary changes beyond the survival point. The incomplete contracts (with the suppliers, the workers and the managers) reinforce the defensive capacity of the firm and establish barriers against continuous and efficient adjustments[7]. The bankruptcy system can be an additional obstacle to the firm's exit.

The third aspect is related with the changes in control and property rights that take place in the bankruptcy procedure. It has been defended that the procedures have to

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[4] A question that is pointed out is that, as a consequence of mechanisms established by bankruptcy laws, the firm's judicial value is very far away from the firm's market value. In fact, recent normative studies try to establish adequate mechanisms as to overcome this limitation (Roe, 1983; Bebchuck, 1988, Aghion, Hart and Moore, 1992)

[5] It is one of the approaches used in analysing the bankruptcy system efficiency in comparative studies like Franks, Nyborg and Torous (1995, p. 3)

[6] In their comparison of U.S., German and U.K. bankruptcy procedures, Franks, Nyborg and Torous (1995, p. 23) point out that the control rights location throughout procedure has important effects on the incentives of continuing / liquidate: so, in the U.S., upon giving the managers an important control in the procedure, there exist strong incentives to continue, while in G.B. (and, in a certain measure in Germany), on the contrary, upon giving the initiative to the creditors, a major inclination towards the liquidation of the firm is observed.

[7] Jensen (1993, p. 849)

respect the initial contract terms. First, because changes produced within the bankruptcy system create incentives to strategic behavior: the most favoured agents could cause the premature entry into the system (producing inefficient liquidations), while, on the contrary, the most affected ones would try to delay entry (prolonging the inefficient firm's management and reducing the possibilities of recovery)[8]. Secondly, the effects on the transaction costs in the economy have already been commented[9]. As for the firm's control, many bankruptcy systems facilitate the continuity of the managers who led the firm to the crisis, in spite of the fact that changes in control may increase firm's value. Similarly, it has been pointed out that creditors control on decisions after the bankruptcy could improve the firm's management, also increasing its value[10].

3- Essential aspects of the Suspension of Payments procedure

In a wide sense, one could divide de procedure in two parts: the first one corresponds to the evaluation of the firm's financial position; the second one to the negotiation between the debtor and the creditors.

To start the procedure some documents have to be delivered by the debtor with the basic purpose of knowing the firm's position: asset information, amount and quality of debts, a specific memorandum on the causes that led the firm to the suspension of payments and a proposal of payments to the creditors (art. 2). This information will be analyzed by the judge basically from a formal point of view. After the request is accepted, the L.S.P. provides a mechanism of evaluation of the state of the company which consists of the election by the judge of two accounting experts and a creditor (art. 4) so as to prepare a report (being the legal term neither inferior to 20 days nor superior to 60) about the firm's situation. In practice the purpose of the report consists in

[8] Jackson (1986, p.26) points out that the change of value of the rights creates incentives so that agents that deal better with the procedure prefer to make use of it, even if it is not in the collective interest of the creditors.

[9] Franks, Nyborg and Torous (1995, p.4) assume that changes in the original conditions of the debt contract have negative implications on ex ante efficiency, in the sense that it could affect, not only the cost of capital, but also making it difficult to reach an agreement.

[10] Wruck (1990, p. 433)

determining whether the assets are or not superior to the total amount of debt (art. 8). The judge bases his decision on this information; so, usually, when the experts determine that assets are superior to liabilities, the judge will declare the company being in a state of provisional insolvency. In this case, the procedure will continue normally to the following phase. In case the liabilities are superior to the assets, and when the debtor is able to obtain resources that re-establish the equilibrium, the procedure also continues normally. In the case of not achieving the equilibrium, the judge determines that the company is in definitive insolvency and the creditors may force the procedure to be finished and the liquidation procedure to be declared: for this two fifths of the total liabilities is required; this is not easy, because of the short period established by the Law: 5 days. If this quorum of two fifths is not reached, even in spite of the disequilibrium reflected by the experts report, the procedure will continue to the following phase. In fact, the definitive insolvency declaration will not necessarily imply the procedure to be finished and substituted for a liquidation procedure. One observes that the resource allocation will not be directly conditioned by the accounting experts' valuation of the firm.

