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# The impact of the economic crisis on the corporate insolvency's evolution in Romania

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**Abstract**

This article aims to analyze the impact of the financial crisis on the corporate insolvency's evolution and the changes in the Romanian insolvency regime. The Romanian government was determined, as other European Union member states' governments did, to improve its insolvency law in order to save the viable businesses and to stimulate the creation of new ones. We want to highlight Romania's position within the European Union in terms of time, cost of insolvency, recovery rate and dynamics of business insolvencies' number and to propose specific measures to improve its situation.

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*Keywords*: insolvency, recovery rate, economic crisis, Romania;

## 1. Introduction

The 2008 global economic crisis and its negative effects (restricted access to credit, reduction in trade finance and foreign direct investment) have affected businesses around the world. The significant raise in the number of insolvent companies emphasize the importance of improving insolvency regimes.

Some of the legislative changes made in 2009-2011 by many EU member states, including Romania, were inspired by the economic crisis that had been a good opportunity for governments and policymakers to engage in significant reform of the bankruptcy process. They have improved their insolvency laws through specific mechanisms like: empowering creditors, insisting on qualifications, promoting out-of-court workouts, keeping abuse in check, setting time limits, promoting specialized courts, protecting secured creditors and increasing transparency.

## 2. Literature review

The efficiency of bankruptcy and reorganization procedures is not only an academic issue but also a matter of importance for government and corporate policy (Ravid & Sundgren, 1998). Speed, low costs and continuation of viable businesses characterize the top performing economies (Doing Business).

Among the economies where resolving insolvency is fastest, the majority has systems where reorganization is more likely than foreclosure or liquidation. Bankruptcy reforms that support reorganization diminish failure rates among SMEs and the liquidation of viable businesses (Doing Business).

Modern bankruptcy laws focus on the survival of viable businesses and the creation of solid reorganization procedures. By giving efficient companies a chance at a fresh start, bankruptcy law helps maintain a higher overall

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level of entrepreneurship in an economy (Armour & Cumming (2008)). The most important goals of insolvency systems are keeping viable firms operating. A good bankruptcy regime should prevent early liquidation of sustainable businesses (Djankov & others (2008).

The odds of saving the firm are especially low in the French legal origin countries, which have highly formal bankruptcy procedures. Simpler mechanisms, such as foreclosure with no or limited court oversight and floating charge, which essentially transfer control of the firm to the secured creditor, might be preferred (Djankov 2008).

Lower bankruptcy costs can help keep efficient firms in existence while simultaneously encouraging the creation of new firms and promoting healthy competition in the economy (Cirmizi, Klapper & Uttamchandani, 2010).

Well-functioning bankruptcy regimes can facilitate access to finance, especially for small and medium-size enterprises, and thus improve growth in the entire economy (Uttamchandani & Menezes (2010)). Secured creditors must be protected or granted priority under the law, or they will have less incentive to lend in the future and that leads to a less developed credit market (Claessens & Klapper (2003)).

According to Funchal, stronger regulation protections for creditors are associated with lower costs of debt as well as an important increase in the overall level of credit (Funchal 2008). If in a case of bankruptcy creditors can recover most of their investments, they can keep reinvesting in viable firms, improving companies' access to credit (Doing Business).

Economies with good bankruptcy procedures are those that maximize the total value of recovered debt and make it possible to do so at a low cost (Doing Business). Recovery rates are higher in going-concern sales (mean 39%) than in piecemeal liquidations (mean 27%). Secured creditors receive on average 69% (median 83%) (Ravid & Sundgren 1998).

## 1. Research methodology

We have gathered data from Creditreform, Doing Business, Euler Hermes in order to make a comparative analysis between the EU average and Romania's business insolvencies in the 2007 - 2012 period. We have used the following variables:

- Time to resolve insolvency (years) represents the average time to close a business;
- Cost (% of debtor's estate) represents the average cost of bankruptcy proceedings. The cost of the proceedings is recorded as a percentage of the estate's value;
- Outcome (0 as piecemeal sale and 1 as going concern);
- Recovery rate (cents on the dollar): it calculates how many cents on the dollar claimants (creditors, tax authorities, and employees) recover from an insolvent firm;
- The percentage of change in number of insolvencies (2011/2010).

## 2. The insolvencies' evolution in Romania

According to La Porta (1997, 1998) the legal system should protect investors ensuring sustainable financial development leading to economic growth. This theory distinguishes countries based on the following criteria:

- The type of regulatory framework applied, that is civil law or common law;
- Whether bankruptcy regulations are favorable to debtors and creditors.

All countries in Europe have legal systems based on civil law, except the United Kingdom and Ireland which have common law and Cyprus and Malta that have pluralistic law (elements from common and civil law).

