

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

Pierre-Cyrille Hautcoeur
PSE - EHESS

Joint work with Paolo Di Martino (U. of Manchester)

Journée « faillites », Nanterre, 11 juin 2010

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 from 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).
 - Musacchio (2007, 2009); Bordo-Rousseau (2005) suggest little role for legal families in financial development in 1900.

- 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.

« law in action »

- **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

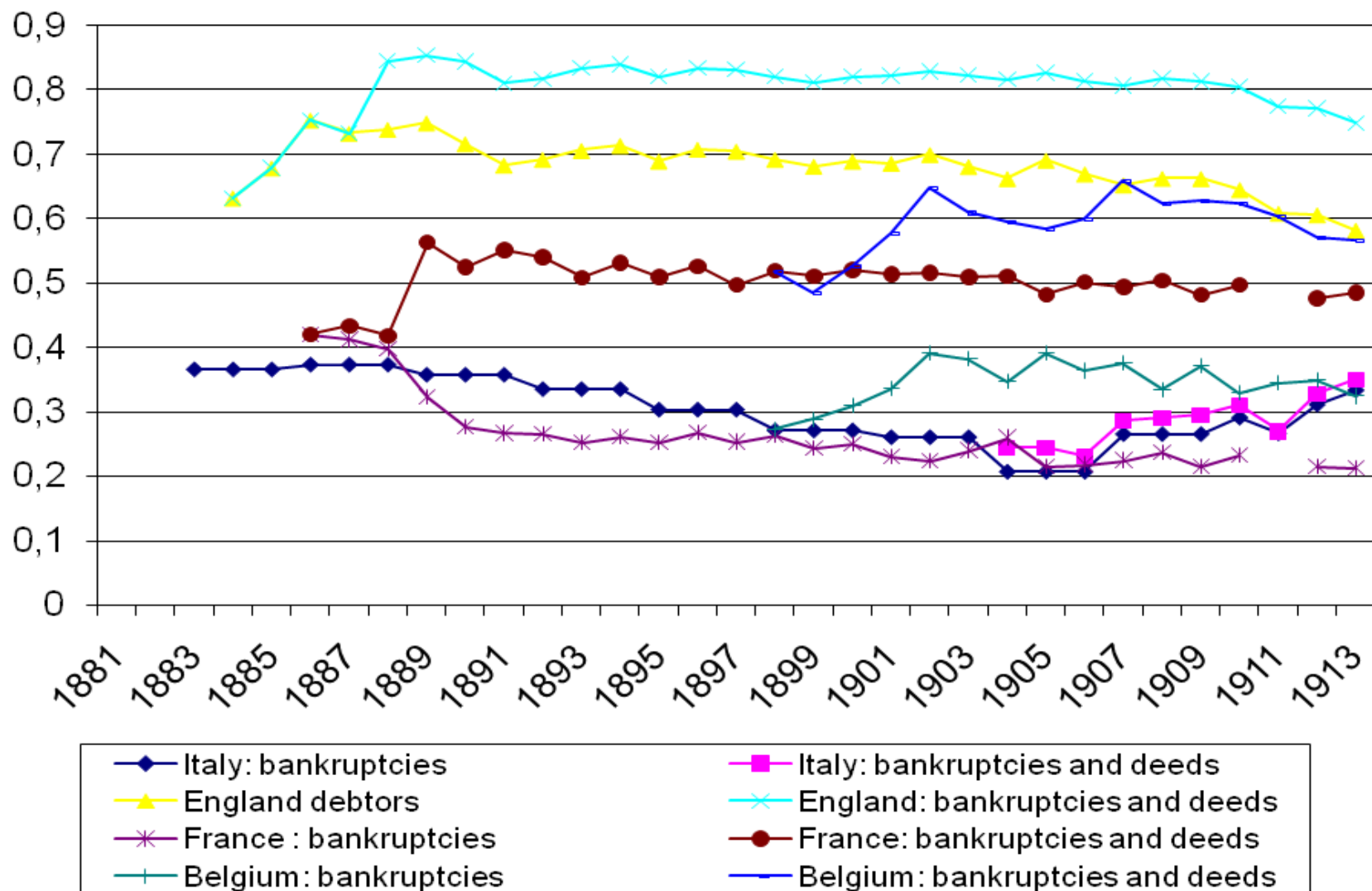
- **Sources: official judiciary statistics published yearly.**
- **Efforts at international comparability (Yvernès 1876)**
- **But : by contrast with the portion dedicated to criminal justice, the purpose of the portion dedicated to the civil and commercial justice was restricted to the efficiency of 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).**

