IMPLICATIONS OF INSOLVENCY LAWS ON FIRMS' GOVERNANCE. AN ANALYSIS FROM THE RELATIONSHIPS WITH CREDITORS IN FRANCE

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Abstract

This paper aims at showing that ex post consequences of insolvency law are not the only one visible after a judge states that the amount of equity is not enough to repay all the debts. On the opposite, the judicial system that defines bankruptcy shapes the relationship between a firm and its stakeholders among which lenders play a specific role. Thus, the expectations of failure that are generally considered from a pure statistic point of view have to be enriched by the introduction of legal elements to understand fully the strategic behaviour of lenders and borrowers. Such is the point we want to present here taking the French case. Section 1 reminds that insolvency law is not only a tool implemented and improved to maximise creditors' wealth but also to protect others stakeholders. Having state this multiplicity of goals, section 2 shows the influence of insolvency laws on bank-borrowers relationships according to the institutional context. Section 3 considers insolvency law as a governance device that structures the need of information and behaviour of creditors in the firm's ordinary life. We conclude reminding that if that law matters in crisis but also as a milestone economic actors refer to determine their preferred situation.

Keywords: corporate governance, bankruptcy, insolvency, creditors, France

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Introduction

Bankruptcy occurs when a debtor is unable to pay his debts. From thi broad definition, it appears that bankruptcyt is a collective enforcement procedure whereby the debtor's assets are liquidated and the money raised is used to pay creditors[4]. In many jurisdictions different bankruptcy procedures are available for corporate and individual debtors[5]. In addition to collective enforcement, bankruptcy procedures open to individuals ('personal bankruptcy law') serve important social functions of providing social insurance against failure, and of punishing or rehabilitating financially distressed individuals (Adler, Polack and Schwartz, 2000).

The 'severity' of these consequences for the debtor is mitigated in two ways that history refines since their introduction in the beginning of the modern period. First, some assets are exempt from the process. Universally, debtors are entitled to retain living expenses, personal effects and the like[6]. Secondly, many jurisdictions or at least many courts allow a bankrupt debtor to obtain a 'fresh start': namely, that after a certain period of time, a bankrupt is permitted to discharge his outstanding credit obligations and emerge from bankruptcy proceedings. Over the world, many jurisdictions do not permit a discharge of debts following insolvency; Japan is still an example of such a situation. For those that do, the length of time which must elapse, and the other conditions which must be fulfilled, vary considerably[7].

4 Bankruptcy law solves a collective action problem. When a debtor becomes insolvent, creditors have incentives to engage in a 'run on the bank', enforcing their individual claims as quickly as possible, even if this results in a reduced overall value being obtained for the debtor's assets. In response, bankruptcy law provides a mandatory and orderly mechanism for the realisation of the insolvent's assets (Jackson, 1982).

5 In the US, Chapter 7 and Chapter 11 bankruptcy proceedings are open both to individuals and to corporate debtors. However, many countries have different procedures for individuals and corporations, or distinguish according to whether the debtor is a 'trader' (individual or corporate) or a consumer. This is indeed the case in France where personal bankruptcy originally authorized in two regions (Alsace and Moselle) has been applied to the whole country in 2003. Until this date two different regimes applied. The insolvency law included in the "Code de Commerce" for merchants and the "déconfiture" a much more severe system devoted to individuals embedded in the "Code Civil". This split was sealed in the Napoleonic Codes (see Hautcoeur and Levratto, forthcoming).

6 In France, the so-called 'patrimoine de la famille' originally compounded of the dower and nowadays equivalent to the minimum income necessary to leave cannot be seize. In the US, debtors are also allowed to retain an interest in their homes, although the maximum value of this 'homestead exemption' varies from state to state.

7 In almost all jurisdictions, a debtor may emerge from bankruptcy by entering into a 'composition' with his creditors, whereby he agrees to repay a proportion of the face value of his debts and the

In addition to the legal consequences of bankruptcy, the circumstance of 'being bankrupt' or 'having been bankrupt' typically carries with it social stigmatisation (Athreya, 2004). Bankruptcy in most places is viewed as a signal of financial irresponsibility, and, even after a legal 'fresh start'; individuals who have been bankrupt often find it difficult to obtain credit. Demanding for information concerning the past performances of an entrepreneur banks and other creditors enhance the vicious circle initiated with a first failure. Furthermore, there may be a loss of reputation from other individuals associated with this public signal of failure. These effects will mean that the adverse consequences of bankruptcy for an individual may extend for much longer than the formal legal proceedings. There is evidence to suggest that such social attitudes to bankruptcy vary across countries (Flash Eurobarometer Entrepreneurship Survey, 2007).

This paper aims at showing that ex post consequences of insolvency law are not the only one visible. On the opposite, the judicial system that defines bankruptcy shapes the relationship between a firm and its stakeholders among which lenders play a specific role. As providers of financial resources banks are indeed involved in the projects undertook by an entrepreneur without having any control on their management. Moreover, as demonstrated by credit rationing theory, the asymmetry of information worsen by the hands off management system imposed to external investors, often causes a shortage of credit that can entail a decrease in the probability of success of an investment. Thus, the expectations of failure that are generally considered from a pure statistic point of view have to be enriched by the introduction of legal elements to understand fully the strategic behaviour of lenders and borrowers. Such is the point we want to present here taking the French case as an example of the relationship between the functioning of the debt market and the insolvency law.

Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (1998, 1999) have documented relationships among countries' financial laws and their legal origin. These authors created an index to measure the quality of investor protection in various countries, and then analyzed the index data across countries. The study found correlations between, on the one hand, corporate ownership and investor protection, and on the other, the respective origins of the legal system. In particular, the studies found dramatic differences between legal systems evolved from the French civil law model and the Anglo-American common law model [8]. Countries whose financial laws derived from French civil law, in general, possessed weaker investor protection and higher transaction costs (Weber, 2005). We take this assessment as the point of departure for our own analysis. We however don't use it to demonstrate the superiority of one system on the other but to examine how any insolvency procedure transforms the economic relationships between debtors and creditors. This change in the economic transactions induces by a rule of law happens of course when the situation concerned by the law takes place. But, as stated by the weberian tradition, actors take into account the rules prior being concerned by their application. Regulation becomes then a background for any economic action. This is particularly important for firms financing since already shaped by expectations on risk, these contracts are also influenced by the judicial consequences of the inability of the borrower to repay his debts. This is what we aim at studying here.

First section will remind that insolvency law is not only a tool implemented and improved to maximise creditors' wealth but also to protect others stakeholders. Having this multiplicity of goals in mind, the second section will show the influence of insolvency laws on bank borrowers relationships according to the institutional context will be enlighten. In the third section we consider insolvency law as a governance device that structures the need of information and behaviour of creditors not only when the firm goes bankrupt but also in its ordinary life. We conclude reminding that if that law matters in crisis but also as a milestone economic actors refer to determine their preferred situation.

