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## **Conference**

### **Financial Institutions, markets and ethics: Mixed approaches in the European context**

Jean Monnet Chair "European Financial and Banking Integration",

ESCEM and European University Institute

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### **Bankruptcy: from moral order to economic efficiency<sup>1</sup>**

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### **Abstract :**

The evolutions of the bankruptcy law seek to reach many aims: economic safety, firms' creation and expansion in a capitalist economy, protection of the interests of the agents involved in transactions that goes far beyond creditors and debtors, and prolongation of the activity of viable firms. This contribution examines the French insolvency law and its transformations since the 19th century from a historical and concrete point of view which makes it possible to put in perspective the modifications and the uses of the legal rules in an economic and institutional context. The underlying assumptions and the main results contradict the conclusions of the Law and Economics theory which insist on the weak economic efficiency and the low ability to protect creditors' interest of the bankruptcy law. We show that far from being only one means of selection thanks to which the market could be cleared of its failing agents, the bankruptcy law opens a non commercial space of resolution of the failures of market which, by releasing the actors of their former constraints, authorizes them to reinstate the business world.

### **1. Introduction: bankruptcy, between an economic state and a legal construction**

Company default is an inseparable component of any market economy in which the survival of producers is conditioned in the short term by liquidity and in the long term by their solvency. Failure to comply with the latter condition, defined in accounting terms as insufficient available assets to meet current liabilities, endangers the company and may be grounds for proceedings that could lead to liquidation of the business. These financial considerations suggest a clear-cut separation, either based on accounts or virtually naturally, between healthy and failing companies. The origins of bankruptcy law show that this is not the case and while the nature of the default is obviously economic, it is also, and to the same extent, legal. The source of this twofold connection lies in the definition of bankruptcy, which means a trader is unable to honour his payments. As Bravard-Veyrières (1840) emphasised, this definition presupposes that two conditions are met, for "to be in default, it is necessary to have stopped his payments and to have stopped them as a trader" (Bravard-Veyrières 1840, p. 497). Thus, this twofold condition will underlie our discussion of the evolution of the law and litigation practices pertaining to bankruptcy, which today is largely dominated by viewing the law in terms of economic efficiency.

The idea that the law evolves with a view to attaining a greater degree of efficiency is directly inherited from work by scholars focused on the economic efficiency of law and economics and the comparative analysis of legal systems,

led by the emblematic figures of La Porta, Lopez de Silanes, Shleifer and Vishny, abbreviated below as LLSV (La Porta et al., 1998), who have produced numerous disciples in the field of business financing (Glaeser and Shleifer, 2002) and bankruptcy (Djankov et al., 2006). In general, these works help to show the superiority of bankruptcy law based on the common law tradition over the legal system of cessation of payment developed in countries with a civil or Roman legal code. The final proof of good performance in bankruptcy treatment by common law is presented under the heading “Closing a business” in the annual World Bank survey on “Doing business”. Referring to the English law on bankruptcies in 1732 as the source of modern bankruptcy law, the authors of the 2004 report view the greater experience authorised by this seniority as the cause of the efficiency of the legal systems that flow from it. Indeed, they have come farther on the path towards efficiency and, for that reason, among others, are said to come closer than the other legal systems to achieving the three “universal goals of bankruptcy” (Doing business in 2004, p. 72): the maximisation of the value of liquidated assets through a swift liquidation operation, the rescue of viable businesses and compliance with the rank of creditors. The annual ranking, an extract of which is shown below, drawn up on the basis of three indicators of legal efficiency – the duration of the liquidation proceedings, the cost of the bankruptcy as a percentage of assets and the rate of recovery – shows excellent performance in Canada, the Scandinavian countries, Japan, and to a lesser extent, the United Kingdom, considered as common law countries, compared with the very mediocre position of France, an archetype of the civil legal system.

Here we find the clearest manifestation of the economic view of bankruptcy law designed as an instrument to achieve the best possible result (Cabrillo and Depoorter, 1999, p. 261).

Chart no. 1 – Extract of the ranking of bankruptcy proceeding efficiency

	Length of the procedure (in years)	Cost (% of assets)	Recovery rate (in %)
Australia	1.0	8.0	79.7
Canada	0.8	3.5	89.3
Denmark	3.0	4.0	70.5
Finland	0.9	3.5	89.1
France	1.9	9.0	48.0
Japan	0.6	3.5	92.7
Norway	0.9	1.0	91.1
Sweden	2.0	9.0	75.7
United Kingdom	1.0	6.0	85.2
United States	1.5	7.0	77.0

(Source: “Closing a business”, Doing Business, [www.doingbusiness.org](http://www.doingbusiness.org))

In the place of this normative view of the law, in keeping with the distinction made by Kirat (2003), we will substitute a view of the movement of law within a dynamic historical framework combining autonomy and heteronomy that underlies the pragmatist analysis of law in action. Far from being based on an antagonistic conception of the conflict, which should be avoided or minimised at the time, here the proceedings become a possible forms of coordination. As the purpose of the law in this case is no longer to eliminate conflict, it can on the contrary function as a genuine mechanism for social regulation by the way it distances the parties. Instead of seeing the development of bankruptcy law as the result of a search for every better means of increasing the efficiency of commercial relations, we are looking at bankruptcy as an institution through the human and social actions related to the law (Lascoumes and Serverin, 1988). In so doing, we move away from the linear schema according to which the emergence of new institutions results from tendencies outside the individuals that take part in this construction and adopt instead the institutionalist viewpoint, notably due to Commons (1924), for whom the enforcement of a rule, like its construction, contributes to producing the law. The legal proceedings determined by the strategies of the economic actors that initiate them thus contribute in fact to achieving an effect that complies with the one expected by lawmakers.<sup>2</sup>

Two elements, already present in the founding documents of bankruptcy law which are the thirteen articles under title XI relating to default and bankruptcy in Colbert's order of March 1673, reproduced in large part in Book III of the Commercial Code of 1807, will guide us in developing this point of view: firstly, how the judge qualifies the state of bankruptcy and secondly, the determination, by law, of trader status. These two pillars enter jointly into delimiting the scope of application of the rules governing bankruptcy and thereby influence the quantitative size of the legal proceedings initiated by the report of cessation of payment. This initial relationship between the scope of application of the law and the activity of the courts will constitute the first point in support of our analysis. It will be supplemented by questioning the meaning of the relationship as a dynamic factor in the law, which constitutes the second focal point of our work. These two foundations have been presented in earlier work (Hautcoeur and Levratto, 2006). This twofold framework leads us to a critique of the opposition between pro-debtor and pro-creditor bankruptcy law as a guide to assessing efficiency in this area, which the *Law and Economics* approach has done based on the analytic grid it has developed and the assessment method it uses. Then we will propose a new reading of the evolution of bankruptcy law as a capitalist institution, which will give us a grid for a new

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<sup>2</sup> We would recall that for Commons, economics is "a practical science of the coordination of individual and collective actions based on rules, which integrates conflicts of interest and power relationships between social groups, for the rules are largely produced within the scope of settling disputes" (Bazzoli and Kirat, 2003).

interpretation of the evolution of the law and practices relating to cessation of payments. We will rely on two phenomena for this purpose: the extension of the scope of application, on the one hand, and the opposition between a bankruptcy law that organises an optimum mode of sharing company assets and the law governing companies in financial distress aimed at correcting earlier market mistakes such as granting excessive loans, on the other.