CANTONS.	DÉPARTEMENTS.	des faillites.	de	de	de	de	de	immobilier.	mobilier.	hypothécaire.	privilégié.	chirg.
			moins	5,001	10,001	50,001	plus					
			de 5,000 ^f .	à 10,000 ^f .	à 50,000 ^f .	à 100,000 ^f .	de 100,000 ^f .					
		fr.		fr.		fr.		fr.				
	Gers.....	8	2	2	3	"	1	19,000	43,954	16,162	2,704	
	Lot.....	5	"	3	2	"	"	4,717	17,978	"	360	
	Lot-et-Garonne....	11	"	5	4	2	"	59,400	40,028	47,004	11,713	
	Basses-Alpes.....	2	1	"	1	"	"	8,400	2,214	8,394	"	
	Bouches-du-Rhône..	35	"	6	17	4	8	587,000	427,747	232,350	7,285	
	Var.....	18	2	3	12	"	1	92,915	181,398	32,038	2,562	
	Aisne.....	36	8	9	17	1	1	657,795	288,699	885,090	44,818	1,
	Oise.....	30	4	8	14	2	2	130,216	354,688	228,355	58,108	
	Somme.....	33	8	8	12	1	4	203,092	243,413	160,188	33,952	1,
	Maine-et-Loire....	44	9	9	24	2	"	105,429	237,756	150,574	124,344	
	Mayenne.....	11	"	6	5	"	"	31,240	30,331	17,550	13,744	
	Sarthe.....	9	1	1	4	1	2	55,121	150,831	56,339	35,268	
	Corse.....											
	Doubs.....	22	2	3	11	2	4	231,807	158,166	291,172	35,944	
	Jura.....	17	3	1	11	2	"	92,760	119,231	59,322	35,886	
	Haute-Saône.....	13	5	4	3	"	1	47,007	24,295	70,173	5,302	
	Charente.....	33	3	9	19	1	1	96,857	142,720	85,658	26,530	
	Dordogne.....	18	5	6	6	1	"	98,153	71,582	31,237	5,511	
	Gironde.....	58	6	10	31	3	8	154,214	515,097	149,033	19,366	2,
	Cher.....	8	1	"	4	2	1	216,179	249,971	133,190	44,933	
	Indre.....	3	"	"	2	1	"	12,800	27,000	5,050	1,500	
	Nièvre.....	16	4	3	5	3	1	114,012	129,619	117,799	9,958	
	Calvados.....	42	9	7	18	5	3	390,343	331,717	408,630	21,909	1,
	Manche.....	25	3	5	16	1	"	58,921	95,228	84,599	35,605	
	Orne.....	26	3	4	17	2	"	151,852	137,835	168,264	38,062	
	Bas-Rhin.....	51	6	11	23	7	4	475,344	475,344	296,659	82,651	2,
	Haut-Rhin.....	69	10	11	32	6	10	927,191	739,453	779,492	96,694	3,
	Côte-d'Or.....	35	8	8	13	2	4	2,581,494	1,731,943	2,774,700	35,012	11,
	Haute-Marne.....	12	1	4	6	1	"	77,270	37,011	93,247	5,407	
	Seine-et-Loire.....	26	2	13	8	2	1	95,605	132,368	152,354	17,446	
	Nord.....	57	10	10	24	6	7	270,868	558,711	307,952	90,238	2,
	Pas-de-Calais.....	31	9	10	10	2	"	33,221	83,791	47,661	40,345	
	Hautes-Alpes.....											
	Drôme.....	10	1	2	6	"	1	122,323	92,861	96,361	11,263	
	Isère.....	48	6	9	28	1	4	463,925	290,925	202,717	75,406	1,5
	Corrèze.....	8	2	2	4	"	"	6,500	28,811	2,476	6,426	
	Creuse.....	4	"	1	3	"	"	36,129	10,191	21,767	10,364	
	Haute-Vienne.....	18	4	3	10	1	"	2,900	78,684	1,200	12,082	
	Ain.....	9	4	2	3	"	"	21,569	31,189	19,664	6,740	
	Loire.....	39	3	13	18	1	4	36,009	234,905	126,031	68,258	
	Rhône.....	80	8	10	39	14	9	640,812	741,858	738,190	336,044	3,2
	Ardennes.....	35	7	5	12	4	7					
	Moselle.....	16	7	"	6	1	2	622,327	2,573,105	556,080	107,531	1,0

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)