1. Too much Goals For One Law?

When applied to bankruptcy, the approach adopted in Law and Economics, which is essentially positive, presupposes that reforms of the legal system are necessary because the procedures in force are not efficient in most countries. This results in limited use of the rules in place for fear of seeing either the asset value diminish to such an extent that the creditors will only recover a small part of their due, or an exclusion from business life that prompts the entrepreneur to dissimulate his problems. On the contrary, when bankruptcy law is "good", companies in financial distress and their suppliers do not hesitate to have recourse to proceedings from which they expect quick and efficient results. In addition to these direct advantages, the business climate is said to improve as a result of tidying up bankruptcy law. Two dimensions of the application of what is generally

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rest is treated as discharged. The difference between this and the 'fresh start' discussed in the text is, however, that a composition requires the agreement of a majority of the debtor's creditors. A 'fresh start' regime on the other hand entitles the debtor to be discharged against the wishes of creditors.

8 Lamoreux and Rosenthal (2004) paint a different picture: namely, that the broad generalization equating French civil law with higher transaction costs is misguided because it fails to account for the actual historical development of French civil law. Their findings suggest to the contrary that French law offered more organizational forms and flexible contract options than Anglo-American law, which was less responsive to the needs of business community. The Anglo-American common law caught up to French civil law in terms of efficient contract law only in the late twentieth Century. For an exhaustive presentation of the bankruptcy code 19th century France, see Hautcoeur & Levratto, 2007

called the LLSV approach are examined in depth here:

We depart from the minimisation of the transaction costs involved by bankruptcy systematically and often exclusively targeted by the so-called LLSV point of view (1.1.) to adopt a broader perspective according to insolvency law aims at protecting capitalism what requires coping with the role of the stakeholders (1.2.).

1.1. A quest for the Grail: the Minimisation of Transaction Costs

The inclusion of bankruptcy law in an economic perspective centred on the distribution of assets is characteristic of the penetration of the law by the economic policy objectives characteristic of the recent period. By including procedures relating to cessation of payments in the policy agenda to stimulate a sort of growth based on the production of wealth by companies, legislators in most OECD countries gave up a moral and social vision of bankruptcy law. In so doing, they embed it in a private framework guaranteeing company prosperity or turnaround, or in the worst-case scenario, a quick liquidation of the business in such a way as to favour the reuse of production machinery in another framework. The utilitarian approach that prevails here is especially obvious in "Doing Business" which argues in favour of a "modernisation of the law" based exclusively on practical considerations. Thus, one of the two French partners in the survey maintains that the law must be tidied up due to the globalisation of trade, that "the relative efficiency of the law is obviously a factor in economic productivity and [that] in this area, France must do better by pragmatically agreeing to seek greater efficiency..." (Backer,2006, p. 2).

Two questions flow from the positive view of bankruptcy law. Both of them are related to the efficiency of the procedures within the scope of a market economy which orients the content of the research carried out. An initial level of analysis asks what means are available in collective proceedings to distribute the risks among all the actors in a market economy in a predictable, fair and transparent way. In addition to this question, the work seeks to identify what incentive mechanisms collective proceedings have acquired to encourage market economy actors to make sound decisions. Helping to resolve these questions will guarantee the introduction of efficient law, i.e. bankruptcy law in which the proceedings fulfil a twofold function:

- they give rise to good incentives for debtors and creditors in such a way as to encourage entrepreneurship,
- they ensure a good selection of companies by eliminating from the market those that are performing poorly and rescuing the others.

Seen in this light, bankruptcy law is essentially designed to keep businesses going and protect the value of the company in the interest of all the stakeholders. To achieve this objective, collective proceedings must avoid dangerous competition among creditors and enable viable businesses with temporary problems to be filtered out from those with a structurally compromised future. According to LLSV, this aim would be achieved through English common law, which favours private arrangements among debtors and creditors. French law, on the other hand, is held to be inefficient because it is too costly, with low recovery rates of the amounts due to creditors and too favourable to the debtor (Davidenko & Franks, 2005). The changes to be made in procedures for handling cessations of payment thus depend on the level of the country's score and rank in the World Bank classification. In general, they must help improve the level of at least one of the criteria presented above (the length of time required to process a bankruptcy case, the cost of the bankruptcy itself and the rate of claim recovery). Two types of efficiency will then be attained:

- *ex ante* efficiency consisting in encouraging the actors in a market economy (mainly company directors and shareholders, as well as banks in their decision to grant credit) to make the right decisions in order to avoid situations resulting in shortfalls of short-term liquidity and medium- or long-term insolvency. Here again the means available to collective proceedings must be balanced so as not to appear too disadvantageous and discourage the risk-taking inherent in entrepreneurship and the smooth workings of the market economy.
- *ex post* efficiency consists in liquidating only non-viable companies and maximising, or at least protecting, the value of the company in the interest of all the stakeholders and the economy in general. This first principle explains the intrinsically collective nature of this type of procedure: individual proceedings by creditors to recover their claims would result in piecemeal sale of the company that would prevent it from obtaining the best price for the disposal of its assets. The number of stakeholders (creditors with absolute priority, secured or unsecured creditors, shareholders, government administrations and social organisations, potential buyers, society, etc.) generates a variety of often conflicting interests.

Having in mind that financing is the first step in any entrepreneurial project, number of US commentators[9], have argued that the proper function of insolvency law can be used as a tool to ease firms financing. In this perspective, the judicial treatment of economic failure is seen in terms of a single objective: to maximize the collective return to creditors. Thus, insolvency law is best seen as a 'collectivized debt

9 See e.g., Jackson (2001); Baird (1986); Jackson & Scott (1989).

collection device' and as a response to the 'common pool' problem created when diverse 'co-owners' assert rights against a common pool of assets (Finch, 1997, p. 231). Jackson, moreover, has stated that insolvency law should be seen as a system designed to mirror the agreement one would expect creditors to arrive at where they able to negotiate such an agreement ex-ante from behind a 'veil of ignorance' (Jackson, 2001, p. 17)[10]. This 'creditors' bargain' theory is argued to justify the compulsory, collectivist regime of insolvency law on the grounds that were company creditors free to agree forms of enforcement of their claims on insolvency they would agree to collectivist arrangements rather than procedures of individual action or partial collectivism. In agreement with the conclusions of the Law and Economic movement, Jackson sees the collectivist, compulsory system as attractive to creditors in reducing strategic costs, increasing the aggregate pool of assets and as administratively efficient. It follows from the above argument that the protection of non-creditor interests of other victims of corporate decline such as employees, managers and members of the community, is not the role of insolvency law at least for this group of scholars. Many other consider nevertheless that keeping firms in operation must be seen as an independent goal of insolvency law (Armstrong & Cerfontaine, 2000)

In the creditor wealth maximization approach all policies and rules are designed to ensure that the return to creditors as a homogenous group is maximized. Insolvency law is thus concerned to maximize the value of a given set of assets, not with the allocation of entitlements to the pool. Accordingly effect should only be given to existing pre-insolvency rights what will soon lead to introduce the difference between secured and unsecured debt deeply studies elsewhere (see for instance Ponoroff & Knippenberg, 1997). Moreover, in order to keep the hierarchy among creditors stable, new rights should not be created once the default is stated by the judge. Variation of existing rights is only justified when those rights interfere with group advantages associated with creditors acting in concert what has been organized by the last version of the French insolvency Act voted in July 2005 (see below).