## **2. Spatial and historical breaks: questionable keys for interpretation in *Law and Economics***

The renown of the economic approach to law maintained by LLSV rests on an analysis of the evolution of the law and rules governing bankruptcy that relies on a methodology characterised by considerable recourse to econometrics to substantiate the framework for interpretation constructed by the authors connected with it. This framework is rooted in a preconception that can be assimilated to a Coasian bargaining situation<sup>3</sup>. Situations are compared to a sort of ideal benchmark that defines a normative standard, prompting Djankov et al. to say that “in a theoretical model of an ideal court, a conflict between two neighbours can be settled equitably by a third party, with a little bit of knowledge or a limited use of the law, without lawyers or written proceedings, without procedural constraints regarding the manner of investigation, testimony, the way of presenting arguments, and without appeals” (Djankov, et al., 2003, p. 455). When a “good” law is defined as the one that does not exist, a series of often quantitative arguments will be mobilised to demonstrate the superiority of interpersonal relationships over legal proceedings and of common law over civil law. By focusing our approach on the treatment of companies in financial distress, we are seeking here to deconstruct the method and its presuppositions (paragraph 2.1.) before giving an account of the fragility of the identified divisions (paragraph 2.2.).

### 2.1. Theoretical *a priori* and methodological bias

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 efficiency 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, efficient results. In addition to these direct advantages, the business climate is said to improve as a

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<sup>3</sup> Here we find implicitly imposed Locke’s idea according to which contractual freedom is a natural human right, an institution of natural law which exists independently of the consent or sanction of society and therefore of the legal system.

result of the tidying up of bankruptcy law. Two dimensions of the application of the LLSV approach are examined in depth here: the systematic and exclusive minimisation of transaction costs (2.1.1.), and knowledge of the law in the books to the detriment of the actual practice of the actors and the methodology underlying the construction of performance indicators (2.1.2.)

### 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 political economy objectives characteristic of the recent period. By including procedures relating to cessation of payment in the policy agenda to stimulate growth based on the production of wealth by companies, legislators in most OECD countries gave up a moral and social vision of bankruptcy law to bring it within a private framework guaranteeing company prosperity or turnaround, or in the worst scenario, a quick liquidation of the business in such a way as to favour the reuse of production plant 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 search for greater efficiency...” (Backer, 2006, p. 2).

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

- They give rise to good incentives for debtors and creditors in such a way as to encourage entrepreneurial
- They ensure 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 help businesses continue and protect the value of the company in the interest of all the stakeholders. To reach this objective, collective proceedings must be implemented which 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 rates of recovery of the amounts due to creditors and too favourable to the debtor (Davidenko and Franks, 2005). The changes to be brought to 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 contribute to improving 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 actions 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, administrations and social organisations, potential buyers, society, etc.) generates a variety of often conflicting interests.

Behind these two types of efficiency, we find the utilitarian conception of bankruptcy law as the guarantor of the smooth operation of the economy insofar as it prevents creditors holding securities from collectively initiating a downward spiral of foreclosures and bank defaults that could cause a worldwide crisis like the one in 1933 (Bufford, 1994). The positive vision of law adopted here is also the source of the univocal association of procedural complexity with legal complexity, captured by the indicator that measures the time required to apply the measures provided for first in the commercial code and secondly in company bankruptcy law. As a result, the analysis leaves aside the social norms and extralegal factors that should be taken into account in any analysis of comparative law (Siems, 2005), especially as “a specific function may be assumed by a legal rule in one country and by an extralegal phenomenon in



another country” (Ibid, p. 529). The question that arises is thus the method to adopt and the sources to use in order to take into account the interdependence between institutions or laws, i.e. to carry out an endogenous assessment of national systems of economic rules and regulations. How can we get beyond a self-centred analysis of bankruptcy law and establish links between company law, credit law and insolvency the law to escape the univocal positivism characteristic of *Law and Economics* and enrich it with a more diverse view of capitalism?

### 2.1.2. An essentially textual knowledge at the origin of biased indices

This reading of bankruptcy law in terms of efficiency relies on a certain reading of the individual laws making it up. The paradigm established around LLSV gives rise to a sort of paradox because, on the one hand, they are writing under the influence of the works of North who insists on the role of institutions as a basis of property and the rights associated with contracts (Milgrom, North and Weingast, 1990), and on the other hand, they produce a totally a-historical analysis of the interaction among institutions and economic development. The result of this ambiguity is the production of performance measurement indicators from processing questionnaires based on content derived directly from the “law from the books”. By adopting this approach, LLSV are reviving a sort of legal formalism criticised by many authors in France (Raymond Saleilles and François Gény) and by the Realists in the United States. According to Saleilles, this traditional method of interpreting the law “consists in taking a code as a self-sufficient whole, which, without living an organised (in fact, far from it), is content to draw the logical consequences of its own underpinnings, so as to present, through a process of narrow deductions, a series of abstract constructions that come only from itself and include nothing from outside”. (Saleilles, 1899, p. V). Although these reservations are well known, they do not keep the supporters of the positivist conception of law from using that method.

This first methodological bias is patently obvious in the topic “Closing a business” in the “Doing Business” survey, entirely constructed on the assumption that “reformed bankruptcy rules allow viable businesses to get through liquidity crises and quickly eliminate insolvent companies” (Doing Business 2006, p. 67). Here, the economy is used to argue in favour of this idea, without discussing it, whereas bankruptcy law also contains a significant a moral aspect and has, since the beginning, oscillated between a will to exclude and a need for rehabilitation (see Hautcoeur and Levratto, 2007, for a presentation of these two tendencies in French law in the 19<sup>th</sup> century). Like the laws governing property rights to which it is closely related, bankruptcy law and its need to evolve into a system that enhances company business rests on a form of fictional economy (see Tartarin, 1982) in which growth is the consequence of flexible laws. The means used to foster dynamic entrepreneurship and encourage direct arrangements between debtors and creditors and thereby keep businesses in

operation – because a plant’s value is higher when it is operating - (see the OECD reports on this issue, particularly the Bologna charter) are defined with a high degree of precision, without any analysis or prior verification of alternative possibilities. It is as if the constructed indicators had to reinforce the conclusion reached from the outset, which consists in saying that preference should be given to out-of-court bankruptcy procedures. This is explicitly indicated by the preparatory work for the law of 1984 and 2005, which specifies that “one of the causes of the failure of current procedures is their complexity” and consequently, “it is advisable to simplify them by encouraging negotiation rather than court intervention” (National Assembly, 2005, p. 2), which nevertheless resulted in a conciliation procedure with approval by the commercial court.