In fact, as for the financial and economic information, one could say that it improves as the procedure progresses. After facilitating the documents on behalf of the debtor, this information has to be corrected by the experts; then a new correction is produced on the part of the creditors, in which they verify whether their credits are appropriately reflected or not, thus establishing the definitive list of creditors that is mentioned in art. 12. As for the stage of negotiation, which starts when the judge declares whether the firm is in provisional or definitive insolvency, the L.S.P. determines a period of 30 days (with an extension to 60), after which the creditors and the debtor meet in order to negotiate the agreement. As to the creditors meeting to be constituted, at least 3/5 of the liabilities is necessary, discounting preferent creditors who use the right of abstention (right to remain outside the agreement). The majorities required for the approval vary according to the proposed plan (they vary between the 3/4 and the 2/3 of total liabilities). If an agreement is not reached, there is another

opportunity by celebrating a new creditors meeting. On the other hand, when the number of creditors exceeds 200 (art. 18, L.S.P.), before the meeting is held, it can be substituted by a written procedure; in this case creditors cast their vote in writing. This procedure lengthens the negotiation (by one to four more months), increasing the opportunities to reach an agreement. If agreement is not reached, the L.S.P. permits an additional extension of the procedure for another month.

Generally, at the beginning of the procedure of suspension of payments, there is no possibility of exercising individual actions against the debtor's assets and the par conditio creditorum principle, by which the losses are shared by all creditors, is applied. However, not all the creditors remain subject to this principle. In fact, the L.S.P. establishes a hierarchy by which creditors are divided into two groups: preferent and ordinary. The preferent creditors may act outside the procedure of suspension of payments in order to recover their credits and they will not be affected by the agreement achieved by the debtor and the ordinary creditors. The debtor is normally going to negotiate only with the ordinary creditors, unless the preferent creditors also want to participate (by giving up their privilege). Many of the preferent credits correspond to the debts accumulated with the workers, Social Security, Treasury, and the credits with collateral.

Throughout the procedure, the experts will supervise all the debtor's operations; however, it has to be remarked that, unless extraordinary circumstances are produced, from the moment when the company enters in suspension of payments until the procedure has finished, the L.S.P. maintains the property and the control of the resources in the debtor's hands. On the other hand, the judge acts passively in the negotiation, while waiting for the parts to solve the conflict themselves. Whatever the procedure (creditors meeting or written), the agreement will remain formalized in a document, and there is a wide freedom to determine its contents.

4- Empirical results

In this study a sample of 92 suspension of payments cases filed with the Barcelona courts between 1984 and 1992 courts is analyzed. As to the sampling selection a minimum amount of 300 million (ptas., 1992) in liabilities were required. which implies that very small companies are not part of the sample.

(Insert Table 1)

The sample comprises firms belonging to a wide variety of sectors. distributed in the following way: 58,7% industrial firms, 34,8% service firms, and 6,5% belonging to the construction sector.

4.1- Stage of evaluation

Following are the results of the stage of evaluation for the firms in the sample:

(Insert Table 2)

As observed in Table 2, in more than 80% of the cases the judge determined the provisional insolvency of the firm (including the cases in which definitive insolvency was changed into provisional, as a result the debtor's making additional resources available) while 19,6% were definitive insolvencies. The service sector, with a greater proportion of definitive insolvencies, compares badly with the industrial sector.

Let us now analyze the background to these results. The beginning of the suspension of payments is an unequivocal sign of the inability of the firm to meet its obligations. However it is in the debtor's interest to show that it is a transitory crisis and that. at least from a solvency point of view, the situation of the firm is not critical.

otherwise liquitation should be applied for. Besides, in spite of the fact that the suspension of payments procedure admits the possibility of definitive insolvency, it has been assumed that L.S.P. did not repeal art. 870 and 871 of the Trade Act, in the sense that in order to apply for suspension of payments, assets have to exceed liabilities. So it is normal to present balance sheets in which assets clearly exceed liabilities, even when it is not adjusted to the reality[11]. Similarly one cannot expect that the explanatory memorandum of the causes that led the firm to the suspension of payments represents realistic information. Neither does the initial proposal of payments to the creditors: the L.S.P. did not repeal art. 872 of the Trade Act which establishes that the debtor's proposal include a payment commitment over a period of no more than 3 years. This explains why the major part of initial proposals are very different form the agreements really reached.

The experts' report constitutes the main mechanism of firm's evaluation. The L.S.P. contemplates a static vision of the firm, characteristic of the time it was adopted. This explains why, from the financial point of view, the report only shows the balance sheet, ignoring or omitting the profit and loss account. Nor does it include forecasts that allow to recognize if the going concern value is or not superior to that of liquidation. Therefore, these reports do not reflect adequately the firm's possibilities when judged against current instruments of financial analysis.