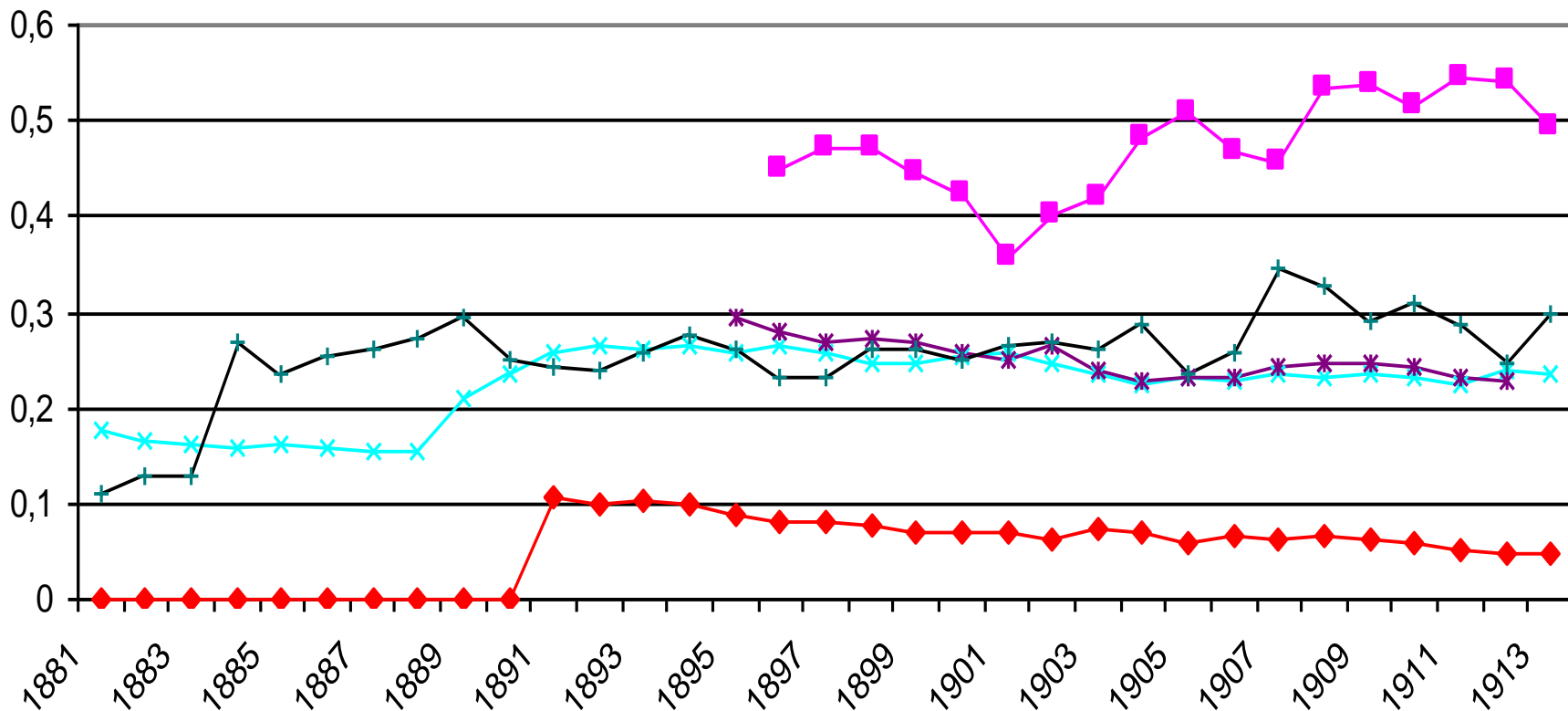
Second case : Pro-continuation / pro-liquidation