In answer to these remarks, which emphasise the deficiencies in an approach exclusively centred on formal law, one could retort that the questionnaires sent to bankruptcy practitioners originally came from databases created to measure the efficiency of the law. Hence, they are intended to evaluate practices and not written rules. This counterargument does not hold, however, because LLSV are not irreproachable even as regards the database content.

The nature of the collected information is thus the source of the second identified bias and it must be examined to show that the limits of the World Bank indicators established through questionnaires filled out by national expert-practitioners, usually legal firms including an American one operating in Paris, again for the “Closing a business” section. The data, gathered by consulting correspondents, does not aim to be exhaustive or even representative; at best, it conveys the feelings or impressions of professionals in the field – whose scope of action is never specified – in their particular area of work. Their perceptions are interesting in that they reflect the current climate and, in this domain, are justified by specialists such as Kaufman et al. (2003) who stress that “the subjective perceptions of governance are often as important as the legal reality” (Kaufmann et al., 2003, p. 20). This is especially the case with regard to the actual length of the proceedings, the estimate of which can only be made by a practitioner based on local experience, which gives no assurance of representing the overall situation. This method nevertheless reveals a significant amount of observational bias, a result the survey attempts to avoid by discussing *facto* situations that enable an assessment of “law in action” independently of the opinions of certain experts regarding the way the laws function. Recourse to experts in charge of informing the survey body concerning objective legal data that at best provide descriptions of positive law in force nevertheless does not prevent the use of databases developed with econometric tools from which the international rankings of bankruptcy law efficiency are drawn (see Davydenko and Franks, 2005 or Djankov et al., 2006).

Thirdly, the World Bank method brings a certain degree of dissatisfaction because the selected indicators measure the procedural rules in force and not

how they are actually used in situations when companies find themselves in financial distress. For example, the duration of proceedings varies considerably according to the type of commencement of bankruptcy and the procedures adopted (see chart below). Immediate judicial liquidations take place within a period of 1.7 months after the case is brought to court, with half the immediate liquidations ordered in less than two weeks. Judicial liquidations following an observation period are ordered on average within 6.4 months and half of them last less than five months. Recovery packages take much longer to decide. In 2005, the time between bringing the case before the court and the adoption of a plan was 8 months when it led to winding up the company and 12.4 months when it resulted in continuing operations. Nevertheless, many recovery packages require far more time: 10% of continuation plans took more than 19 months to complete and 10% of sale plans necessitated more than 15 months. In the event that liquidation is ordered (immediately or after an observation period), the final closing decision takes place on average after three or four years. These time periods, which may be much longer, allow the liquidator to exercise the rights and actions relative to the debtor's estate, to divide up the proceeds of sales among the creditors, and update the accounts (see Milan and Poutet, 2006). None of the variations in relation to a standard time for processing cases (as fictional as it is reductive) is mentioned in the work of the World Bank.

Chart no. 2: Decisions of commercial courts regarding companies in financial distress

	2001	2002	2003	2004	2005	Evolution 2005/2004 (in %)
<b>Judicial liquidations</b>	<b>38,062</b>	<b>39,389</b>	<b>40,380</b>	<b>42,792</b>	<b>45,146</b>	<b>+5.5</b>
Type of liquidation						
Immediate judicial liquidation	28,204	29,441	30,355	32,192	33,971	+5.5
Average time (in months)	2.0	2.0	1.7	1.6	1.7	
Liquidation after an observation period	9,858	9,948	10,025	10,600	11,175	+5.4
Average time (in months)	6.9	6.9	6.6	6.4	6.4	
<b>Recovery packages</b>	<b>4,458</b>	<b>4,390</b>	<b>4,699</b>	<b>4,960</b>	<b>5,290</b>	<b>+6.7</b>
Type of recovery plan						
Continuation plan	3,573	3,424	3,676	4,024	4,448	+10.5
Average time (in months)	13.3	12.8	12.4	12.1	12.4	

months)						
Sale plan	885	966	1 023	936	842	-10.0
Average time (in months)	7.9	7.6	8.0	8.0	8.0	
<b>Decisions to close liquidations</b>	<b>42,742</b>	<b>40,360</b>	<b>39,842</b>	<b>44,059</b>	<b>41,710</b>	<b>-5.3</b>
Reason for closing						
Insufficient assets	41,979	39,614	39,047	43,096	40,511	-6.0
Average time (in months)	42.8	43.0	45.0	44.8	45.1	
Termination of liabilities	783	746	795	963	1,051	+9.1
Average time (in months)	52.1	57.6	59.4	60.3	61.3	

Source: SD SED – general civil repertory

Between the abrupt character of the sole yardstick of length proposed by “Doing business” and the nuances contributed by the statistical data of the Ministry of Justice, it should once again be emphasised that the first approach does not help shed light on the actual workings of justice which requires an examination of bankruptcy files and practices in addition to the legal framework (an example of the application of this method to bankruptcies is proposed by Hautcoeur and Levratto, 2006). We can therefore reproach these indicators, constructed on the basis of a standard reference, for providing a literal reading of the rules and playing an active role in forming the types of legal systems that will result from their use.

One may wonder then to what extent the three biases we have noted influence the assessment of bankruptcy laws and the recommendations regarding their evolution. Is there not a danger of overly determining the results?

## 2.2. Fragile categories

The information collected and processed by the World Bank, together with the macroeconomic databases and datasheets specific to bankruptcies, allow the upholders of *Law and Economics* to propose a twofold division in the modes of handling the legal proceedings resulting from cessation of payment. The first is part of a comparative perspective and applies at a given moment in time; it differentiates rules first of all according to the interests they protect and ends by identifying pro-creditor and pro-trade creditor rules (section 2.2.1.). The second division is orthogonal to the previous one; temporal and historical in nature, it finds the cause of the differences in the degree of bankruptcy legislation efficiency in the opposition between civil law and common law treatment

(section 2.2.2.). We are seeking to show here in what way these divisions are sensitive to the selected method and the analytic framework.