In a certain sense, the report improves the information on the firm. Starting from the data presented by the debtor, the experts' report usually reduces the amount of assets and increases liabilities, with the assets being modified to the greater extent, as it can be seen in Table 3:

(Insert Table 3)

[11] This resulted in the recent Penal Code of 1995 to include strong penalties for those who present false data relative to financial statements when applying for suspension of payments.

Compared with the data presented by the debtor, the assets decrease by as much as 22%. The adjustment of the assets has been bigger when the report was unfavourable for the debtor. On the other hand, the total liabilities presented by the debtor increases by 13% on average. The adjustment is clearly smaller in the liabilities than it is in the assets. This is due to the fact that there is little freedom to hide the debts: after all, they will be adjusted by the creditors themselves. On the contrary, as to the determination of assets, the L.S.P. does not provide concrete instructions as a guide for the experts, allowing for very different approaches to be used. It is true that, with the recent Auditing Law, the accuracy that has to guide the experts' report (L.S.P., art. 2) has been associated with the concept of true reflection, so that, in a way, this seems to have reduced the degree of freedom in preparing the reports. Nevertheless, the purposes of auditing are clearly different from the ones used for the valuation of a financially distressed firm, in which case the focus is centered on the comparison between the going concern value and liquidation value, so the problem is far from being resolved.

In fact, the significant differences observed in the adjustments of the assets whether the verdict is favourable or not suggest that there is much leeway for the debtor and the experts to negotiate the result of the report. The debtor is particularly interested in avoiding the definitive insolvency to be declared, since, in this case retroaction (restoration of assets ordered by the judge when these assets were subject to fraudulent acts) will be applied (art 21). The interest to avoid the definitive insolvency is often shared by creditors that have a more advantageous position before the beginning of suspension of payments (e.g. by having more information than the rest of the creditors).

The valuation mechanism as provided by the L.S.P. is not usually very positive. This impression is reinforced if one observes that the information contained in the experts' report referring to liabilities is not very reliable: total liabilities in the definitive list (adjusted by the creditors) are bigger by as much as 9%.

The most significant aspects of the stage of evaluation are summarized in Exhibit1 :

(Insert Exhibit 1)

One of the positive aspects is that creditors know the position of each other. Certainly, the entry into the procedure has the effect of revealing important information which is very difficult to obtain in the pre-bankruptcy stages.

However, as to the firm's assets, the information is insufficient: this is why reports prepared by the accounting experts are not very well regarded. The L.S.P. allows to waste significant resources in the valuation of the firm (usually paid by the debtor) with the following consequences: delaying the beginning of the negotiation stage, giving partial information on the firm's financial position and offering the debtor the possibility of reaching his strategic interests.

4.2- Negotiation mechanisms

As can be seen in Table 4, whether through the written procedure or through creditors meeting, in most cases (in four out of five) an agreement was reached.

(Insert Table 4)

One of the reasons that probably contributed to this result is that the L.S.P. allows for wide time span for the agreement to be reached. It is interesting to observe that in many cases in which the number of creditors exceeded 200, the written procedure was chosen. One also sees that many agreements were reached after a second meeting of creditors, or after the appointment of a new period in the written procedure.

Thus, as can be observed, the procedure is quite flexible, and this flexibility is used by agents when they negotiate in order to reach an agreement.

4.2.1.- Results from the continuity/liquidation perspective

Table 5 analyses the result of the procedure in terms of the firm's continuity/liquidation. However, keeping in mind the deficiencies observed in the mechanisms of evaluation, we cannot extract valid conclusions from the efficiency perspective: we do not know in which cases the best solution is reached.

(Insert Table 5)

One can find fewer restructuring agreements within the services sector, which is consistent with the lower judicial valuation of these firms. On the other hand, it seems that size is an excellent variable in explaining the expectation of reaching an agreement.

From an overall perspective, if liquidation agreements are added to the group that conclude without agreement, one finds that a very important proportion of companies are liable to disappear after the suspension of payments. On the basis of this breakdown, a multivariate analysis has been carried out, taking 1 for the dependent variable representing the restructuring agreements, and 0 for the rest of the cases. Starting from the data contained in the files, it has been analyzed if it was possible to predict the probability of reaching a restructuring agreement. Two specific characteristics have been included in the model: size (total liabilities) and age. Two variables related to creditors structure have also been considered: the so-called concentration index C5 (percentage of the 5 bigger credits on the total amount of ordinary liabilities) and the percentage of the ordinary bank liabilities on the total of ordinary liabilities. Finally, two economic quality variables have been added: the quotient between assets and liabilities; and the relationship between preferent liabilities and total assets (so as to measure the effect they could have on the firm's value). Probit analysis results are shown in Table 6:

(Insert Table 6)

One observes that the predictive capacity of the model is quite high. The most significant variables are Size, Age and the quotient A/L (Assets/Liabilities). Size is positively related to the probability of achieving a restructuring agreement. A possible interpretation is that the bigger the firm the likelier are the agents implied to agree on avoiding liquidation, because of the consequences this solution could have from a social point of view. This suggests that there are more obstacles when liquidating a big firm, than a smaller one. As for Age, a clear explanation of the obtained result does not exist a priori: the older the company the smaller the probability of achieving a restructuring agreement of the debt. On the one hand, one could find in this an explanation for the disappearance of older companies due to structural factors (technological obsolescence, labour costs structure, etc.); as for the younger companies, the explanation could be found in the liquidity problems associated with a rapid growth, in which case liquidation would not be the solution.

Also, the fact that A/L is one of the most significant variables suggests that the bigger the difference between assets and liabilities the healthier is the firm (from the going concern point of view), and the more possibilities of achieving a restructuring agreement. However, if one takes into account the limitations in the judicial valuation of assets as remarked above, this result needs further explanation. In fact, Table 7 shows that not in all the cases in which there is a favourable verdict will conclude with a restructuring agreement.

(Insert Table 7)

Had the judicial evaluation been binding, fewer firms would have been liquidated immediately. This suggests that the valuation is too optimistic.

Variables related to creditors structure are not significant. It seems that the financial creditors participation is not very active when deciding how resources entering in the procedure have to be allocated. This suggests that, in the Spanish economy, the

traditionally limited involvement of the financial institutions in the productive economy does not change when confronted with a firm in financial distress[12]. As for the creditors concentration and the preferent creditors participation some aspects will be commented below.

4.2.2- Distributive aspects of the negotiation

In liquidation cases, the ordinary creditors will receive the net worth after the preferent creditors grab part of the assets, while the debtor will not participate in the distribution. However, when there is a debt restructuring agreement, a distribution of the future cash flow generation will take place between the debtor and the ordinary creditors. In order to evaluate the 52 restructuring agreements from a financial point of view, the percentage of payments (discounted to the date of bankruptcy application) on the total amount of ordinary credits has been established. The results are shown in Table8 :

(Insert Table 8)

Results clearly show the low collection expectations when creditors are involved in a case of bankruptcy. It has to be pointed out that these payments merely represent a promise made by the debtor under the going concern assumption. For this, we should talk about collection expectations, depending on the firm's continuity, an aspect that could not be valued, since there is not any court control on the agreement execution. It should be pointed out that different multivariate calculations have been carried out in

[12] However, Padilla and Requejo (1997) find a positive relationship between the likelihood of employment cuts and leverage (firm's debt exposure) within a debt restructuring process. This may be consistent with banks playing an active role under financial distress (with firms considered in financial distress when the ratio of earnings before interests, taxes, and amortizations to interest expenses decreases significantly). The underlying reasoning is that 'the greater the firm's debt exposure the deeper the conflict of interest between the firm's shareholders and the incumbent bank and, therefore, the larger the reduction in employment needed to persuade the bank to restructure its debt (p 26)'. These employment cuts may increase the ex ante value of the firm's investment project in the post-distress period (p.3).

order to measure whether the variables collected explain the level of payment agreed. however, the results obtained were not satisfactory. The main conclusion is that, with the information generated in the procedure, this variable cannot be predicted.

As for the clauses included in restructuring agreements, as can be appreciated in Table 9, several types of control have been observed[13]. One can establish three categories in function of the control incidence in the management aspects of the firm: a strong form of control exists when creditors interfere directly in strategic and management decisions; the weak form is observed when control is limited to the execution of the agreed payments; in some cases no type of control was observed.

(Insert Table 9)

In most of these agreements some sort of control on the debtor behavior can be found, which should start from the moment the suspension of payments is lifted. In some cases (mainly in the industrial sector) this control affects the firm's normal management activities. However, generally the control is limited to the pursuit of the execution of the agreed payments and usually a creditors' commission is elected. In more than 80% of restructuring agreements a clause is included by which the firm would be liquidated in case of non-compliance. This could reflect that creditors are not very confident about the debtor's payment capabilities.

4.2.3- Negotiation mechanisms: institutional aspects.

Some institutional aspects relative to the resource reassignment and property rights are pointed out in Exhibit 2.