Among the countries with civil law, there are three sub-groups of legal systems, those influenced by the French civil law, those influenced by the German civil law and those influenced by Scandinavian civil law, while some countries have legal systems with elements from both the French and German civil laws (European Commission). Romania fits into the French civil law.

According to a European Commission's survey, the majority of the EU member states have creditor – friendly legal systems (15 out of 27), five countries are debtor-friendly and the rest of them are neutral. Romania is among the debtor-friendly countries.

In relation to the impact of debtor-friendly vs. creditor-friendly bankruptcy framework, debtor-friendly bankruptcy systems have a higher rate of insolvencies than creditor-friendly ones (European Commission).

An European Commission survey revealed that efficient bankruptcy procedures are not determined by the type or orientation of legal system, but by concrete provisions like the existence of out-of-court settlements, the existence of fast track procedures for SMEs, the different treatment of honest and dishonest bankrupts, the existence of an early warning system and other that may significantly affect the efficiency of the system.

The most important insolvency reforms made by Romania in the period 2009-2012 as a reaction to the economic crisis are the following:

- Elimination of formalities or introduction of time limits;
- Promotion of specialized courts – Romania created special insolvency departments within tribunals (2009);
- It took steps to prevent abuse;
- It established or promoted reorganization, liquidation or foreclosure procedures;
- It established special pre-insolvency procedures for distressed companies trying to avoid bankruptcy (2010)
- Introduction of out-of-court debt restructuring options (creditors and debtors can more easily agree to change the terms of debt repayments, allowing the debtors to continue to do business without initiating insolvency proceedings in court) (Doing Business)

The Doing Business data presented in table 1 reflect a below-average profile for Romania compared to the EU-27 in terms of resolving insolvency. In the EU, in terms of resolving insolvency indicators, all three registered improvements: the time and the cost to resolve insolvency slightly decreased, whereas the recovery rate increased with 3,2 cents on dollar.

Table 1. Resolving Insolvency Romania – EU average

| Economy | Year | Resolving Insolvency | | | |
|---|---|---|---|---|---|
| | | Time (years) | Cost (% of estate) | Outcome | Recovery rate (cents on dollar) |
| European Union | 2007 | 2,11 | 10,52 | | 59,41 |
| | 2008 | 2,08 | 10,69 | | 57,55 |
| | 2009 | 2,08 | 10,77 | | 57,56 |
| | 2010 | 1,95 | 10,54 | | 60,36 |
| | 2011 | 1,99 | 10,52 | | 60,85 |
| | 2012 | 1,99 | 10,22 | 1 | 62,61 |
| Romania | 2007 | 3,3 | 9 | | 28,9 |
| | 2008 | 3,3 | 9 | | 29,5 |
| | 2009 | 3,3 | 11 | | 28,5 |
| | 2010 | 3,3 | 11 | | 25,7 |
| | 2011 | 3,3 | 11 | | 28,6 |
| | 2012 | 3,3 | 11 | 0 | 29,2 |

In terms of time of recovery, Romania ranks last but one among the EU-27 member states, along with Bulgaria (3,3 years). The EU country in which resolving insolvency lasts more is the Slovak Republic (four years). The time to resolve insolvency in Romania remained constant whereas the cost increased in 2009 from 9% to 11% of the debtors' estate. Concerning the cost of recovery, Romania ranks eighteenth on a par with Spain (11 cents on dollar) among the EU-27 member states.

Regarding the outcome (0 as piecemeal sale and 1 as going concern), in Romania we encounter a piecemeal sale whereas in the majority of the EU member states (17 of 27) there is a going concern sale. Recovery rates are higher

in going-concern sales than in piecemeal liquidations (Ravid & Sundgren (1998)). This statement is confirmed in the case of Romania.

In terms of recovery rate, the best-ranked EU countries in 2012 are Finland (89,7%), Netherlands (88,8%), Belgium (88,7%) and United Kingdom (88,6%). We must mention that Romania has the lowest recovery rate in the EU in 2012, of 29,2%. This is due to the 2008 insolvency reform, when the Romanian government increased the cost of the liquidation procedures with the purpose to stop the falling market. The amendment to the bankruptcy law demanded that 1,5% of the amount recovered to go to a fund for repaying the expenditures of insolvency administrators. The reform put additional constraints on closing businesses that lead to increasing inefficiency.

In Romania the recovery rate decreased with 0,3 cents on dollar in 2012 compared to 2008, the year when the crisis started. The recovery rate decreased in the years of crisis (2009 and 2010) and then registered a slight increase, but has not yet reached the 2008 level and it is well below the EU average (46,64% of the EU average).