### 2.2.1. A pro-debtor vs. pro-creditors division without demonstrated strength.

In the literature devoted to bringing out an optimum form for handling cessation of payment, two main issues are debated: first, the balance sheet (assets or liabilities) that should be restructured and secondly, the consequences of breach of financial contract by the company director.

- Restructuring the debt or the assets of a company in financial distress.

In a context in which the stakeholders' support for a company project, whether sound or not, is presented as a key factor in success, the main arguments in favour of renegotiating its debts concern the need to associate all the creditors in the decision-making process (Gertner and Scharfstein, 1991). This same argument prevailed in the reform of the law on insolvent companies as demonstrated by the presence of a friendly settlement procedure it introduced for bankruptcies in 1985, known as the Badinter law,<sup>4</sup> which was confirmed by the law of 10 June 1994<sup>5</sup> and reformed by the company protection law which came into force on 1 January 2006,<sup>6</sup> which called for the intervention of a judge to keep certain creditors from anticipating renegotiation of the debt to dispense themselves from participating in it. This solution is widely preferred to the piecemeal disposal of assets, which is nevertheless favourable to creditors for the costs of liquidation are taken out of the revenue (Shleifer and Vishny, 1992). Yet, while the choice between these two avenues depends on the characteristics of the company and the investment decisions of its management,<sup>7</sup> it is also influenced by the legal context, the second point debated by the authors.

- The type of legal framework to adopt according to its repercussions on the various actors involved in the crisis (debtors, employees claimants, etc.).

Taking into consideration the effects of the law on the behaviour of debtors and creditors leads to the question of which type of rules will best ensure debt restructuring for economically viable companies with temporary financial

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<sup>4</sup> This law introduced a negotiation process within the framework of a friendly settlement procedure between creditors and debtors. It yielded mediocre results due to the delayed activation of the provision, the opportunistic behaviour of some company directors aimed at obtaining sacrifices on the part of the creditors to increase their profits and the "clandestine passenger" attitude of some creditors who refused to reduce their demands, counting on company recovery authorised by payment deferrals granted by others.

<sup>5</sup> This law, oriented towards continuing company activity, actually improved the situation of secured creditors, while seeking to encourage the start of a friendly settlement and increase the weight of creditors in negotiations.

<sup>6</sup> This law provides for three different procedures of friendly company management prior to actual cessation of payment: a specific mandate that does not require validation by a judge in which creditors take part voluntarily in possible waivers of debt, a conciliation procedure that allows confidential renegotiation of the debt with the creditors with approval of the agreement by a judge and a protection procedure that authorises the company head to ask to have its liabilities frozen in order to renegotiate the debt.

<sup>7</sup> In a case of financial distress, the manager may be tempted to reduce expenditures and investment or, on the contrary, to take more risks and over-invest. A strict bankruptcy law might pressure management to adopt the first approach, whereas a mild one should encourage taking more risks to try and save the business (see Eberhart and Senbet, 1993)

problems on one hand and the liquidation of inefficient companies on the other (see Blazy, 2000, p. 53 et. seq.). With a view to determining the characteristics of a law that would limit the behavioural deviation on the part of company management and the mistakes of judges, Aghion, Hart and Moore (1992) began to wonder about the beneficial effects of strict laws against managers who display imprudence or whose management is marked by incompetence. Their model reveals the disciplinary effect of systems in which company bankruptcy ends either in eviction of the company management or liquidation of the business, with the entire procedure under the supervision of a judge. In addition of its *ex ante* effect of encouraging prudence, this so-called pro-creditor rule (in the sense that it attributes to creditors rights over the management and capital of the company)<sup>8</sup> should make it possible to avoid inefficient restructurings. The British system is traditionally held to be in keeping with this logic insofar as the administrative receivership procedure initiated by a creditor holding a floating charge<sup>9</sup> then takes place under the supervision of a professional appointed by the initiator of the procedure with a view to being paid off (Pochet, 2001). The introduction of reforms in 1986, which was supposed to turn company rescue into “a genuine institution” (Armstrong and Cerfontaine, 2000, p. 563) did not alter the desire for vengeance and exclusion that characterises the Insolvency Act of 1986 (Ibid, p. 564). The same holds for the Canadian law governing companies in financial distress.

These pro-creditors systems are not exempt, however, from harmful effects ranging from premature liquidation to liquidation of efficient companies, in cases grouped together by White (1994) under the name Type II error.<sup>10</sup> Several works show that they could be avoided by introducing a greater degree of clemency into the formal procedures to encourage company management to behave in such a way as to optimise their investment plans and financing structures. This is the case of the Berkovitch, Israel and Zender model (1994), which shows that as the human capital specific to the business that is accumulated by the company manager determines the value of the company, it may be untimely and costly to replace the team in place if the poor results obtained are caused by the current economic situation. Similarly, the sanctions associated with a bankruptcy caused by what would be interpreted as excess investment might lead to excessive caution on the part of the manager, under-investment harmful to company performance, and consequently to an increased

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<sup>8</sup> The model foresees the problems of company valuation raised by this procedure and solves them through the Bebchuk procedure (1988) which, by organising a system of attribution of property rights by successive, orderly share buyout by creditors guarantees a transfer of control under good conditions. Obviously, this manner of proceeding is quite difficult to put into practice.

<sup>9</sup> The term “floating charge” designates a special pledge of the whole estate of the debtor business. The value of the estate may change over time (e.g. the inventory) and the company may freely dispose of this property with the consent of the protected creditor until the moment when the claim “crystallises”. This “crystallisation” may take place, for example, when an administrative receiver is appointed, at the time of company liquidation, or in the cases provided for in the contract that created the claim.

<sup>10</sup> It is distinct from a Type 1 error which consists in reorganising the debt or the assets of an inefficient company.

risk of bankruptcy. Most of the authors (Bowers, 2000, Davydenko and Franks, 2005, Pochet, 2001 and Recasens, 2003) consider that American law, marked by the determination to preserve the company, the most visible manifestation of which is the famous Chapter 11,<sup>11</sup> is typical of a pro-debtor system. In France, the company rescue law adopted on 26 July 2005<sup>12</sup> also seeks to protect the business, and through it, the debtor. The negative effects of these rules have often been underscored in the case of the United States, where air freight, energy and automotive industry companies in particular are put under the protection offered by Chapter 11 and thus escape from many creditors, including the bodies that dispense employee social protection and old age pensions.