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



- **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.**

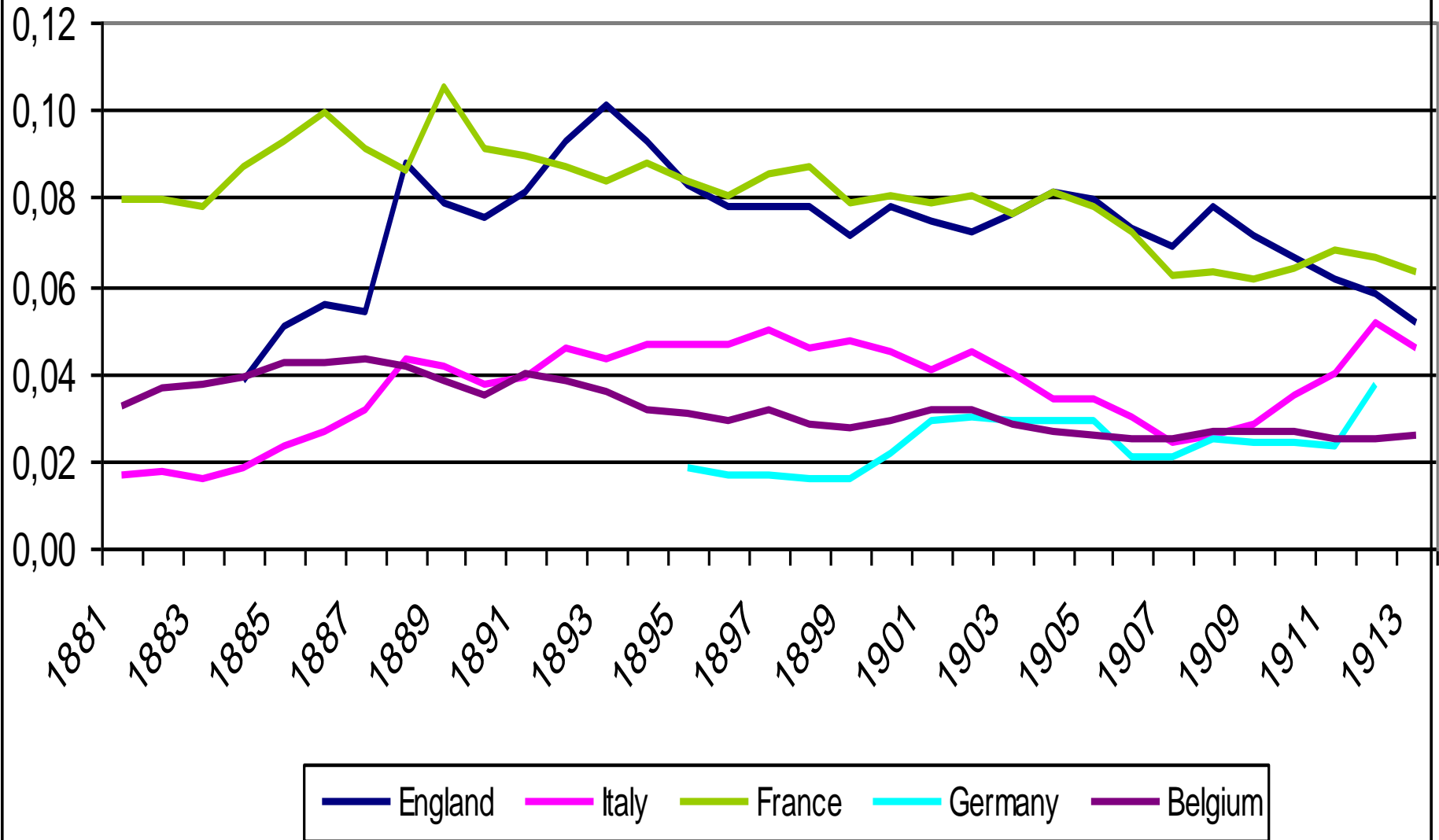
Legal system's efficiency

- **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.**

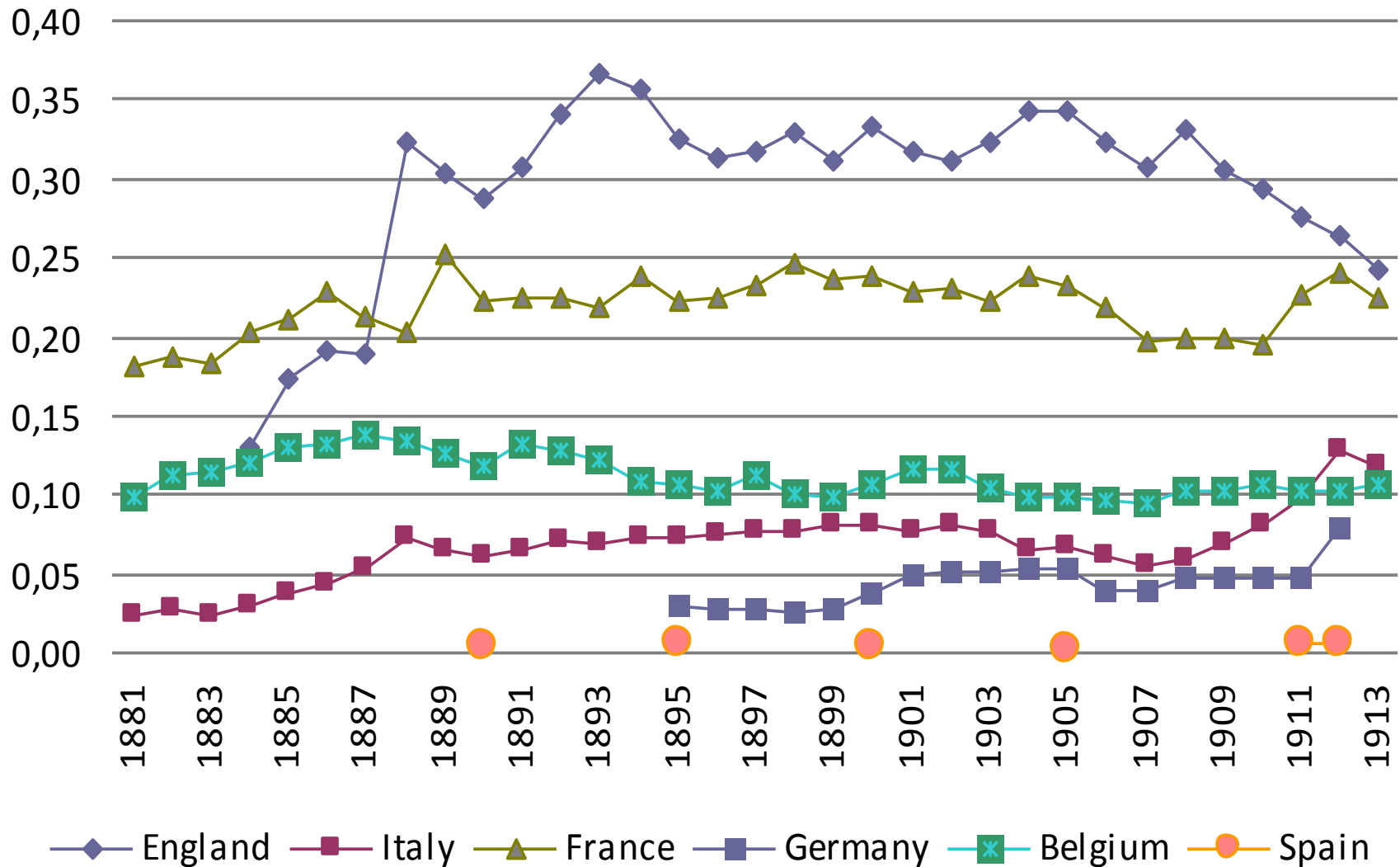
Use of law

- **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)
 - Historical evidence : Nabayashi and Okasaki (2007) on 19th Japan.
- **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



