BANKRUPTCY IN HISTORICAL PERSPECTIVE:
A EUROPEAN COMPARATIVE VIEW (C.1880-1913)

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Motivation

• Credit important to development;
• Legal enforcement important to credit development since private settlement is costly, especially for time contracts;
• Bankruptcy law crucial: edicts default solution in case of non-payment and when no market solution is found. Affects property rights.
• **Questions**: is the content of these laws important? Coase would say no: endogenous adaptation of agents' behavior to a distribution of property rights.
• Or are efficient courts important?
• Or: do substitutes exist (e.g. financial market: other firms absorbing the likely bankrupt)?
• The dominant « law and finance » view (LLSV 1996s):
  – Optimal law exists; based on micro-incentives theory and independent form particular economic context;
  – Actual laws mostly results from legal families. Most are bad.
• Empirical support: cross section regressions including dummies for legal families.
• Empirical weaknesses: historical argument but no historical support:
  – Legal historians consider the concept of “legal families” as an heritage from 19th c. nationalist debates; and much less adapted to commercial law than to civil law (lex mercatoria origin).
  – Sgard (2007, 2009) suggests convergence of bankruptcy law occurred during the 19th c. despite actually special (repressive) English law up to 1880 (which converged then).
Recent theory (White, 1989; Hart, 2000; Berkovitch-Rosen 1998; Stiglitz, 2001) suggests there is no optimal law but one adapted to the characteristics of a financial system and an economy.

- E.g. If banks are very bad at screening loans applications and at controlling post-loan use of funds by firms, they must be sanctioned (and incited to improve) by a pro-debtor legislation.
This paper:

• Suggests examining bankruptcy law enforcement using official statistics on bankruptcies in order to observe their actual
  – Orientation (pro-debtor/credit; liquidation/continuation);
  – Efficiency (using various measures).
• Concentrates on late 19th century because of the debate on convergence/divergence in financial systems (Rajan-Zingales 2003);
• And on a small number of countries pertaining to the major legal families: Belgium, England, France, Germany and Italy.
What is bankruptcy?

- A judicial procedure designed to resolve a conflict between a debtor and all his creditors
  - Which may result as well from fraud (Madoff), excessive risk (AIG), incompetence, structural factors (GM), bad luck or from an industry or nation-wide crisis.
  - And takes the form of illiquidity (suspension of debt payments) as an indicator of potential insolvency (liabilities > assets).

- Several purposes:
  - Guarantee equality among creditors
  - Sanction fraud
  - Eliminate incompetence
  - Share the impact of bad luck
  - Allow continuation in case of purely external shock
  - Provide correct incentives to debtors and creditors.
Several solutions:
- For the firm: Composition (debt reorganization: delays, reduction) vs liquidation (sale) of assets (firm disappears);
- For the entrepreneur: Loss personal wealth and of political and commercial rights vs debt discharge (conditional).

Major alternatives in bankruptcy law design:
- Usually emphasized:
  - Pro-debtor (social + incentives to lenders + pro-business keynesian-type arguments) versus pro-creditor (low interest rates, incentive to borrower). Depends on information distribution and governance.
  - Pro-continuation (goodwill argument) versus pro-liquidation (efficient reallocation of assets). Depends on market efficiency.
- Also important:
  - Pro-judicial enforcement (public information) versus (implicitly) pro-private agreements (lower cost, but unanimity required, and risk of violence).
  - Strict rules (simplicity, credibility) versus discretion (adaptation to peculiar situations, risk of corruption).
19th century context

- Very small firms an overwhelming majority (e.g. 4 millions firms outside agriculture in France, most of them single-owner with no employee);
- Limited liability not broadly developed yet (at most a few thousands firms except Britain);
- Prison for debt not always ended (France 1867).
- Credit still mostly provided by furnishers (commercial credit), but development of banks on various models over Europe.

Then:
- The continuation of the firm cannot be separated from the situation of the debtor, and much of the capital to be reallocated is the human capital of the entrepreneurs (so “fresh start” important).
- Bankruptcy is to transfer personal property as much as business assets. So interaction with civil law important (protection of personal property conflicts with that of creditors).
- Emergence of a model of bank credit based on information building, in contrast with commercial credit among interdependent traders.
Three reasons why law enforcement may prove more important than law in the books:

- Commercial law considered even by legal scholars as good if allowing practical solution-building rather than pure deduction from principles-based law;
- Differences in judiciary organization (e.g. quasi-private justice abandoned to merchants’ communities as a peculiarity of commercial law, in unexpected countries like Belgium and France).
- Courts may function more or less correctly for other reasons (e.g. budgetary ones), when importing a good code is easy.
Data

• Sources: official judiciary statistics published yearly.
• Efforts at international comparability (Yvernès 1876)
• But : by contrast with the portion dedicated to criminal justice, the purpose of the portion dedicated to the civil and commercial justice was restricted to the efficiency of the judiciary in a restricted sense (Perrot 1989, Hautcoeur 2008), not to the evaluation of the law and its impact.
• Data mostly include : number of cases, steps (initiation, solution, dividends, assets and liabilities involved, length). Organized by judicial district or region (in Spain : nation-level data unavailable !)
• Data does not include : private arrangements; interaction between variables (e.g. fate of debtors’ initiated cases) (pseudo panel). Little information on the firms involved (except, sometimes, the industry). Archives provide it but at a high cost (Hautcoeur & Levratto, 2009).
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Legal systems’ orientations

• Data used to infer these orientations
  – assuming the distribution of bankruptcies is similar in the various countries.
  – Discussing the weakness of this assumption (below).