[13] Wruck (1990, p.433) points out that not only costs have to be associated with financial distress, but rather benefits also exist derived from control changes that positively affect firm's value. Gilson (1989, 1990) obtains empirical evidence in the U.S. of important changes in control and administration of the firm in the context of financial crisis.

(Insert Exhibit 2)

Following some of these aspects will be commented:

i) Flexibility:

Besides the issues mentioned above (commenting Table 4), there are other elements that allow to affirm that the procedure is quite flexible. Evidence suggests that. in order to facilitate the agreement, the L.S.P. establishes a quorum that seems quite reasonable. For the major part of the agreements, a minimum of 2/3 of the ordinary liabilities is required (66,6%). Chart 10 shows that the total amount represented by the five major ordinary creditors reaches more than 50% of total ordinary liabilities.

(Insert Table 10)

Under such a concentrated structure an agreement should be easy to reach. as is suggested by Table 11:

(Insert Table 11)

It shows the fact that, when the sum of liabilities of by the first five creditors surpasses the percentages usually established by L.S.P., an agreement is reached in a greater proportion of cases.

Another aspect that can have a positive effect on the negotiation is that the liabilities created after starting the procedure are not affected by the par conditio creditorum principle. This generates new incentives to the suppliers to continue financing the firm and it facilitates the continuation of operations, decreasing indirect costs caused by lost business opportunities upon entering into the procedure[14].

[14] Kaiser and Kaiser (1993, p. 30) and Franks, Nyborg and Torous (1995, p. 29)

Even though all these aspects are qualified as positive, it should to be pointed out that all the advantages provided by the flexibility are usually lost, because generally the debtor and, in some cases, the most important creditors, make an strategic use of them damaging the rest of the creditors.

ii) Transparency:

The negotiation between the debtor and the ordinary creditors is carried out by initiative of the former or of any important creditor. However the consulted documents suggest that the true identity of the proposing agent is not always known: of the cases in which any type of agreement was reached (73 cases) in only 7 (less than 10%) the author of the proposal was the debtor. In 22 files (30% of the total accepted agreements) the author was a creditor who was not even listed among the 10 major ordinary creditors. It is quite usual to observe that an important part of creditors goes to the meeting without knowing the proposals that are going to be discussed. Besides, the ordinary creditors do not have a precise knowledge about the negotiations of the debtor with preferent creditors like, for example, the Treasury and the Social Security in order to avoid executions or seizures on the firm's assets: in the cases analyzed, a 15% of the assets may be affected by their actions. All these elements suggest that the negotiations are not very transparent.

iii) Separation of the preferent and ordinary creditors

One aspect that has been criticized frequently is the wide range of privileges that is offered to some agents, limiting the going concern possibilities: in spite of the fact that the results of the multivariate analysis do not provide empirical evidence of this fact, the opposite does not seem very convincing either. First, because in many cases the proportion reached by preferent creditors is quite important, as one can see in Table 12:

(Insert Table 12)

In Table 12 the volume of preferent creditors is related to the total assets in order to appreciate the incidence that these credits could have on the assets and on the going concern value of the firm. The fact that this relationship reaches almost a 30% on average suggests that, even in those cases in which an agreement is reached to restructure the debt, the behaviour of these creditors will substantially reduce its completion. Secondly, among the preferent creditors there are agents whose participation is decisive as to achieve the recovery of the firm. Therefore, in some cases these credits could be qualitatively very important. On the other hand, upon not being involved in the procedure, the separation of this type of creditors will reduce their incentives to ex ante control of the firm, and it will also inhibit them of taking actions when a deterioration of the firm is observed. Besides, the privileges offered to creditors with collateral will ex ante modify market practices (limiting access to credit only to firms whose assets are not affected by collateral) and will incite certain actions of the agents in order to improve their position when facing the possibility of the firm's entry into the bankruptcy system, and therefore damaging others' interests[15].

iv) Negotiation between ordinary creditors and the debtor

In many occasions, the negotiation mechanisms established by the L.S.P. induce the ordinary creditors to approve the restructuring plan, since the alternative of liquidation is not very attractive. Professionals involved in bankruptcy procedures are of the opinion that at least in the suspension of payments a part is recovered while, on the contrary, in the liquidation nothing is ever collected. This threat may explain the low collection levels, implying that important advantages are offered to the debtor[16].