Several works attempt to bring out the superiority of one model over the other without succeeding in establishing a stable hierarchy between the various systems of *prise en charge* by the law de cessation of payment. The theoretical models (Alary and Gollier, 2004, Chopard and Langlais, 2006 and Recasens, 2001) seek to identify the prerequisites for avoiding the occurrence of strategy failures on the part of company managers or of Type I and II errors. With a scope often reduced by the restrictive assumptions on which they are based and by the problems they encounter in trying to grasp the strategies of the various categories of actors involved, these models result at best in a typology of bankruptcy systems (Blazy et Chopard, 2006). The empirical research seeking to pinpoint the most efficient bankruptcy system has also been impeded by heavy reliance on assumptions and the sensitivity of the results to the selected criteria and the fragility of the established hierarchies (Davydenko and Franks, 2005, Djankov et al., 2006). The main conclusion of these studies is the usually poor performance of the various types of laws governing companies in financial distress. But this overall conclusion is nuanced by taking into consideration the type of country in which the rules are applied: “In the rich countries, the most efficient procedure is reorganisation. In the lower middle income countries,

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<sup>11</sup> Chapter 11 procedure may be compared to the French receivership system. In most cases, the company itself decides to file for bankruptcy. This procedure results in suspending any collection effort on the part of unpaid creditors (this is the Automatic Stay which corresponds in France to temporary suspension of individual proceedings). Failure to comply with the suspension of proceedings (e.g. lawsuits as well as letters and telephone calls to the debtor) may incur the payment of damages on the part of the creditor. The period of protection offered to the debtor is used to negotiate and draw up a restructuring plan that must be approved by the majority of creditors and the judge

<sup>12</sup> It provides for, in particular:

- the substitution of the conciliation procedure for the friendly settlement procedure. In cases of financial distress, it will allow entrepreneurs to engage in friendly renegotiation of their debt with the main creditors as confidentially as possible without suspending the proceedings. The firm must give evidence of its legal, economic or financial problem, either actual or foreseeable, without being in a state of cessation of payment. The agreement may be approved by the commercial court. The company manager retains control of its management.
- the creation of a rehabilitation procedure. This is a system of negotiation enabling the suspension of proceedings prior to cessation of payment. The aim is to arrive at a rescue plan negotiated with the creditors and approved by a qualified majority. This is a prevention procedure and not a recovery procedure. The company manager remains in charge of the company; he is merely assisted by an administrator for the negotiations. He may set up two committees: one bringing together banking institutions and other suppliers and the other, suppliers. The company manager presents them with a draft of the plan and must obtain a majority vote in favour of it (2/3 of the votes and 1/2 of voters). The court takes official note of the agreement.
- a period of 45 days, instead of the former 15-day period, as of the cessation of payment, to request the commencement of a recovery or judicial liquidation procedure.
- the recovery or judicial liquidation procedure may henceforth be commenced after the cessation of professional activity if it is the source of all or part of the debts.

attempts to rehabilitate the firm almost always fail, so the best procedure is foreclosure.” (Djankov et al, 2006, p. 5). It is also tempered by the study of the rights acquired by creditors (Franks and Sussman, 2005). In the end, the preceding authors unanimously acknowledge that the threat of eviction looming over management is far from the sole factor explaining efficient bankruptcy law; other factors also play an important role, such as how the business is authorised to continue its operations, and even more, the attraction exerted by the commencement of legal proceedings from the viewpoint of direct out-of-court renegotiation, and, another essential characteristic point of *Law and Economics*, the legal origin of the rules.

### 2.2.2. Legal origins contradicted by the convergence and mixing of legal systems

In the area of bankruptcy, the opposition between the flexibility of common law and the formalism of civil law leads to the conclusion the former is more efficient than the latter. The international comparisons carried out insist on the inefficiency of the French system which limits the rights of creditors and dilutes the value of collateral, including the sizeable personal collateral required by banks, without resulting in a satisfactory rate of recovery. The German and English legal systems, which give greater control and decision-making power to creditors while limiting formalism, guarantee higher recovery rates. However, these three countries demonstrate perceptibly equivalent performance when one observes private, out-of-court renegotiation procedures between debtors and creditors (Davydenko and Franks, 2005, p. 23-24). The factors that explain these variations usually concern the legal origin of the rules, which would explain the shareholder structure of the companies, the efficiency of the financial markets, the financial fragility of the systems, macroeconomic growth and the recovery rate of company liquidations (Beck, Demirgüç-Kunt and Levine, 2002)

We will limit ourselves here to recalling the main characteristics attributed to the two types of systems. Civil law designates the set of fundamental rules of private law – the general principles of law, the rules concerning the status of persons and of the family, the system of property and the theory of obligations – which constitute the general law. It is often defined as a law originating in Roman law, but this definition reveals only part of its essence, for although most civil law countries include rules that can be traced back to their origins in Roman law, they usually also have rules that come from canon or customary law. Common law is more recent; it was gradually developed by the royal courts that sought to create a uniform law in opposite to local customs, based on a general – and fictional – custom applicable throughout the kingdom. The work of judges, it is therefore law that finds its source in court activity,<sup>13</sup> which often

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<sup>13</sup> The rules drawn up by the courts do not necessarily constitute Common Law rules in the strict sense, because only the rules accepted and applied by the Royal Courts of Westminster establish Common Law. In the 15<sup>th</sup> century, however, the Court of Chancery enriched English law with rules of *equity*. Dual jurisdiction was abolished in England by the Judicature Acts of



leads to assimilating it with unwritten law, based on jurisprudence case law, as opposed to rules flowing from legislative sources. Nevertheless, its method and inductive reasoning which consists in generalising from precedents by observing the analogies between them are above all what distinguish common law from civil law, which, as more rational, is characterised by its deductive method and its will to generalise.

Denounced in its principle, the opposition between bankruptcy law that is rigid because it comes from civil law and an adaptable law arising from its customary nature is no more relevant to making international comparisons in the area of debt renegotiation and company liquidation. The most relevant criticisms are expressed by Siems (2006) and Lele and Siems (2006) who deconstruct the groupings created by supporters of the *Law and Finance* approach and conclude that the character of the legal sub-sets they constitute is totally artificial. First, because only temporal arguments are used to justify considering two countries as coming under the same legal tradition (e.g. Austria and Switzerland are viewed together because their civil codes were constructed simultaneously). Secondly, because the identified legal families<sup>14</sup> are based on a priori ideas and incomplete cultural constructs since they eliminate, among other things, any reference to an Islamic legal tradition. This decentring of the perspective leads to aggregating the countries of Eastern Europe, Asia and Africa, strongly marked by arbitrariness (see Siems, 2006, pp. 9 and 10 for examples of debatable groupings). The failure to take equally important factors into consideration regarding legal origins also weakens the typology and conclusions of LLSV. Among these criteria, we find the forms of colonisation and their impact on the laws in force in the colonies, the language in which the laws are written and the degree of independence of the magistrates which, when taken into account, results in forming other sub-sets accompanied by statistical tests that are as significant as those exhibited by LLSV (ibid, p. 22).