The creditor wealth maximization vision has been subject to severe criticisms. Major concerns have focused, firstly, on insolvency being seen as a debt collection process for the benefit of creditors. This fails to recognize the legitimate interests of all the stakeholders who are not defined as contract creditors. That is indeed the case for managers, suppliers, employees, their dependents and the community at large. To see insolvency as in essence a sale of assets for creditors, moreover, fails both to treat insolvency as a problem of business failure and to place value on assisting firms to stay in business. Thus, it has been argued that to explain why the law might give firms breathing space or re-organize them in order to preserve jobs requires resort to other values in addition to economic ones. The economic approach, as exemplified by Jackson, is, therefore, alleged to demonstrate only that its own economic value is incapable of recognizing non-economic values, such as moral, political, social and personal considerations[11]. The idea, moreover, that a troubled company constitutes a mere pool of assets can also be criticized. Such a firm can be seen not purely as a lost cause but as an organic enterprise with a degree of residual capability: it results from the potential imbedded in a going concern what differentiates a corporation that can continue as an enterprise from a mere property. Insolvency law, indeed, recognizes that the rehabilitation of the firm is a legitimate factor to take on board in insolvency decision-making.

Does it make sense, in any event, to point to a common pool of assets to which creditors have a claim before insolvency? Unless credit is secured, it arguably is extended on the basis that repayments will be made from income and not from a sale of fixed assets. Income, moreover, can be said not normally to be produced by the assets themselves but, in the case of an enterprise, from 'an organizational set-up consisting of owners, management, employees plus a functioning network of relations with the outside world, particularly with customers, suppliers and, under modem conditions, with various government agencies. It is, indeed, insolvency law itself that creates an estate or pool of assets and this undermines any assertion that insolvency processes should maximize the value of a pre-existing pool of assets and should not disturb pre-insolvency entitlements. The idea that insolvency law can be justified in a contractual fashion with reference to a creditors' bargain has also come under heavy fire. The creditors' bargain restricts participation to contract creditors. In this sense the veil of ignorance used by Jackson is transparent since the agreeing parties know their status in insolvency. It is not surprising that in an ex ante position such creditors would agree to maximize the value of assets available for distribution to themselves. Another vision of insolvency law attempts to overcome the restrictions of creditors' wealth maximization taking into consideration not only the interest brought by the other partners in the firm's activity but also the capitalist system itself.

10 See Jackson, ibid, 17.

11 According to Korobkin 'Bankruptcy law includes provisions that empower courts to decide bankruptcy-related matters; specify the duties and powers of the representative of an estate and regulate it in matters affecting rights of parties to the bankruptcy case; afford to creditors a mechanism for enforcing their rights against the debtor and the estate; provide, in the case of an individual, for repayment plans or, in the case of a corporation, for plans of reorganization; and discharge the debtor from some kinds of debt.' (Korobkin, 1991, p. 723).

1.2. From Protection of The Rights of Creditors to that of the Business: A Capitalist Evolution

Historically, the repayment of debt was considered as a moral act and the inability to comply with this rule implied prohibition from any contractual activity as well as the suspension of all civic rights. By excluding bankrupt owners simultaneously from the market and civil society, the first bankruptcy procedures merged the civic and economic dimensions of society. While the use of the rules in the 19th century conveyed a concern for reinsertion manifested by the trader-judges, the crises of the 20th century were to make the rehabilitation of the bankrupt trader and the protection of the business more systematic. We are going to look at this dimension through two elements: first, the establishment of a hierarchy among creditors so as to eliminate the race to the courts (1.2.1) and secondly, the replacement of exclusion by protection (1.2.2).

1.2.1. The Redistribution of Assets: between Hierarchy and Collective Proceedings

Splitting assets among creditors is the core redistributive challenge of bankruptcy. With the passage of time, successive reforms have constantly sought to attenuate the risk of a race to the courts fostered by the principle of "first come, first served", in force for a long time, for example in German law (Desurvire, 1992). Whereas the judge takes official note of the failure of the business, the owner-entrepreneur or the shareholders are formally and legally expropriated. This removal is required in liquidation and the accompanying disposal of assets. This is the stage in the procedure when conflicts emerge among the various categories of stakeholders, which have been given considerable attention in the literature on bankruptcy. Overall, the law provides that the payment of creditors shall be based on the price of the sale or the proceeds from the liquidation, with the income serving to repay creditors. Here a new level of bankruptcy organisation appears with a view to ordering the actual losses which until then were potential and now become real, and as a result, charged to the balance sheets of the various partners. The amount depends on the rank of the creditor's claim in the order of repayment: legally or conventionally secured creditors (the State, employees, secured suppliers) are repaid in order of priority according to the rank and extent of their privilege from the proceeds of the sale of the pledged property. In every case, their repayment takes place before that of creditors who relied on the debtor's ability to pay (unsecured creditors), who are then paid in proportion to the amount of their verified, accepted claims out of the amount remaining after payment of the privileged creditors. These dividends are often low and in many cases unsecured creditors receive nothing.

These differences of status and the resulting variations in payment explain why unsecured creditors, especially banks in the recent period, continually denounce the unfair treatment reserved for them. Hence, it seems timely to study the internal conflicts within the class of creditors to understand the observable differences in the order of priority and the numerous reorganisations they have brought about since the procedure took on a collective character (Goré, 1969). By emphasising the existing tensions between the personal interests of the creditors and those of the mass to which they nevertheless belong, we can shed new light on the conflict between the need for swift liquidation of a business in cessation of payments and the attempts to protect the company and maintain its business which benefit not only ordinary creditors but also third parties either directly (employees, for example) or indirectly (local authorities, etc.).

1.2.2. Company Protection or Liquidation of Assets?

The fate of the company is one of the major concerns of the different actors involved in the bankruptcy process. The future of the firm's productive assets – both tangible and increasingly intangible – is indeed important not only to the owner but also to commercial judge, the court-appointed administrator and the creditors who, from the 19th century onwards, have worried about the loss entailed by the cessation of business. Early on, reports by court-appointed administrators and the minutes of general meeting of creditors expressed this fear linked to the loss of what would later be called 'goodwill', by pointing out the damaging effects of interrupting business on the amount of payout to creditors. The latter, grouped together and assumed to play a key role in settling the bankruptcy through general assemblies, soon realised the antagonism that existed between their interests and those of the court-appointed administrator:

- the creditors, like the entrepreneur to a certain extent, see their interests preserved by continuing the business which enables receipts to come in instead of having only disbursements to record,
- the trustee or the court-appointed administrator often finds it advantageous to keep the proceedings going, for his remuneration depends on the number of steps carried out and because he may have connections with other entrepreneurs with an interest in taking part in the dismemberment of other companies to boost the growth of their own businesses.