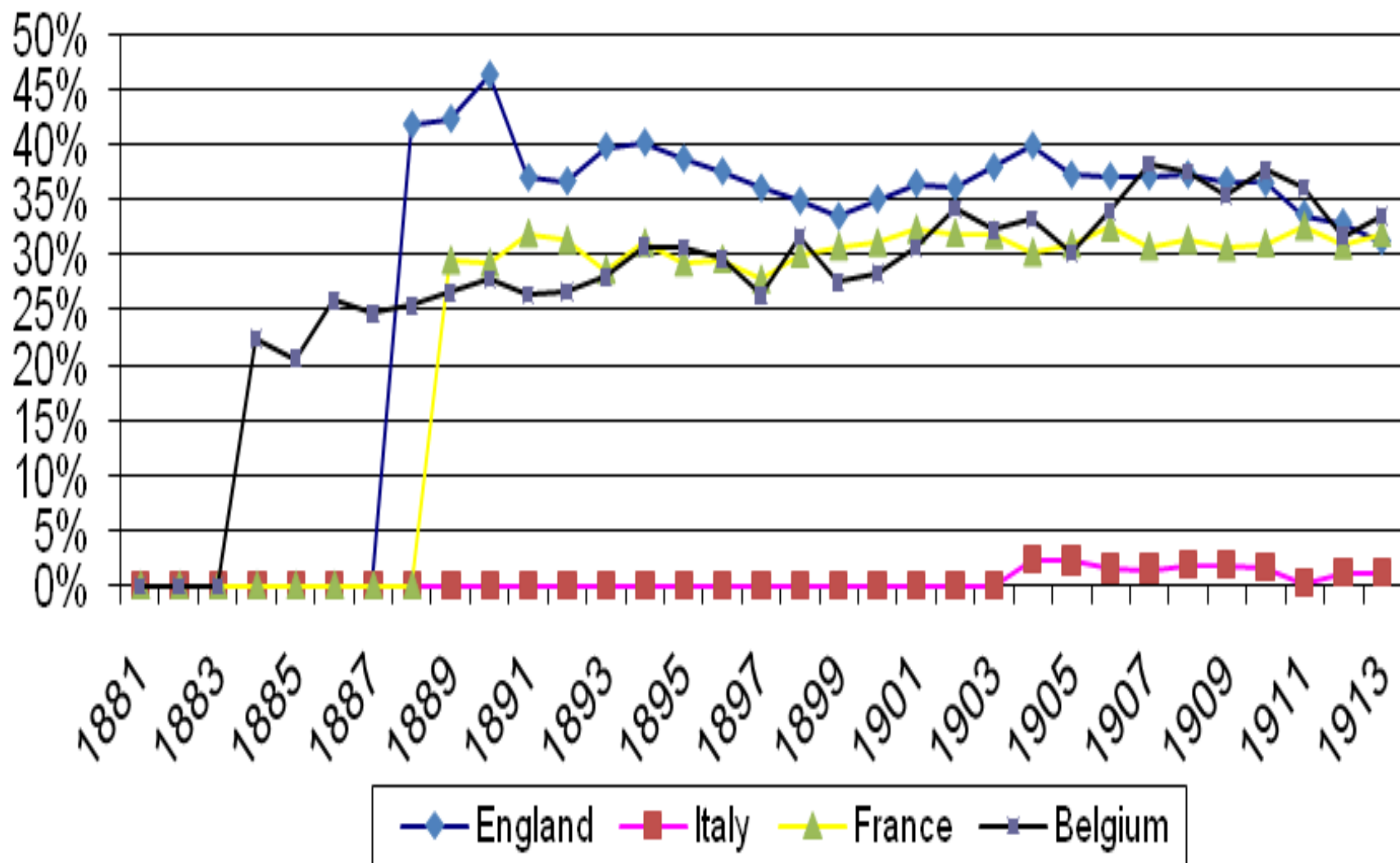
1.2 Bankruptcies per million inhabitants



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.**

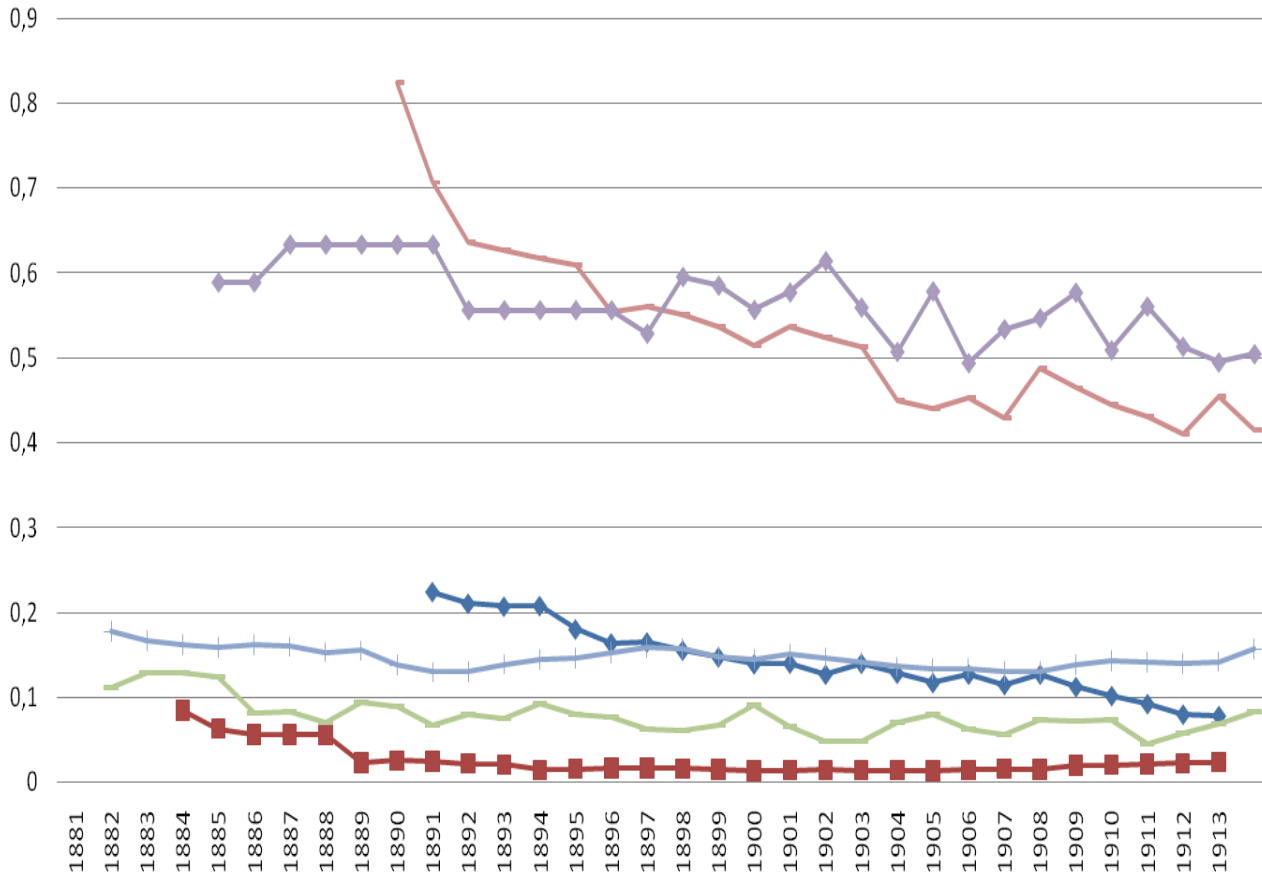
Graph 2. Deeds as a percentage of total procedures