According to the Creditreform and Euler Hermes data, the number of insolvencies in Romania increased constantly since the onset of the economic crisis in 2008 whereas in the EU this number raised in 2009, diminished in 2010 and then increased again in 2011. Romania registers a higher positive variation in 2011 to 2010 (4,42%) in comparison to the EU change of 0,19%.

Table 2. The insolvencies' evolution in Romania and the EU average (2007-2011)

| **Country** | **Years** | | | | | | **Change 2011/2010** |
|---|---|---|---|---|---|---|---|
| | **2007** | **2008** | **2009** | **2010** | **2011** | **TOTAL** | |
| Romania | 14.104 | 14.483 | 18.421 | 21.692 | 22.650 | 91.350 | 4,42% |
| EU average | 153.029 | 176.292 | 218.624 | 217.613 | 218.029 | 983.587 | 0,19% |

In terms of insolvencies dynamics, the highest decreases were registered in Latvia (-65%) and Estonia (-39,5%) and the highest increases in Greece (+33%) and Slovenia (+32%). Taking into consideration the fact that the average EU change in insolvencies between 2010 and 2011 was +0,19% we can say that the number of insolvencies stagnated.

According to the Euler Hermes and Credit reform data, among the EU member states, the highest recovery rate is registered in Finland (89,7%) and the lowest in Romania (29,2%); the fastest insolvency procedure is encountered in Ireland (0,4 years) and the slowest in the Slovak Republic (4 years); the cost of the recovery (% of the debtor's estate) is the lowest in Belgium, Denmark, Finland, Netherlands and Slovenia (4) and the highest in Italy (22).

Taking into consideration the Credit reform data, we notice that the insolvency rate (the number of insolvencies per 10.000 firms) is the highest in Romania (347), Hungary (343) and Luxembourg (316) and the lowest in Poland (3), Greece (5) and Bulgaria (12). For the first two we can say that it is the consequence of an unstable economic environment. We must highlight Romania's great distance from the EU average of 99 insolvencies per 10.000 firms.

We have analyzed the EU member states recovery rates according to their type of regulatory framework applied (civil, common or pluralistic) and whether bankruptcy regulations are favorable to debtors and creditors (debtor-friendly, creditor-friendly and neutral) and we conclude that the countries that are ranked above the EU average recovery rate of 62,61% belong to the following categories: Scandinavian Civil Law debtor friendly (89,70%), Common Law creditor-friendly (88,05%), German Civil Law debtor-friendly (83,30), Scandinavian Civil Law neutral (80,90%), French Civil Law creditor-friendly (72,18%) and the Pluralistic Law creditor-friendly (70,70%).

In order to find a solution for Romania's low recovery rate we must analyze these categories and determine which one suits it best. We mention that Romania is located in the French Civil Law debtor-friendly category along with France, the recovery rate of this category (38,80%) was below the EU average of 62,61 % in 2012.

Taking into consideration the geographic region and its history and customs, we exclude the Scandinavian Civil Law, the Common Law and the Pluralistic Law so we must choose between the German Civil Law debtor-friendly category and the French Civil Law creditor-friendly category. From the last two categories we choose the French Civil Law creditor-friendly category because Netherlands and Belgium have a higher recovery rate than Austria (the

only German Civil Law debtor-friendly country) and because it is faster to adopt some regulations in order to protect creditors than to adopt other civil law.

## 3. Conclusions

The Doing Business statistics reflect a below-average profile for Romania compared to the EU-27 in terms of resolving insolvency. Romania scores under the EU average in terms of recovery rate and above it regarding the time, cost of recovery and variation of the insolvencies' number.

Romania has the lowest recovery rate in the EU, of 29,2%, determined by the lack of regulatory protections for creditors, the increased cost of insolvency due to the amendment to the insolvency law in 2008, the excessive length of the insolvency procedure and by the piecemeal liquidation (the recovery rates are lower in this kind of liquidations compared to the going-concern sales).

Economies with good bankruptcy procedures are those that maximize the total value of recovered debt at a low cost. Romania needs to increase the recovery rate in order to determine creditors to reinvest in viable firms and to continue lending by diminishing the time and cost to resolve insolvency and by selling in going concern. By taking these actions Romania will have a more developed credit market.

Romania must adopt and implement concrete provisions that may significantly affect the efficiency of the bankruptcy system, such as: different treatment of honest and dishonest bankrupts, the existence of an early warning system, it must strengthen the rights of secured creditors and so reduce their risks leading to a lower cost of recovery and increasing recovery rate.

Considering that the economies where resolving insolvency is the fastest the majority have systems where reorganization is more likely than foreclosure or liquidation, Romania needs to support reorganization, to reduce the share of liquidation among insolvencies which is very high in comparison with other EU member states. A faster insolvency procedure determines lower costs and an increase of the recovery rate.

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