Here again, in the face of deviations from the doctrine revealed by an interpretive reading, we observe that very early on the commercial courts demonstrated imagination in getting beyond the lack of definitions of the basic concepts of bankruptcy to assess as best they could the complex situations experienced by bankrupt companies (Noël, 2003).

Often deviating from the legislation condemning most bankrupt owners, the victims of events beyond their control, the actors in the proceedings (magistrates, agents, court-appointed administrators, and creditors) seem to be largely free from the weight and rigidity of an essentially repressive procedure to adopt an economic attitude towards failing companies authorised by their experience and familiarity with the local business network. While this practice would initially result in protection of creditors whose interests were affected by the complexity and length of the proceedings as well as the loss of assets following the shutdown of business operations, it would also be concerned with the interests of the debtor. In this respect, although attenuated by the law of 28 May 1838, the extremely strict provisions introduced by legislators in 1807 were soon be skirted by the judges who often favoured continuing business activity. During the 19th century, the latter would also mean almost systematically recognising the excusable character of the bankruptcy and a tendency to easily obtain the rehabilitation of the bankrupt owner, allowing the latter to begin commercial activity anew.

The will of French legislators to promote the survival of companies in financial distress is visible above all in legislation in 1955, 1967, 1985, 1994 and 2005. [12] It also distinguished itself by granting essential authority to the courts and by the prevalence of the rights of debtors over those of creditors. The concern for continuing the business usually means deciding on a receivership procedure, which attributes to the judge the power to set, only in the cases where receivership is not manifestly impossible, an observation period which may last from six to twenty months, during which the management of the company is placed under direct or indirect court control. At the end of the observation period, the court may decide to liquidate the company or impose a receivership plan on the debtor and all the creditors. As the procedure almost always results in liquidation of the firm, the law of 2005 sought to strengthen the means implemented in favour of protection and to do whatever was necessary to give the prevention of company failure precedence over receivership.

Here again, we see that the various legal systems for handling bankruptcy have resulted in a sort of convergence tending to favour keeping companies alive, as the value of a "going concern" is systematically assumed to be superior to the value of dismembered assets. In this case, it should be recognised that French bankruptcy law, represented today by the company protection law, authorised very early on an explicit distinction between the prevention of problems and their treatment.[13] The priority given to the survival of the business is therefore presented as a supplementary objective to the minimisation of transaction costs which consequently cannot constitute the sole criterion for assessing the efficiency of the law governing the end of operations. In any case, the legislators and court actors raised the question at an early date concerning returning the unused assets of companies involved in litigation to the market. Thus, they met capitalism's need for self-regulation which, more than the simultaneous exclusion from the market and civil society in force in outdated law, requires setting up a system that authorises the cancellation of debts after liquidation of assets and decriminalisation. This dissociation of the economic order from that of civil society makes it possible to close the economic cycle by charging losses to balance sheets, returning part of creditors' capital so they can reinvest it and giving the debtor a chance to engage in business once again.

2. How Creditors Are Influenced By Insolvency Laws?

The multiple goals possibly associated to a single insolvency law open various possibilities as far as creditors' behaviour is concerned. Much of the insolvency process aims at sorting out rights among creditors (Jackson, 1982). In a judicial perspective, bankruptcy helps to constrain creditors from attempting to promote their individual interests every time they are in conflict with the overall interest of the group of claimants (employees, suppliers, financing partners...). Insolvency law can thus be seen as an attempt a compulsory system that rational creditors acting under a 'veil of ignorance' would privately agree to before the bankruptcy occurs. One can pretend the order fixed in the law exert a strong influence on the creditors behaviour especially when the contracts does not result from a social subordination, as it is the case for the contract of employment, but is a genuine mean used by the co contractors to maximise their wealth. Debt contract enters in this category. And the importance of the ex ante distribution of remaining assets on the decision to enter or not in a financial relationship is illustrate by the insistence the banks put to access to the group of privileged creditors all over the history of bankruptcy codes. We propose to shed some light on

12 These trends were also perceptible abroad. Starting in the 19th century, bankruptcy law in the United States gradually detached itself from English legislation. Throughout the century, economic crises encouraged the adoption of laws favorable to debtors, which allowed the sale of residual property to creditors and sometimes recognized the right to be freed from unpaid debts without the consent of the creditors, which were repealed several years later under pressure from creditors. At the same time, the practice of amicable agreements between creditors and debtors became more widespread, even though it was impeded by the power of any creditor to denounce these agreements by requesting the commencement of bankruptcy proceedings. In Italy, the same demands were expressed by the Prodi law and several other extraordinary laws introduced between the end of the 1960s and the beginning of the 1980s to limit the social effects of industrial crises.

13 The use of out-of-court modes of payment by companies in financial distress guaranteeing wide latitude for negotiation with stakeholders appeared as early as the *Ancien Régime* (Bertholet, 2004) and was quickly denounced due to the high costs they engendered (see Michel, 1900, p. 985 or Balzac, 1948, pp. 147-150).

this phenomenon referring to the French case and, more precisely, to the last insolvency Act voted in July 2005 (2.1). Then we will show how, given this context, the possible issues of the failure process will determine in turn the respective behaviours of debtor and creditors.

2.1 What about the French Insolvency Law Voted in July 2005?

The new French insolvency law took effect on 1st January 2006. The decision to overhaul the law came after figures published by the French ministry of justice showed that 89 per cent of the 44699 insolvency proceedings in 2003 ended up in liquidation. The key aims of the reform were to:

- promote voluntary arrangements between the debtor and the creditors;
- anticipate debtor difficulties by allowing it to ask the court to commence insolvency proceedings before the traditional insolvency test (*cessation des paiements* – basically a simple cash flow test, meaning the debtor company is no longer in a position to repay its debts with its available assets) is met;
- simplify proceedings; and
- reduce the length of proceedings (in 2003, the average length of French insolvency proceedings was about four years).

Much emphasis has been put on the fact that the new act voted by the Parliament in august 2005 and applied since January 2006 shows a marked willingness on the part of the legislator to implement a kind of Chapter 11 *à la française*. However, in addition to implementing US-style insolvency proceedings called *sauvegarde*, the proposed reform promotes the existing voluntary arrangement procedure (*conciliation*) and re-defines the purpose of reorganization (*redressement judiciaire*) and liquidation proceedings (*liquidation judiciaire*). The legislation also reforms the sanctions applicable to managing directors of insolvent companies.