The introduction of the historical dynamic undertaken by these authors opens the way to recognising the process of convergence of national legal systems, which, although strengthened by the development of international trade in the contemporary period, dates back to 18<sup>th</sup> century. But it was in the 19<sup>th</sup> century that the greatest awareness of the need for harmonisation of commercial law in general and bankruptcy law in particular developed. Locré (1827-1832) was especially clear on the subject during the debates on Book III of the Commercial Code and the will to harmonise it with other European legal systems, notably English law, among the legal experts who drafted it. Even if significant differences remain (Colfavru, 1863, p. vi and Santella, 2002) and the will to harmonise did not always result in a process of effective convergence, one will

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1873-1875 when the new High Court of Justice was created. While all courts can apply both the rules of Common law and of equity, equitable remedies (e.g. the right of injunction) are still opposed to Common law remedies (e.g. the right to damages) today. In the event of a conflict, the rules of equity prevail.

<sup>14</sup> Djankov, McLiesh, and Shleifer (2005) distinguish the countries of English, German, Nordic and socialist legal origin.

note with Sgard (2005) that, in some respects, it is impossible to differentiate the various national laws. This legal mixing has taken different forms depending on the country and ranges from a fully bi-legal system as is the case of Canadian law on bankruptcy and insolvency<sup>15</sup> to borrowing rules such as the introduction of a form of friendly agreement inspired by the American Chapter 11 in the French reform of collective procedures. This concern about harmonisation is especially strong at the European level where, despite the uncertainties generated by the recent bankruptcy procedure regulation of 20 May 2000 which came into force on 31 May 2002, one must acknowledge that the effort conveyed by this law to bring concepts and procedures closer together has already produced tangible effects.<sup>16</sup>

All in all, whether the result is a mixing stemming from political will, the action of history or commercial necessity, the various national bankruptcy laws present significant similarities and, for that reason, cannot be classified solely on the basis of their origin. This weakens the typology and hierarchy established by LLSV. What can be substituted for this positive approach to law?

### **3. Bankruptcy law, a capitalist institution: a reinterpretation of reforms of the law governing companies in financial distress**

A distinction is generally made between the handling of cessation of payment proposed by civil law inherited from the strict Commercial Code which seeks to exclude debtors from economic, political and even social life by keeping them in disgrace and the process authorised by customary law which is flexible and therefore favourable to an entrepreneurial spirit. In place of this distinction, we propose a division based on the nature of the assets at stake in the contract between debtors and creditors and the underlying vision of the firm. This change of viewpoint is legitimated by the transition that took place in the second half of the 19<sup>th</sup> century between a moral, individual and social conception and a commercial, capitalist vision of bankruptcy. The optimum sharing of the debtor company's assets and the inquisitorial procedure used to carry out this total dismemberment was substituted by a search for means to reinsert bankrupt company owners and the assets they managed into the life of the economy. These measures were first found in the practice of law, and were later given renewed codification with the law governing bankruptcy of 23 May 1838 aimed at encouraging the survival of efficient businesses, particularly through the introduction of a court-approved arrangement with creditors and above all, the law of 4 March 1889 which instituted judicial liquidation. Instead of a punitive

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<sup>15</sup> On this subject, one may consult the special 2003 issue of the *Revue Juridique Thémis* devoted to the harmonisation of bankruptcy law with Quebec civil law.

<sup>16</sup> To prevent the initiation of a different insolvency procedure in each Member State of the European Union where a company in a group is represented, the EU regulation of 29 May 2000 introduced a single procedure for recovery or judicial liquidation effective in all Member States. The legislation of the Member State in which the company has its main interests is to be applied, even if the company's head office is not located in that country. The "Isa Daisytek" decree of the Versailles Court of Appeals, dated 4 September 2003, applied the provisions of this Regulation in France for the first time.

law resulting in dismembering the failing company's assets, a moral and economic sanction was introduced, on which the smooth running of society as a whole depended, through successive reforms designed to substitute laws more favourable to the continuation of company activity. This appears quite early in the decisions of the commercial courts, notably that of the Seine department, which frequently ruled in favour of excusing the bankrupt trader and keeping him at the head of the company starting in the 1840s. These decisions reflected a desire to keep the company in the market rather than exclude it. Indeed, they can be interpreted as a means to correct earlier market failures such as granting excessive or untimely loans, which could be traced to rationing problems, planning mistakes arising from poor information or outside shock effects causing the insufficient liquidity or even insolvency of some companies.

Two sets of elements coming under the scope of the law governing companies in financial distress and the change of status of the parties support the thesis of a bankruptcy law more concerned about the recovery of entrepreneurs than their exclusion from business life. The first is the establishment of a line of demarcation between situations of insufficient liquidity and those of insolvency (section 3.1.); the second is the arbitration between the respective rights and interests of the creditors and the debtors (section 3.2.).

### 3.1. A law for traders applied by traders

Systematically decried by legal experts, debtors, bankers and chambers of commerce, as attested by the criticisms levelled against Book III of the Commercial Code upon its promulgation, bankruptcy law, originally reserved for traders, nevertheless exercised such a strong attraction for other categories of the population that its scope was widened to include individuals. Beginning in the 19<sup>th</sup> century, commercial law manuals insisted on the specification of the definition and identification of the rights and duties with which “those who exercise commercial acts and make them their usual profession” had to comply (Commercial Code, Book I; Title 1). Among them, we are particularly interested in the determination of who would benefit from trader status, and hence from bankruptcy law and the operation of the commercial courts where disputes between debtors and creditors were settled.

#### 3.1.1. Who is a trader?

The term “trader” was introduced by the commercial code of 1807. Formerly, one spoke of merchants, wholesalers, bankers and artisans. At the end of the Ancien Régime, commercial courts had jurisdiction *ratione personae* to handle disputes between traders, but the law did not define this term and mere membership in a guild was not considered proof of status. The nobles, who were prohibited from engaging in commerce on pain of exclusion, skirted this rule by becoming sleeping partners, and some of them thus interfered in company

management without trader status.<sup>17</sup> With the introduction of the Civil Code, the scope of trader status constantly expanded, conveying the will of participants in the business world to benefit from the treatment provided for by the Commercial Code, particularly as regards bankruptcy. The widening scope of the law led some authors (Marco, 1992 and Di Martino, 2005), by the way, to see this as the explanation for the steady rise in the number of bankruptcies during the 19<sup>th</sup> century.