[15] It has been observed in other countries that protection of the preferent creditors have effects on the credit markets: for example, the protection of privileged creditors in Germany has motivated a wide variety of practices in order to assure that their credits do not lose the privilege in the case of entering in a bankruptcy procedure (Kaiser and Kaiser, 1993, p.29)

[16] Enough works exist in the U.S. in which deviations under the legal restructuring procedure (Chapter 11) regarding the original contracts are analyzed: some of this studies are by Franks and Torous (1989), Eberhart et. al (1990), Weiss (1990), and more recently, Betker (1995). The main cause of these deviations resides in the fact that, in spite of the Absolute Priority Rule that prevails in the U.S. bankruptcy system (by which no junior creditor has the right to receive any payment unless senior creditors are completely satisfied): 1) the debtor has granted an important power in the procedure and 2) the judge has the capacity of forcing the acceptance of the plan proposed to dissident creditors, by the

5- Implications of the study

Some implications of the aspects analyzed in this work are pointed out in Exhibit3:

(Insert Exhibit 3)

The evaluation mechanisms provided by the L.S.P. are inefficient. There are costs produced by the accounting experts' activity. There are also lost opportunities because the valuation stage delays the decision making process in the negotiation stage. Besides, the L.S.P. does not facilitate the creditors to evaluate the real resource generation capabilities of the firm. The asymmetry of information and the flexibilities that result from the procedure offer the debtor a clear advantage in the negotiation, enabling him to reach his strategic objectives. The non-cooperative behaviour of the debtor may reduce the possibilities of maximizing the firm's value. This is the case of the debtor who, by being favoured by an important discount in the liabilities and financial expenses, hopes to maintain its firm in operation, at least for an additional period.

It has been widely accepted that one of the main objectives of the bankruptcy system should be to avoid the individual actions of the creditors against the firm's value[17]. One of the main critical aspects of the L.S.P. lies in the fact that it causes an interference between distributive aspects and those of resource reassignment upon permitting the individual behaviour of an important part of the agents involved: workers, treasury, financial institutions. Although it is true that, from an ex ante efficiency point of view, the desirable outcome would be that a bankruptcy system

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Cram Down mechanism (Wruck, 1990, p. 440). Even when Cram Down is not frequently used, it is important to consider the impact that the threat can have on creditor's willingness to negotiate and reach an agreement (Kaiser and Kaiser, 1993, p.27).

[17] Jackson (1986)

respect their priority, this individual behaviour has clear implications for the ex post efficiency, basically because it could affect assets that could be essential from a productive point of view, and also because these creditors are not taken into account in the continuing / liquidation decision.

As for the agreement between the ordinary creditors and the firm's owners, and since the L.S.P. promotes a negotiation mechanism that ends either in liquidation or in debt restructuring, in many cases creditors accept the restructuring plan proposed by the debtor, since in practice it is demonstrated that the alternative of liquidation represents foregoing all chances of recovery. The analysis of these restructuring plans indicate that creditors hope to recover a very low percentage of the credit and suggest that ex post inefficiencies are generated upon facilitating the firms to continue operations. The distributive aspects in bankruptcy will not always bring the agents to initiate the procedure when it is needed. In fact, the low quality of the agreements reached suggests that companies enter the procedure too late.

As for the control aspects of these agreements, it has been shown that, in most of the cases, the creditors do not limit the debtor's decision making capacity, restricting the control basically to the pursuit of the execution of the financial agreements. So the advantages associated with an ex post control of the firm are lost.

On the other hand, upon changing the initial contract terms, transaction costs in the economy are generated: the damage to creditors affected by bankruptcy will lead to a greater cost and to add restrictions in the credit market. In a system that does not protect the creditors, the costs of error in classification (grant a credit to a bad firm) are high: the creditor cannot ex ante distinguish bad and good firms, so the risk incurred in a credit transaction is high, reducing firms financing possibilities and increasing cost of capital.

Finally, distributive aspects restrain creditor's ex ante control activities: in the case of ordinary creditors, the control costs will be unrecoverable once bankruptcy is applied for; and in the case of preferent creditors, they are not concerned with the firm's

evolution, since their rights will prevail over the rest of the creditors' in bankruptcy situations.

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TABLES and EXHIBITS

Table 1

Size (1992 ptas.)	Liabilities (92 cases)	Interval	Number
Average	1,111,373,515	From 300 to 500 million	32
St. Dev.	1,129,085,822	From 500 to 1,000 mill..	29
Medium	709,324,509	From 1,000 to 2,500 mill.	21
Maximum	6,398,594,293	From 2,500 to 5,000 mill.	8
Minimum	302,203,045	Over 5,000	2

Table 2

Judicial qualification	Provisional insolvency	%	Provisional Insolv * (a)	%	Definitive Insolv.	%
All	68	73.9%	6	6.5%	18	19.5%
Industry (b)	45	83.3%	4	7.4%	5	9.25%
Services	22	68.7%	2	6.25%	8	25%
Total Liab. less than 700 m.	32	71.1%	3	6.7%	10	22.2%
Total Liab. more than 700 m.	36	76.6%	3	6.4%	8	17.0%

Notes: (a) In Provisional Insolvency* unfavourable report has been prepared by accounting experts, however the debtor has reestablished the equilibrium by bringing new resources into the firm (b) In the activity breakdown construction firms have been excluded, because of their reduced number.