- The anticipation of financial difficulties
- The amended voluntary arrangement procedure
- The voluntary arrangement procedure is currently available to companies that are still solvent according to the French *cessation des paiements* test. It is a brief three-month process (renewable for an additional one-month period) during which the court-appointed mediator (*conciliateur*) supervises the negotiation of a voluntary arrangement between the debtor and its creditors.

Under this new legislation, the voluntary arrangement procedure is also available to companies that have been insolvent for less than 45 days. The process has been extended to four months (renewable for an additional one-month period). As under the previous legislation, the commencement of a voluntary arrangement procedure does not stay proceedings against the debtor. In order to encourage lenders to finance the debtor company, the legislation provides that lenders who consent to finance the debtor's company during the conciliation will have priority in the re-payment of these claims. Safeguard proceedings allow companies that face difficulties but are not yet insolvent to anticipate financial difficulties and negotiate a reorganisation plan with their creditors while enjoying a stay of proceedings. This change has primarily affected large companies (in terms of turnover and number of employees). For the purposes of the negotiation of a reorganisation plan the court will appoint two committees of creditors: one composed of credit institutions and the other composed of the debtor's main trade creditors. The two committees have to vote on the plan. If they reject it, the court may nevertheless approve such reorganisation plan and impose a rescheduling of the creditors' debts.

As with the safeguard proceedings, the new reorganization proceedings enable companies that are already insolvent to be reorganised whilst benefiting from a stay of proceedings. The law provides that a company has to file for reorganization proceedings (*redressement judiciaire*) within 45 days of the date it becomes insolvent (instead of the previous 15 days), if it has not asked the court to open a voluntary arrangement procedure during that period. As in the safeguard proceedings, the legislation introduces creditor committees for large companies in the reorganization proceedings. Another possibility may however occur. The legislator provided that a company that cannot be reorganised through a reorganisation plan would have to file for liquidation proceedings (*liquidation judiciaire*) within 45 days of the date it becomes insolvent (instead of the previous 15 days), if it has not asked the court to open a voluntary arrangement procedure during that period. The commencement of liquidation proceedings imposes a stay of proceedings. A simplified and quicker *liquidation proceedings* for smaller companies has also been introduced in the new Act. In this case, a sale of the debtor's business (plan de cession) can only be implemented in liquidation proceedings.

Generally speaking, the *sauvegarde* laws permit management to retain control over the company and provide for a more limited charge for the administrator [14]. In fact, the *sauvegarde* mimics Chapter 11's exclusivity period by providing a time lag of 30 days prior to the constitution of the creditors' committees, and a two-month time lag before the debtor must present a plan to the committees (Sauvegarde law, art. 83 (art. L.626-30 of the Commercial Code). But if all goes well, the firm will not be forced into redressement, and will be able

14 Sauvegarde law, at arts. L.621-4 and L.622-1 of the Commercial Code) ("L'adminstration de l'entreprise est assurée par son dirigeant.").

to reach a compromise with its creditors' committees without too much heavy-handed interference of the administrator. By preserving management's control, the sauvegarde system grants management a stake in the firm's future, if management is willing to appease creditors. The goals of preserving going concern value and efficiently distributing assets (as well as preserving employment) are synchronized with the goals of reducing the ex ante agency conflicts.

The modifications introduced reveal the will of creditors to be given a priority rank that will allow them to anticipate a higher payout than that granted to ordinary unsecured creditors. The order of payment instituted by article L.622-17-II of the Commercial Code establishes the following ranking among earlier and later claims:

1. The highest privilege of employees,
2. The privilege of court fees prior to the decision to commence collective proceedings,
3. The privilege of conciliation (see article L.611-11 of the Commercial Code),
4. Later claims eligible for preferential treatment,
5. In the event of the sale of property subject to a special actual pledge (special privilege, pledge, mortgage) during the observation period or during the execution of a protection or rehabilitation plan, the holders of special pledges will be paid:
   - before later creditors not entitled to preferential treatment and earlier creditors,
   - but after later creditors entitled to preferential treatment.
6. Later claims not entitled to preferential treatment and later claims.

The law of 26 July 2005 introduced a distinction among the later claims[15] and provides that only those creditors whose claims are "useful" to collective proceedings shall benefit from favourable treatment. This modification corresponds to a new privilege in favour of later creditors, consisting of payment priority for later claims defined in articles L.622-17-I and L.641-13-I, in the event of failure to pay these claims by the debtor. This is a privilege insofar as the benefit of payment priority is maintained, even if further collective proceedings are subsequently initiated, regardless of whether they involve receivership or liquidation. This means that the 'useful' later claims of the first proceedings will retain their payment priority over the earlier claims of the second. They will, however, be ranked after the new "useful" later claims of the second collective proceedings.

This provision, which improved the rank of bank claims, was introduced to give creditors an incentive to take part in company receivership. Does this mean that, even if the outcome of the proceedings is market-oriented, a dividing line can be traced between the liquidated assets that will be put back into the market by the buyers who will attempt to enhance the value of the machines and technologies included in those assets, on the one hand, and the rescue of viable companies that will be able to face the commercial world after restructuring their assets and liabilities, on the other?

2.2. A Presentation of Entrepreneur and Creditors Behaviour Under Insolvency Law

Our main theoretical claim here is that bankruptcy is not a clear-cut common knowledge fact, a situation in which a firm is and one that the court can recognize and settle. To enter a bankruptcy procedure is a choice which depends partly from the situation of the firm as known by the actor making the choice, partly from what he expects from the decision to enter the procedure, which depends on bankruptcy law and the behaviours all other actors concerned. This "realist" epistemological choice leads to emphasize the strategic and the information dimensions in the bankruptcy process, as well as the characteristics of the legal system and the economic environment.[16].

We will simplify the model by supposing that the choice to enter a bankruptcy procedure is either made by the debtor or the creditor, letting aside those cases when the courts take the initiative (less than 10% of all cases during our period). One can consider the start of a legal case as the default situation since both sides must agree on a private settlement (and actually all creditors, as we saw) when a single side can impose the legal procedure.

The choice for a debtor lacking liquidity was between borrowing more, filing for bankruptcy and asking his creditors for a private settlement. We suppose that the debtor could not borrow anymore when he faced that choice. Concentrating then on the last two solutions, we can consider that the private settlement was superior for him in terms of reputation (nobody knew of it except the creditors) and in terms of transaction costs; it also did not bring the risk of the death and liquidation of the firm if no concordat could be obtained. Nevertheless, if there was a conflict among the firm's owners (*associés*) because of asymmetric information among them, it was less likely that a private settlement would be accepted by all of them. It was also probably inferior in terms of the debt reduction that could be obtained at least inasmuch as it maintained the information asymmetry

15 Traditionally, later creditors known as "article 40 creditors" (art. L. 631-32 of the Commercial Code) benefited from favourable treatment insofar as their so-called "later" claims had to be paid at due date by the debtors, as opposed to so-called "earlier" claims that were frozen until the end of the observation period and then settled, if possible, either within the scope of a continuation plan or a sale plan.