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).**

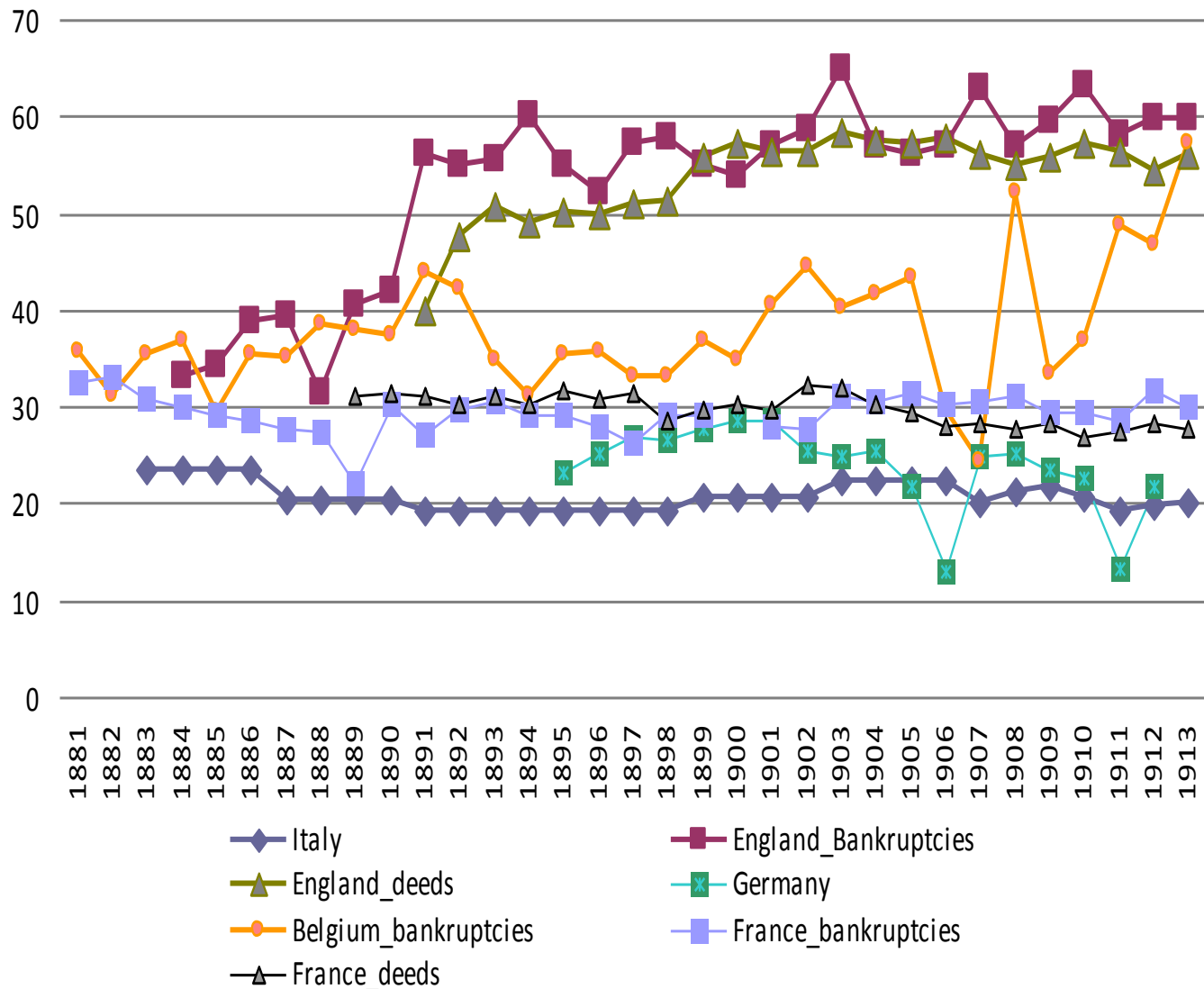
Compositions as a proportion of closed cases