The question that arises is what led debtors to prefer the application of bankruptcy laws to bankruptcy offence (*banqueroute*). Was it due to the greater ability to begin new trading activity authorised by the former, which, ever since the “decodification” of 1838, showed itself increasingly favourable to the survival of companies and maintaining entrepreneurs in the economic world? This interpretation is supported by the introduction of the contract by waiver of assets introduced by the law of 17 July 1856, which released the bankrupt owner from administration of his estate, allowed him to return to commercial life after an arrangement with his creditors and halted his exposure to legal action by creditors. In contrast, the system of bankruptcy offence still favourable to traders would gradually become obsolete. Indeed, negligent bankruptcies could no longer benefit from liquidation and a fraudulent bankruptcies could no longer hope for an arrangement with creditors, or to be excused or rehabilitated (Guyot and Raffalovitch, 1901, “*Faillite*” article). With regard to non-trading cessations of payment, failure in no way protected the business: a collective procedure was not applied, especially as no organised party requested it whereas it would have been highly advantageous, and the fear of expropriating peasants led to removing them permanently from the scope of bankruptcy law. In the face of these disadvantages, a few courts sought to avoid them by creating the name of “civil receivership” for procedures that resembled bankruptcies (ibid, “*Déconfiture*” article).

The advantages that traders obtained from a law made for them and applied by them explain in large part the abundance of case law relative to section 1 of article 437 devoted to the definition of trader status at the beginning of Book III “bankruptcies and bankruptcy offences”. Some 101 commentaries were noted by Dalloz and Vergé (1877, pp. 547-549); the same task of listing examples of the doctrine in this area was carried out by Tripier (1902, pp. 640-641), thus demonstrating the intensity of the debates over the interpretation of trader status and the possibility of acquiring it. The evolution of bankruptcy law observed in France testifies to the unification of commercial and civil law which admitted bankruptcy of corporations under non-trading private law (non-commercial partnerships, associations, trade unions, cooperatives), authorised receivership

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<sup>17</sup> In 18<sup>th</sup> century France, the Third Estate contested the immunity to personal bankruptcy enjoyed by the nobles and the clergy, which spared them imprisonment for debt. In 1789, traders and financiers demanded tighter rules, which was granted for a while by the Commercial Code of 1808, in a society that had become bourgeois and individualist, where the estates had been abolished (Hilaire, 1986).

for artisans in 1985 and for farmers in 1988 and allowed the liquidation of companies to be extended to their managers who were still did not have legal trader status. The same phenomenon of unification occurred in other countries in Europe, albeit at very different periods: in England, the Insolvency Act (1986) applied to all debtors, in Germany, the procedure ensuring equal rights to payment on execution among unsecured creditors (1877) was also applied to all insolvent debtors (which explains why this particular system was maintained in the three recovered departments of Alsace-Lorraine), as well as in the Netherlands (see Sgard, 2005).

The bankruptcy system and the protection it offers were therefore valued by debtors who, owing to the compulsory "class", did not run the risk of finding themselves confronted by isolated creditors seeking to commence proceedings first, for fear of being overtaken by the others.

### 3.1.2. Commercial judges with essential attributions

Commercial courts, which are special courts within the judiciary system, are systematically criticised for their mode of operation. Since they were first instituted, their prerogatives in bankruptcy proceedings have nevertheless been confirmed. As the arbiters who determine the moment when a firm leaves the world of the commercial economy dominated by contracts and private property to enter that of litigation which organises the legal expropriation of the owners, judges are thus key components of bankruptcy as a capitalist institution.

As bankruptcy is in no way a natural state, the question of defining the date on which the cessation of payment occurred arose very early for the courts and the authors of manuals and user guides for practitioners. In volume 1 of the "*Dictionnaire des faillites*", Mascret listed the various conceptions of the state of cessation of payment and recalled the point of view of P-S. Boulier Paty expressed in the book "*Des faillites et banqueroutes*", in which he maintained "it is less a question ... of the trader being solvent or insolvent, than of knowing if, in fact, he pays or does not pay: whatever his assets, even if they are superior to his liabilities, if he stops paying, he is in a state of bankruptcy. On the contrary, if, through sustained credit, he constantly honours his commitments, even if he owes more than he possesses, he is not bankrupt" (Mascret, 1863, p. XXIII). The analytical commentary on the law of 8 June 1838 written by F. Lainné in 1839 seems to have dissociated the accounting situation of the business from bankruptcy, as the author considered that "...it is up to the judges to decide, in view of the circumstances, if the suspension of payments is equivalent to a real cessation ..." (Lainné, 1839).

Beyond the control they exercise over the methods of applying the law, commercial judges thus 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.

This provision appeared early on, for while the outdated legislation provided within a civil framework mainly for enforcement procedures that could vary according to local suzerainties, Title IX of the commercial order of 1673 stipulated that “Bankruptcy or bankruptcy offences will be considered to commence on the day that the debtor withdraws or that the official seal is placed on his property” (Bravard-Veyrières, 1840, p. 617). This “...will of the royal legislator to bring legal clarity to the commencement of the procedure” (Desurvire, 1992, p. 39) enshrined the absence of any absolute criterion used to define bankruptcy and consequently, the importance of the judgement exercised by the courts. Commercial law manuals are clear on this point: the mission of the courts is to declare cessation of payment, they are also sovereign in their assessment of the circumstances and the facts related to cessation of payment, which leads them in particular to fix the date of cessation of payment (Colfavru, 1863, p. 433). This provision is essential, for the date of commencement of bankruptcy makes it possible to fix the “suspect 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.

The key role played by the judges in the bankruptcy decision definitively distances this procedure from the image of a struggle of the weak (the debtors) against the strong (the creditors) with which the law of the market is often associated. Nevertheless, a breach of contract by the entrepreneur nevertheless does not put him out of play. On the contrary, he leaves one instituted system – the monetised market, regulated by the discipline of contracts and property rights – to enter into a judicial mechanism of governance and distribution of income. Like any transitional phase, this passage carries with it certain risks and the actors should be protected from them. Filing for bankruptcy, which the entrepreneur is asked to do to signify his honesty and spirit of cooperation<sup>18</sup> to his creditors, flows from the same logic. This applies as well to the creditors who, from the start of the procedure, are prohibited from access to individual instruments for protecting their contractual rights which were available to them when the company was still in the market: seizure of assets, complaints to the prosecuting authority, etc. (see Jackson, 1986). The acknowledgement of the failure of the business owners and the organisation of the sharing of the assets under the control of the courts removes the multiple contractual ties binding the firm to the commercial framework and places it in the world of sharing debts among the various creditors, asset takeover by investors and a fresh start which, at the outcome of a procedure completely foreign to individualist, contractual logic, authorises its return to the market (on this topic, see also Ayotte, 2007).