16 The realistic approach differs profoundly from the idealistic approach of finance theory which leads to such optimal systems such as those proposed for example by Aghion & alii, (1992) or Hart & alii, (1997), which suppose that the value of the firm is independent from who controls it, when in the period under study almost all firms were entirely dependent from their owner-manager, and, correspondingly, the bankruptcy procedure did not provide any instrument allowing for the transfer of control of an existing firm.

between the debtor and the creditors.[17] The main difficulty was to obtain the agreement of all creditors, since no single debt could be reduced without the agreement of the creditor concerned (who could always sue for bankruptcy).

The choice for the creditor was not entirely symmetric. He also preferred the survival of the firm, but only if the actualized value of the flow of payments it would make was likely to be superior to the present value of its parts. Both a private settlement and a concordat would allow for a survival. The differences between them were the procedure cost and the agency costs. The procedure cost made the creditor prefer a private settlement; the agency cost with the debtor made the creditor prefer the bankruptcy procedure, which would provide him with information on the actual situation of the debtor allowing him to adjust the debt reduction to the exact need of the debtor. Furthermore, a legal procedure protected the creditor against differences in information among creditors and the risk that some creditors may obtain privileged access to the firm's funds, since equality among non legally-privileged creditors was a basic principle of bankruptcy law. In sum, the legal procedure can be seen for the creditor as an option allowing him to ask for the liquidation of the assets (but only under a majority vote procedure) in the case an agreement cannot be reached with the debtor and the other creditors. The value of such an option increases with the probability of such a liquidation, with the uncertainty of the debtor toward the actual situation of the firm and with the risk of a conflict with other creditors; its price is the cost of the bankruptcy procedure.

As a conclusion, we can consider that the choice between private settlement and legal procedure resulted mostly from:

- The actual situation of the firm (the probability of a legal procedure increasing when the situation of the firm worsens);
- the information asymmetry among the firm's owners, between debtor and creditor or among creditors (the probability of a legal procedure increasing with these asymmetries);
- the relative costs of the two procedures (the probability of a legal procedure decreasing with its cost);
- the cost for the debtor of the start of a legal procedure: reputation cost in particular (the probability of a legal procedure decreasing with that cost);
- the difference between the value of the firm as a going concern and the value of its assets (the probability of a legal procedure decreasing with that difference);
- the risk of not agreeing on a concordat for a given situation in the case a legal procedure was chosen (the probability of a legal procedure decreasing with that risk).

Furthermore, it is likely that the choice of a legal procedure would be made by the debtor the more frequently the less dangerous it was for him in terms of reputation and risk of future liquidation, when the firm's situation was relatively good and the asymmetry in information with the creditors and among creditors were low as well (so the risk not to obtain a concordat was low). The creditors' initiative of a bankruptcy procedure would appear when the option value would be high enough. Both would be incited to go to the court by a reduction in the procedure cost.

Once a bankruptcy procedure started, creditors and debtors could again choose between a concordat and a union, but they had to agree on a concordat for it to be accepted when each of them could impose a union (with the proviso that the creditors' decision was based on majority, not unanimity). The advantages of the concordat are obvious, since it allowed the debtor to keep control and escape the most infamous aspects of the faillite. But the union could free the debtor from all its debts (although it was not legally the case), and provided the creditors with low, but immediate and risk-free dividends. Again, transaction costs and information asymmetries would intervene in the choice. So among bankruptcies, the probability of a concordat being chosen was:

- increasing with the actual situation of the firm;
- increasing with the difference between the value of the firm as a going concern and the value of its assets;
- decreasing with information asymmetries between debtor and creditors;
- increasing with the cost in reputation of the union vs. the concordat;
- increasing with the relative procedural cost of the union vs;.the concordat.

Graph 1 may help understanding our logic: on the x axis, it represents the actual situation of the firm, in terms of assets to liabilities. On the y axis, the loss of creditors (implicit gain of debtors) is represented for various terminations of the conflict, as a distance to the central optimal 100% line.

When the situation is relatively good (high assets/liabilities ratio), the most likely is a private settlement. When it deteriorates, a legal procedure is more likely. The curves are indifference curves of a category of agents (debtors or creditors). The difference between both agents' curves is the deadweight loss of bankruptcy (what the creditors loose without gain for the debtor). When curves intersect (like at points x(p,l)c or x(l,f)d), the agents switch from preferring one solution to the other. Since

17 We suppose that this information asymmetry would never be suppressed under private agreements given the lack of reliable common-knowledge accounting systems during that period, and the cost of transferring the adequate information in the case of small businesses.

both must agree, the decision is imposed by the first agent to reach such an intersection starting from the right: e.g. x(p,l)c > x(lp,l)d in the case depicted on the graph, so that creditors will ask for a *liquidation proceedings* before the debtor.

The legal system and the courts practice explain the distance between the indifference curves and the optimal 100% line, and the impact (possibly variable through time) of the legal system and practice. Because situations vary and there is a menu of procedures, we suggest there is no optimal bankruptcy system, but the creation of new procedures, if they substantially better the menu, can bring substantial welfare gains: in the graph, the creation of the *reorganisation proceedings* allows for a solution better than either arrangement procedure thanks to private settlement or *liquidation procedure* in many cases (from x(p,l)c to x(l,f)c).