Better
Differentiation
(bankruptcy vs deeds)
in Belgium and
France than
England

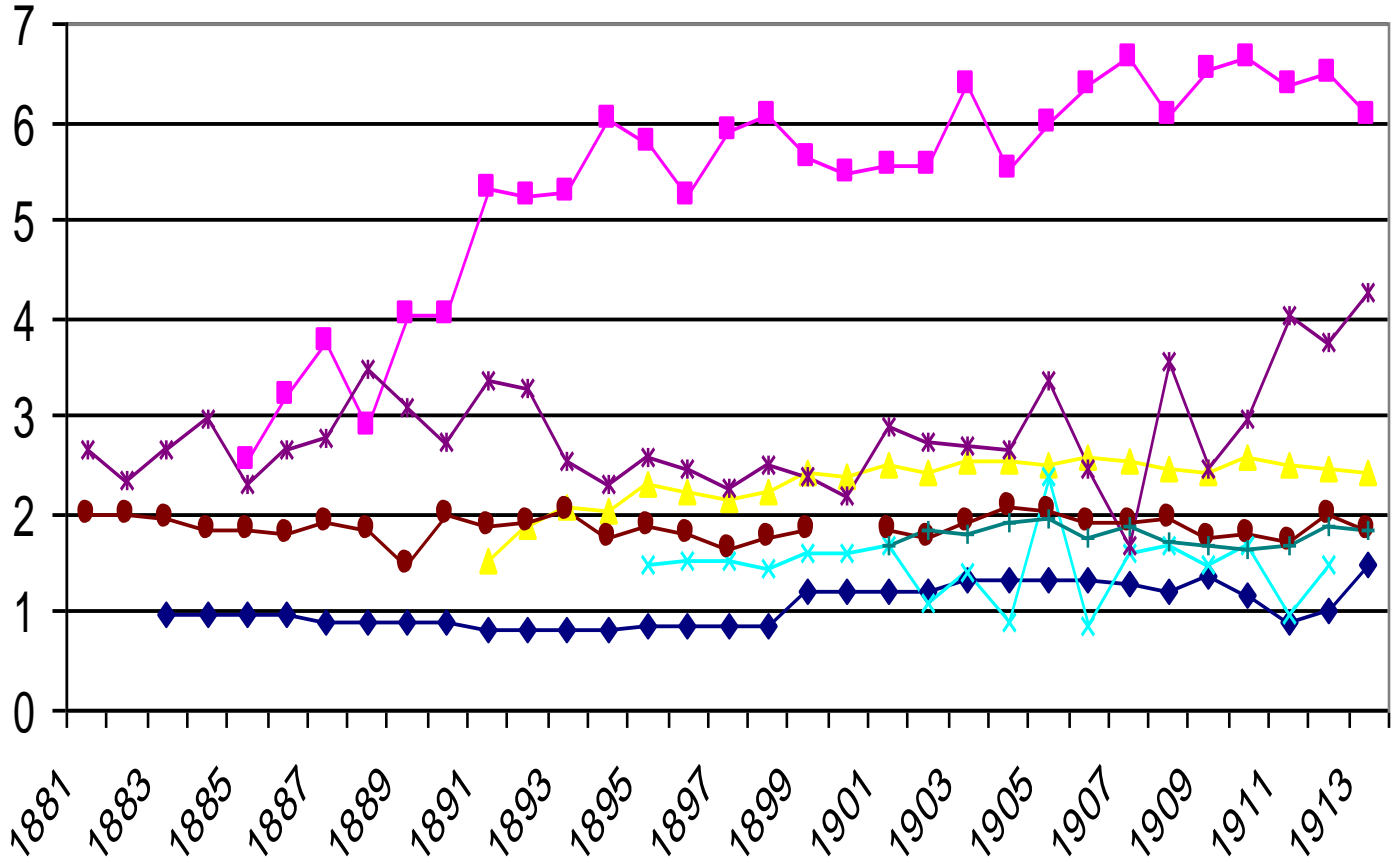
- ◆ deeds_England
- bankruptcies_England
- + France: bankruptcies
- Deeds_France
- bankruptcies_Belgium
- ◆ deeds_(accepted/proposed)_Belgium

Graph 5. Average dividend in compositions (%)

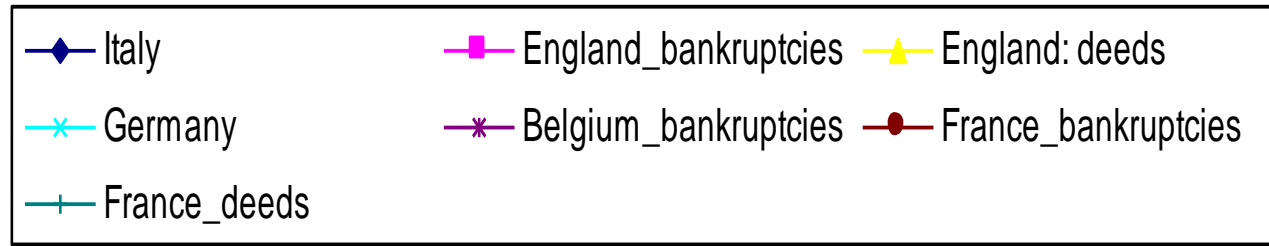


- Levels: huge differences;
 - High in England (Belgium)
 - Low in Italy (Germany)
 - Bankruptcy vs deeds:
 - Little in England and France
- = low efficiency