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<sup>18</sup> Filing for bankruptcy marks the entry into the procedural order: the bankruptcy is made public and all management actions are subject to restrictions and close supervision – buying, paying, hiring, investing and repaying. From a formal standpoint, it is no longer the same agent. But the judges’ capacity to set the date of the beginning of cessation of payment also confers upon decisions prior to the formal commencement of the procedure an eminently suspect character: they can be cancelled retrospectively, by the way.

### 3.2. From protection of the rights of creditors to that of the business: a capitalist evolution

Historically, the repayment of debt was considered 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 initial bankruptcy procedures merged the civic and economic dimensions of society. While the use of the rules in the 19<sup>th</sup> century conveyed a preoccupation with reinsertion manifested by the trader-judges, the crises of the 20<sup>th</sup> century were to give the rehabilitation of the bankrupt trader and the protection of the business a more systematic character. 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 (3.2.1) and secondly, the replacement of exclusion by protection (3.2.2).

#### 3.2.1. The redistribution of assets: between hierarchy and collective procedure

Dividing up 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. 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 (State, employees, secured suppliers) are repaid in 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 masse 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 payment 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.).

The recent modifications introduced in French law reveal the will of creditors to be given a priority rank that will allow them to anticipate a higher dividend 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 super privilege of employees,
2. the privilege of court fees prior to the decision to commence the collective procedure,
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, 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<sup>19</sup> and provides that only those creditors whose claims are “useful” to the collective procedure shall benefit from favourable treatment. This modification corresponds to a new privilege in favour of later creditors, consisting of payment priority for later claimed 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 a second collective procedure is subsequently initiated, whether it **is** a procedure of receivership or of judicial liquidation. This means that the “useful” later claims of the first procedure will retain their payment priority over the earlier claims of the second.

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<sup>19</sup> 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” claim 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.



They will, however, be ranked after the new “useful” later claims of the second collective procedure.

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 procedure is oriented to the market, 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?

### 3.2.2. Company protection or liquidation of assets?

The fate of the company is one of the major concerns of the various 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 bankruptcy judge, the court-appointed administrator and the creditors who, from the 19<sup>th</sup> 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 assemblies 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 dividends paid 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:

- les 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 court-appointed administrator often finds it advantageous to keep the procedure 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 companies in bankruptcy (Noël, 2003). Often deviating from the legislation condemning most bankrupt owners, victims of events beyond their control, the actors in the procedure (magistrates, agents, court-appointed administrators, 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 procedure 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 19<sup>th</sup> 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.<sup>20</sup> 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 result 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 failures 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.<sup>21</sup> 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

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<sup>20</sup> These trends were also perceptible abroad. Starting in the 19<sup>th</sup> century, bankruptcy law in the United States gradually detached itself from English legislation. Throughout the century, economic crises encouraged the adoption of laws favourable to debtors, which allowed the sale of residual property to creditors and sometimes recognised 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 friendly 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.

<sup>21</sup> 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 it engendered (see Michel, 1900, p. 985 or Balzac, 1948, pp. 147-150).

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.

## **Conclusion**

As a symptomatic treatment of market failure, bankruptcy law is still subject to criticism, despite an increasingly pronounced will to protect businesses in every country, in the name of economic imperatives and efficiency. Forgetting the fact that "beyond its economic objective, aside from the repayment of creditors, the essential function of a law on collective procedures is to soothe minds and channel individualism" (Soinne, 1995, p.23), supporters of an approach gauged in terms of efficiency recommend introducing a system of managing bankruptcy solely for economic purposes. Conceived as an extension of company law and a necessary counterpart to contract law, LLSV maintains that the function of bankruptcy law should be reduced to setting up efficient means to ensure the redistribution of assets from an estate perspective. In our view, this form of pragmatism appears untenable at two levels:

- First, at the empirical level which refers to our deconstruction of the indicators used in "Doing business" and of the categories on which they are based. The distributive imperative that underlies them and the minimisation of the time spent outside the market – a situation considered abnormal and useless by LLSV – can be explained by assimilating the company exclusively to an economic entity that should be sent bank into the market if it is viable or, if it is not, eliminated as soon as possible. In both cases, a profitable allocation of productive financial resources must result. This conception of protection in the name of particular economic interests has the defect of relegating the social questions and the conception of an enterprise as a mode of organisation bringing several groups of actors into play. It also leaves aside the debates raised by the question of the status and role of bankruptcy law in history and the status of a public concern acquired by bankruptcy over time. The laws and practices in force in the 19<sup>th</sup> century in France are especially revealing as regards this mutation of an outdated law mainly concerned with preserving morality and the interests of creditors – who also often held power in civil society – into a law that integrates the rights of the various parties and leaves the

possibility of handling all the economic consequences of insolvency and settling market failure in a non-market sphere. It was at then that the separation between the entrepreneur and the citizen or, more systematically, between the economic realm and the civil sphere became definitive, and bankruptcy law was to become an instrument acquired by politics to correct the harmful effects of an unfavourable economic environment.

- Next, at the theoretical level, since we have replaced the search for economic efficiency of bankruptcy law by a conception of bankruptcy as a capitalist institution. Within the scope of this work, we have been able to show that bankruptcy does not correspond to any “natural” situation but rather that its occurrence depends exclusively on the existence of the laws that define and treat it. Thus, just as Weber considered that divorce does not exist without a law by the same name, we have suggested here that there cannot be bankruptcy – sanction of a trader’s failure to honour his commitments – if there is no legal system to qualify a situation of insolvency as bankruptcy. This conception has allowed us to develop the thesis of a bankruptcy law that would have neither a vocation to moralise society nor an exclusive mission to allocate assets efficiently. Beyond these two objectives, bankruptcy law would determine who makes up a company, the performance criteria to attain and consequently, the mode of governance of firms. In this regard, the question of the rights of stakeholders other than the creditors and the managers/owners, especially the employees, in the course of the procedure deserves to be explicitly raised, in addition to their right to be paid the wages they are due.

In the end, the laws governing companies in financial distress must respond to more than the opposing interests of categories that are held to play essential roles because they make resources available (creditors) or enhance their value (debtors) or to an exclusively economic logic. It must respond to the question of how the legal institution can solve failures in the market. In our view, that is the meaning of the successive phases of the procedure: i) the insolvent trader is prohibited from exercising or placed under guardianship, ii) the creditors are brought together in a general assembly or joined together in such a way as to give a collective character to cessation of payment and replace individual arbitrations by a collective mode of resolution of the problem and iii) the owners and creditors are released from their previous commitments, which allows them to engage once again in a new activity. This three-stage sequencing enables a continuity between cessation of payment and the disengagement of the parties involved. Thus, far from being solely a selection method that purges the market of its failing agents, bankruptcy law opens up a space for resolving market

failures in a non-commercial way, which authorises the actors to return to the world of business by freeing them from their previous constraints.

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