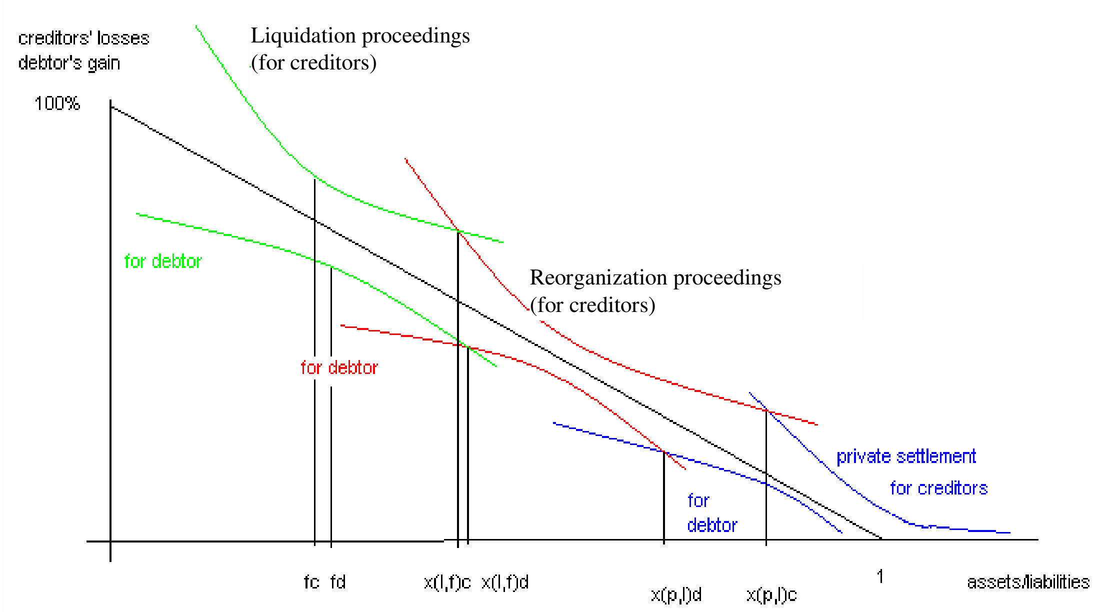

Figure 1. A Simple Representation of the Bankruptcy Choice

In the previous sequence illustrated by graph one, information plays a crucial role. It determines the choice of the procedure but also the gap between creditors and debtors hierarchy of preferences. It is thus highly understandable that the legislator put a high emphasis on the production and use of information in the insolvency law. Information disclosure is vital in insolvency as creditors can only know the financial status of the company through information disclosed by the company. Such a concern involves the standards of the information disclosure to achieve a fair and true revelation of the value of the company in concern. While financial reports and the directors' report have been the ongoing obligation of companies, such reports may be especially important in insolvency. This importance was perceived very early in the history. That is probably why the first French insolvency Act implemented by Colbert in 1663 insisted upon the fact that any bankrupted unable to present correct books felt immediately upon the rule of fraudulent bankruptcy, much more severe than the ordinary one since the death penalty was possible. Still today, directors of a company facing insolvency commit offences if they falsify the company's books or make any material omissions in any statement relating to the company's affairs. The seriousness of such a dissimulation is all the more important that several Acts put transparency and fairness at the core of a safe economic life.

Information disclosure is also important for the reason that insiders may acquire their own benefits at the cost of other stakeholders in corporate rescue activities. The law accordingly prescribes the disclosure of transactions during a certain period prior to the file of insolvency. The safeguard proceedings that aim at determining a reorganization plan [18] is characteristic of this will. Once this step finished, the information becomes public. Also, negotiated rescue plans must be approved by courts or court-assigned insolvency practitioners, who are further required to keep records of their acts and dealings in discharging their duties. The basic objective of these arrangements is to let all relevant parties know the facts and compromises reached. In other words, almost every deal in insolvency is under the supervision of either

[18] The name of this step in the procedure varies according the country. In the supposed pro-debtors countries, the insolvency procedure begins with a phase of consultation between the entrepreneur and the main creditors from which a reorganization plan may come up. During this dialogue, information is only shared by the participants to the discussion and the difficulties the firm is facing are not communicated to board members. If this procedure is unsuccessful, one enters in the arrangement proceeding that supposes disclosure of information.

the court or the insolvency practitioner. Protection to creditors is further enhanced as disclosure rules are enforced on all companies and directors may be sanctioned for the breach of their duties to creditors. The above discussion thus reveals that mandatory information disclosure is a main characteristic of the legal approach to corporate restructuring transactions. Since such information disclosure requirements are initiated by the occurrence of specific events, they are event-driven and thus more specific than the general information disclosure as required when companies are going concerns.

3. Insolvency as a Governance Device

In this section we show that giving its influence upon the sharing of remaining assets in case of failure, insolvency laws act as a governance device. This is particularly clear when a purely economic conception of insolvency law is adopted what seems to be more and more the case. We briefly remind the underlying principles (3.1) and then present in a more detailed way how insolvency laws impact the firms normal life (3.2).

3.1. From Principles…

As companies face insolvency, significant changes to the existing governance structure occur. Since the worsening performance becomes widely known among stakeholders, they will modify their behaviour accordingly. In the vicinity of insolvency or if insolvency is imperative, shareholders may prefer risky projects in consideration of their own short-term interests at the expense of the interests of creditors, as they know what is at stake is the money of creditors and the utmost loss for them is the fixed amount of share capital, which may be worth nothing in the case of insolvency. Or, shareholders may simply prefer a quick exit from a long troubled distress.

In comparison, creditors, especially secured creditors, may want to realize their collateral as quickly as possible so that they can invest in other businesses. The result of such exits, however, is a decrease of the value of the pool of assets of the company. Employees may also make underinvestment if they realize their jobs have already become unsafe. Morale among employees will thus decline. Alternatively, employees may be inclined to get a decent compensation and start their new life elsewhere rather than remain enmeshed in a distressed company. Directors attracted by the generous severance compensation package will at most not interfere to save the troubled business. Or they may simply continue the business recklessly for the benefits of shareholders or for their own reputation without due consideration of the interests of creditors. Or they may set up coalitions with employees for the reason of job security but at the cost of both shareholders and creditors by failing to achieve a better result through quick liquidation.

But firms in distress are not the only one to be concerned by insolvency laws. Indeed, creditors can make expectations of the consequences of their decisions prior to be involved in a run whose the winners are the owners of securitized debts as organized by the law. Such as in the case of disclosure of information, this device was experimented at the very beginning of the modern version of insolvency. Contrarily to the old German or Roman laws who supposed an individual action of isolated creditors, modern law early organised creditors as a class, introducing a clear cut between secured and unsecured debts. The rank of the liabilities determines thus the probability and the amount of repayment. However, the expectations of failure any potential creditor makes financing a project exert an influence upon his will to become a creditor and upon the sort of credit he will provide.

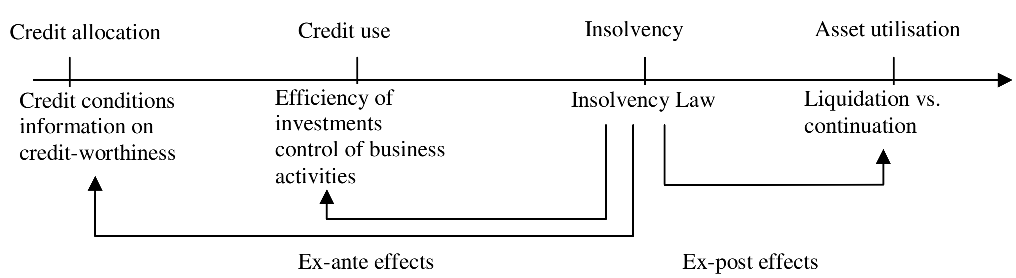

Figure 2. The influence of insolvency law on firm's life

The rules of Insolvency law influence how many credit contracts altogether are entered upon, under which conditions, and how much money is spent to examine the creditworthiness of the borrowers. In addition, the Insolvency law also influences the concrete use of the money lent, i.e. the business model and the investment strategy of the company, as well as the costs which the lender is willing to expend on the control of the ongoing business. Finally, Insolvency law also has an influence on which utilization alternative after the occurrence of insolvency is chosen: dissolution and sale of the individual assets of the enterprise, sale of the complete enterprise or of parts of the enterprise to a new owner, i.e. to a new legal personality, or reorganization and continuation of the enterprise through the existing owners the old legal personality.