Graph 7. Ratio of dividends in compositions and in liquidations



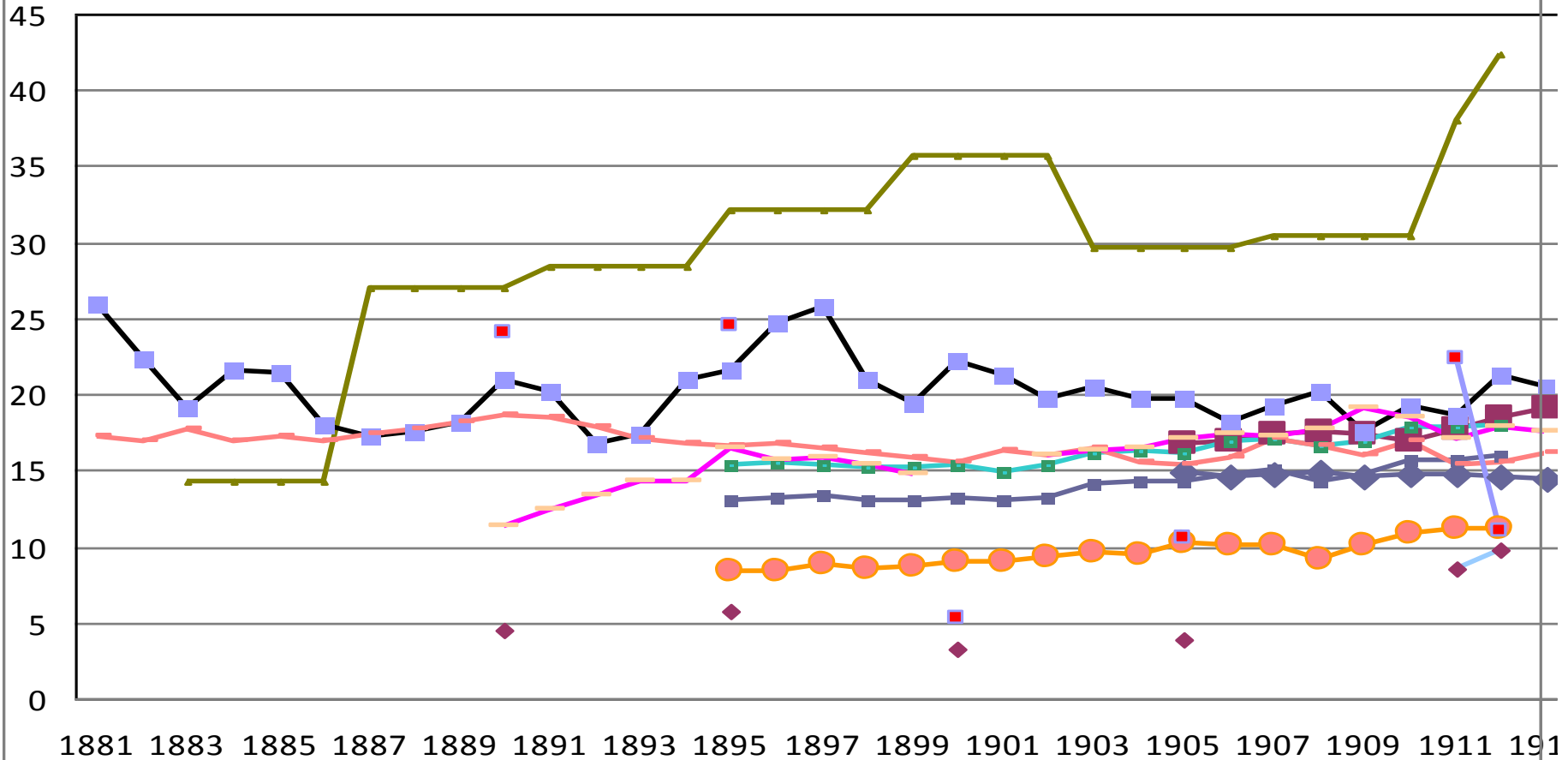
- Levels :
 - all above 1.5 except Italy (and Germany)
 - England (and Belgium) higher
- bankruptcy vs deeds
 - Clear in England
 - Small in France



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:**

Graph 9. Average length (months)



- ◆ England bankruptcy
- ◆ Italy bankruptcies
- Germany liquidation
- Belgium
- France deeds
- ◆ Spain deeds
- England deeds
- Germany
- Germany concordat
- France bankruptcies
- Spanish bankruptcies

Synthesis on « law in action »

	England	Italy	France	Germany	Belgium	Spain
Efficiency						
Attractiveness	3	2	3	1	2	0
Screening	3	0	2	1	2	
Administrative	2	1	2	3	2	1
Orientation						
Pro-creditor	0	2	1		1	
Pro-continuation	0	2	1	2	1	

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.**