Table 3

Assets: Experts' report/ Debtors' accounts	All (90 cases)	Assets greater than Liabilities	Assets inferior to Liabilities
Average	0.7804	0.8694	0.5358
St. dev.	0.3941	0.4093	0.2062
Min	0.1764	0.4588	0.1764
Max	3.6251	3.6251	0.8591
	Analysis of variance	Significant differences	to the 99.97%
Liabilities: Experts' report/ Debtors' accounts	All (89 cases.)	Assets greater than Liabilities	Assets inferior to Liabilities
Average	1.1338	1.1433	1.1080
St. dev.	0.4398	0.5031	0.1867
Min	0.7300	0.7300	0.7889
Max	4.8258	4.8258	1.7006
	Analysis of variance	No significant differences	F-prob: 0.7388

Note: In two cases no information was found on the assets and in three cases no information was provided on the liabilities

Exhibit 1

Summary of the stage of valuation	
Positive aspects	**Negative aspects**
List of creditors - It allows to evaluate the total debts of the company - It allows to know the priority structure of claims - It allows to determine creditors' groups weight (like, for example, the financial creditors) and foresee the difficulty of the negotiation.	**Documents contributed by the debtor** - The judge only analyses them from a formal point of view - They do not allow to know the economic situation of the company - They do not reflect the real motivations that led to entering into the suspension of payments procedure - They do not contain a feasible solution of the crisis **Report prepared by the experts** - It does not improve the knowledge on the economic situation of the company - It represents a high cost in time and resources

Table 4

Development of the procedure	Num.	%	Fewer than 200 creditors	Over 200 creditors
Approved agreement in 1st. Meeting of creditors	25	27.17%	22	3
Approved agreement in 2nd. Meeting of creditors	13	14.1%	12	1
Approved agreement in written procedure without time extension	13	14.1%	-	13
Approved agreement in written procedure with time extension	22	23.9%	-	22
The 1st. Meeting without approval takes place (or the debtor waives his right to continue negotiation before the 2nd Meeting)	2	2.1%	2	-
First Meeting was not celebrated for lack of quorum	8	8.6%	5	-
The debtor waives his right before the celebration of the Meeting or debtor does not attend.	5	5.4%	5	3
Sufficient adhesions in the written procedure could not be obtained	4	4.3%	-	4

Table 5

Result	Non liquidating agreement	%	Liquidating agreement	%	Agreement is not reached	%
All	53	57.61%	20	21.74%	19	20.65%
Industry	34	62.96%	10	18.52%	10	18.52%
Services	18	56.25%	8	25%	6	18.75%
Less than 700 mill. ptas. 1992	20	44.44%	12	26.67%	13	28.89%
More than 700 mill. ptas. 1992	33	70.21%	8	17.02%	6	12.77%

Table 6

Probit analysis	(sample: 92 cases)
Dependent variable: R with R= 1 if there is restructuring of the debt R= 0 liquidation or no agreement is reached	B coefficients (t Significance)
Ln (Size)	0.50955 (0.04635)*
FIN / L (share of the ordinary financial creditors on the total ordinary liabilities)	0.14487 (0.85835)
C5 (percentage of the liabilities of the first 5 ordinary on the rest of ordinary)	- 0.11478 (0.91104)
N (age of the company)	- 0.01691 (0.09894)
PREF / A (preferent credits / total assets)	- 0.69550 (0.40576)
A / L (Assets / Liabilities)	3.1004 (0.00001)*
Constant	- 12,908 (0.01372)

	Prediction		Correct percentage
Observed	0	1	All: 78.3%
0	27	12	69.2%
1	8	45	84.9%

Table 7

	Qualification		Correct percentage
Observed	Definitive Insolvency	Provisional insolvency	All: 75%
Not restructuring	17	22	43.6%
Restructuring	1	52	98.1%

Table 8

Recovery percentage (discounted to dates of application)	All	Industry	Services	Less than 700 million (1992 ptas.)	More than 700 million (1992 ptas.)
Average	37.17	35.01	41.26	39.03	36.11
St. dev.	11.16	10.65	11.25	11.32	11.10
Min	17.11	17.11	27.08	17.11	20.34
Max	61.14	59.03	61.14	61.14	59.03
Cases (b)	52	34	18	19	33
Analysis of variance (F Prob)		Significant difference to the 94.65%	(0,0535)	No significant differences	(0,3686)

Note: discounting rates corresponding to Interest rates for long term loans (over 3 years; source: Banco de España). (b) In one case it was not possible to calculate the level of collection because the date of the agreement could not be established.