Figure 2 recalls the relevant incentive effects of Insolvency law on different acts:

1. The credits should be priced in such a way that the interest rate reflects the additional risks caused through the additional investment what corresponds to an 'efficient credit allocation',
2. The business policy implemented should maximize the expected market value of the firm what supposes the credit is used in an efficient way and
3. After the occurrence of insolvency, the use of assets with the highest expectation value should be chosen in conformity with the rule of 'efficient asset utilization'.

3.2. … to the Application of Insolvency in the Continuum of Corporate Governance

In general, insolvency does not come into being at a sudden event springing out in a favorable period. On the contrary, payments disruption can be expected from signals empirical works try to identify using either zeta score based models or a more qualitative approach. If empirical evidence does not show a clear causal relationship between good governance practices and good corporate performance mainly because it is almost impossible to discriminate among a favourable conjuncture and good practices as causes of success, it is usually the case that corporate insolvency will be a predictable result of bad corporate governance when the company is still a going concern.

Moreover, governance arrangement instituted in ordinary life can still persist when companies turn into distress. If so, it is very possible that what fits to a safe company reveals to be completely inappropriate to an endangered firm. For instance, even though creditors are protected collectively in insolvency, the interests of secured creditors over their collateral or security are expressly excluded from the collective distribution scheme. Alternatively, creditors can stipulate in their contracts with the company much stricter initiating terms than the general requirement in insolvency law. This form of credit rationing boring on other than prices terms is however scarcely studied from a theoretical point of views. It is precisely enlighten by surveys implemented by the Central banks. [19] In consequence, creditors may intervene in corporate governance when such terms are satisfied rather than when rescue efforts will be tried in vain. Therefore, pre-insolvency contractual arrangements may well penetrate into the control structure around the invocation of insolvency.

The influence of an undesirable future on the present decision is all the more complex to define since bankruptcy is in no way a natural state. The question of defining the date on which the cessation of payments occurred arose very early for the courts and the authors of manuals and user guides for practitioners. Beyond the control they exercise over the methods of applying the law, commercial judges possess above all the power to discriminate between a temporary situation of insufficient liquidity and a situation of insolvency, the latter being a necessary but not sufficient preliminary condition for bankruptcy. Commercial law manuals are clear on this point: the mission of the courts is to declare cessation of payments; they are also sovereign in their assessment of the circumstances and the facts related to cessation of payments, which leads them in particular to fix the date of cessation of payments (Colfavru, 1863, p. 433). This provision is essential, for the date of commencement of bankruptcy makes it possible to fix the observation period, i.e. the period preceding bankruptcy commencement during which the debtor may have executed more or less fraudulent legal instruments, for which the creditors may request termination.

Therefore, the role of insolvency as a monitoring mechanism can be extended to governance practices of healthy companies (Pochet, 2002, p.343). For instance, insolvency is tested according to two criteria, one of which is the 'cash flow' insolvency, according to which a company is insolvent if it is 'unable to pay its debts' when they are due, while the other is the 'balance sheet' insolvency, according to which liabilities of a company exceed its assets. The common point is thus that the solvency status of a company is legally evaluated in financial terms only. In turn, even if we are not sure what best governance practices are, we are definitely certain that bad financial performance meeting these criteria will lead to insolvency. The strong financial orientated criteria at the end of the life of a company thus keep ringing a bell to directors when it is operated as a going concern.

Such understandings can, then, help us explain the current disadvantaged position of employees in corporate governance in general (e.g. Deakin & Armour, 2004 and Van Gehuchten, 1987). It is also relevant to the initiatives of entrepreneurs to set up businesses in the first place (see Armour & Cumming, 2005, and Ayotte, 2007). Viewed from this perspective, insolvency law is relevant not only to the demise of a company but also to the birth of a new company. Governance in the normal life and governance around insolvency are thus mutually influenced. As a threat put on incumbent managers, insolvency has a deterrent effect underlined by Hart who warned that 'A bankruptcy mechanism that is 'soft' on management … may have the undesirable property that it reduces management's incentive to avoid default, thus undermining the bonding or disciplinary role of debt.' (Hart, 1995, p. 685)

[19] For instance, each quarter the French central bank publishes a survey that gives an idea of the kind of credit provided and at what price to the borrowing firms.

In addition to the above disciplinary role of insolvency, the pro-creditor insolvency scheme may also help to increase creditors' incentives to make investments. In turn, the potential increase of the ratio of debt to equity may indicate an enhanced governance role of creditors in governance in the normal life. However, it is worth noticing that given the priority for secured creditors in case of insolvency, they may just have fewer incentives to care about the corporate governance in general than to be concerned about the disposition of their collateral once their contractual rights are breached (Li, 2008, chap 2). Viewed from this perspective, the pro-creditor insolvency governance scheme in the US or in France may indirectly discount the governance role of secured creditors in healthy companies. It can specially lead to an inefficient credit allocation given the full priority of the secured creditors (Eger, 2001).

Conclusion

As an ordinary matter of fact, companies are confronted with the claims of a multitude of creditors as a rule. If an enterprise gets into economic difficulties and is permanently not in the position to pay the bills - what is an economic approach of insolvency- the remaining assets must be divided between the competing claims of the creditors. Insolvency law entails, on one hand, a compulsory transfer of the debtor's property rights to the community of creditors. The point of this is to avoid ex post that the managers and shareholders shift risks to the creditors through their decisions. Before the insolvency occurs, the threat of withdrawal of the property rights should serve as a sanction to deter managers and shareholders from carelessly externalizing risks on the creditors. But the rule of repartition of risk and wealth is far from being the only one goal aimed by an insolvency law. It also protect the firm as a going concern an, determining the order according to which the claims of the creditors are satisfied prevent a run of creditors and, at the same time, bring an additional information used by potential creditors to improve the quality of their expectations.

From an economic point of view it is of interest that the procedural and distributional rules of Insolvency law create incentives which refer both to acts before the occurrence of the insolvency -ex ante- as well as to acts after its occurrence -ex post.

Being aware of the consequences of their current decision in case of non repayment of the borrowers, creditors are able to engage in a contractual arrangement that grants a maximum probability of repayment ex ante and a good position in the list of creditors ex post. The insistence of the bank to escape the risk of unjustified financial support in exchange of a higher engagement in the financing of insolvent firms is at the origin of one of the changes brought to the French insolvency law. It gives an idea of the importance of the relationships between the expected consequences of a failure and the current choice of a financial partner.

Besides its conceptual dimension, this question has also an empirical scope. It is of considerable interest for small scale enterprises. In these firms, the debt structure is typically rearranged under court-supervised reorganization by way of debt forgiveness and debt deferral. Entrepreneurs demand more trade credit during the pre-bankruptcy period to finance their loss-making business, and suppliers are willing to provide this credit in exchange of a higher level in the creditors ranking.

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