• First case: Pro-debtor / pro-creditor
  – Who initiates a case?
    • all cases vs bankruptcy only (deeds: only debtors).
  – What is the alternative.
    • The problem of debtors’ prison in England.
    • The question of discharge: not so limited to England.
Graph 3. Percentage of procedures started by debtors (excluding procedures opened by court)
Second case: Pro-continuation / pro-liquidation

A clear case for England as pro-liquidation

A case for Italy as pro-continuation; maybe also Germany in the absence of any composition prone procedure (see below).

Other countries very similar.
4. % of compositions/total procedures

Italy (including deeds)
France (including deeds)
Germany
Belgium (including deeds)
England (incl. deeds)
• Then, one may be tempted to contrast
  – the English system, where debtors enter voluntarily in a still highly liquidation-prone bankruptcy system because they fear debtors’ prison and hope to be discharged and to make a fresh start thanks to their (relatively well protected) remaining personal assets and human capital.
  – The Italian system, where debtors don’t want to enter into bankruptcy in spite of easy access to composition: a mystery (suggestions below).
  – The other systems, which are in between.

• But this would neglect the limitations of these measures:
  – Highly dependent on the proportion of cases settled outside the courts (which should be the “best shape” ones).
    • E.g., if the likelihood for a German firm to be formally bankrupt (by opposition to a friendly private settlement) is lower, the average situation of a German bankrupt should be worse, and then the proportion of compositions lower; this would make the German courts pro-composition compared to, say, the French courts if the average French bankrupt was in a better situation.
  – Also dependent on the legal procedures used (see below).

• So our preference for avoiding direct measures and switch to our measures of efficiency.
Legal system’s efficiency

• If we follow bankruptcy theory and don’t rank bankruptcy laws on a single scale as LLSV, we must find other – more internal or procedural – indicators of efficiency.

• We propose 3:
  – Use of law, or courts’ attractiveness;
  – Screening efficiency;
  – Administrative efficiency.
Use of law

• As a measure of law quality:
  – Better laws attract actors (compared to private agreements) by providing information at low cost while avoiding conflicts among creditors.
  – Contemporary empirical evidence: Claessens-Klapper (2005)

• International comparisons limited by:
  – Absence of data on private settlements (then on total number of illiquid firms); then same hypothesis of similar distributions.
  – Absence of data on number of firms, so comparison to GDP or population.

• But differences are important enough for a hierarchy to appear.
1.1 Number of procedures/GDP

England | Italy | France | Germany | Belgium
1.2 Bankruptcies per million inhabitants

England Italy France Germany Belgium Spain
A case study: The impact of legal innovation: the case of *deeds* or *concordats*

- Comparable innovations in many countries: Belgium 1883, England 1887, Spain 1885, France 1889, Italy 1903. German exception.
- Purpose: give the « honest and unlucky trader » a solution to escape formal bankruptcy and keep control of his business.
- Results:
  - important impact except in Italy;
  - Substitution rather than attraction of new cases in Belgium and France;
  - Substantial rise in the number of cases in England: catch-up process?

- Confirms the importance of the bankruptcy system (both the law and its implementation) for bankruptcy practice.
Graph 2. Deeds as a percentage of total procedures

- England
- Italy
- France
- Belgium
Screening efficiency

• Screening bad and good debtors is a major purpose of bankruptcy systems.
• Measuring screening within each country avoids direct comparison among countries, which is blurred by differences in law and procedures.
• Various screening devices available to courts:
  – choice of procedure (bankruptcy vs deeds, except in Germany);
  – choice of solution (composition vs liquidation)
• Screening efficiency measurable ex-post:
  – Differences in dividends (should be superior in deeds vs bankruptcies; in compositions vs liquidation).
  – Differences in assets/liabilities (idem).
Better Differentiation (bankruptcy vs deeds) in Belgium and France than England
Graph 5. Average dividend in compositions (%)

- Levels: huge differences;
  - High in England (Belgium)
  - Low in Italy (Germany)

- Bankruptcy vs deeds:
  - Little in England and France = low efficiency
Graph 7. Ratio of dividends in compositions and in liquidations

- **Levels:**
  - all above 1.5 except Italy (and Germany)
  - England (and Belgium) higher

- **Bankruptcy vs deeds**
  - Clear in England
  - Small in France
Administrative efficiency

• Length was considered both by governments (who measured it) and business actors (e.g. demands by Chambers of commerce in the preparation of legal reforms) as the most important element in bankruptcy courts efficiency.

• Other costs of the judicial procedures were also deemed too high, but were usually not measured (except Germany).

• Measures suggest huge differences:
## Synthesis on «law in action»

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Countries are ranked on a 0 to 3 scale, 0 being the least in the direction considered (Italian courts are bad at screening).
conclusions

• There may be some impact of legal families when one considers the “law in action”:
  – there are some differences in orientation between English and Continental laws in action; this may result from different preferences in the choice between liquidation vs continuation (and rules vs discretion)
  – But there is no hierarchy among the two legal families in terms of efficiency: differences within the continental legal families are much more important and seem related to economic development.

• Countries differ widely in terms of bankruptcy system efficiency (Italy, Spain, maybe Germany look backward), maybe in relation with some financial backwardness and/or financial system organization (role of German banks).
  – So convergence is not as general as for the “law in the books”.
• Next steps:
  – Control for real explanations of the number or types of bankruptcies (industry dummies, size of firms, etc).
  – Test the impact on financial development (using the regional variations within countries);
  – Explain the changes in the legal systems through time, ideally with a model common to all countries.