Table 9

Control					
Strong	***Control on the management of the company***				
Type 1	Interim management				
Type 2	Member of board of directors				
Type 3	Commission creditors (right to veto)				
Weak	***Supervision of the execution of the payments***				
Type 4	Commission of creditors (supervision of agreement compliance)				
No control	***No control***				
Type 5	No control				
	All	Industry	Services	Less than 700 million (ptas. 1992)	More than 700 million (ptas. 1992)
Type 1	1	1	0	0	1
Type 2	2	2	0	0	2
Type 3	8	7	1	4	4
Type 4	37	22	14	13	24
Type 5	5	2	3	3	2

Exhibit 2

Stage of negotiation: institutional aspects	
Positive aspects	**Negative aspects**
i) Flexibility - Adaptation of the procedure to the number of involved agents - Possibility of continuing the procedure when the agreement is not reached - Free contents of the Agreement - Necessary Quorum quite reasonable - Credits raised after the beginning of the procedure are not subject to the principle of par conditio creditorum.	**ii) Transparency in the negotiation** - The debtor controls the negotiation - Parallel procedures with the government agencies and the workers **iii) Preferent / Ordinary classification** - Loss of productive assets reducing the going concern value of the company - Exclusion from the negotiation of agents crucial for the continuity of the company - Incentives in order to delay the entry into the procedure (ordinary creditors and debtor) - Actiõns ex ante in order to improve the position in view of a possible entry into the procedure **iv) Negotiation ordinary creditors/ debtor** - Alternative to the agreement of restructuring: liquidation of the company - Result: in many occasions acceptance of agreements with low recovery levels of the credit (ordinary creditors)

Table 10

Concentration index C5 (ordinary.)	All	Industry	Services	Less than 700 million (ptas. 1992)	More than 700 million (ptas. 1992)
Average	0.5418	0.4990	0.6178	0.5447	0.5390
St. dev.	0.1860	0.1739	0.1820	0.1613	0.2086
Min	0.1700	0.2148	0.2284	0.2590	0.1700
Max	0.9998	0.9998	0.9241	0.9998	0.9756
Cases	92	54	32	45	47
Analysis of variance (F Prob)		Significant differences to the 99.65%	(0,0035)	No significant differences	(0,8845)

Table 11

Percentage of the first 5 ordinary creditors liabilities.	Agreement was reached	Agreement was not reached
More than 66.6%	19 cases	3 cases
Less than 66.6%	54 cases	16 cases

Table 12

Preferent liabilities/ Total assets	All	Industry	Services	Less than 700 million (1992 ptas.)	More than 700 million (1992 ptas.)
Average	0.2976	0.2607	0.3055	0.2770	0.3173
St. dev	0.3029	0.2077	0.3880	0.3029	0.3162
Min	0.0032	0.0080	0.0032	0.0032	0.0060
Max	1.9823	0.9364	1.9823	1.3517	1.9823
Obs.	92	54	32	45	47
Analysis of variance (F Prob)		No significant differences	(0,4873)	No significant differences	(0,5341)

Exhibit 3

Law of suspension of payments 1922	**Ex ante efficiency**	**Ex post efficiency**
Mechanisms of valuation		
1) Asymmetry of information	- Creditors have few information advantages, reducing willingness to entry	- Procedure controlled by the debtor, favouring opportunistic behaviours
2) Cost in time and resources	- Cost for the debtor: it delays application for entry into the procedure	- It lengthens the procedure, delaying the decision process
Negotiation		
1) Flexibility / lacking transparency	- The game rules do not favour the ordinary creditors (reducing incentives for entry)	- The flexibilities offer advantages to the debtor allowing him to reach his objectives
2) Distributive Aspects	- The most affected creditors will not press for entering into the procedure - Increment of the transaction costs for the economy in general. - Limited ex ante control carried by creditors	- Firm's value destruction: actions of preferent creditors - Incentives for continuity of inefficient companies - The management remains in the debtor's hands. - There is no control by the creditors on the future operations of the company

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