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# The evolution of concepts and procedures concerning the treatment of companies in difficulty

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***Abstract:*** *A healthy market economy is characterized by free and rapid circulation of goods and money in a circuit that continuously repeats: production-goods-money-production. In this cycle, the commerce is the motor of market economy, but the commerce freedom has given rise to competition, and this has generated commercial risk. Thus, commerce appears as an economic activity involving more or less predictable risk. Under risk an economic activity may be bankrupt when it no longer ensures procurement of necessary funds to resume the initial cycle. In general, a business failure comes after a process of continuous degradation of its economic and financial status, process predictable based on anticipated failure symptoms. Whereas in the past 20 years the issue of bankruptcy was the area of interest to many researchers and practitioners and has been addressed legally, economically and financially, we wonder why in an economy where the operators' inability of payment is chronic, and clearly the capital of the companies decreases, their managers and clients prosper and nobody is punished for fraudulent bankruptcy.*

***Keywords****: market economy, bankruptcy, predictable risk.*

***JEL Classification:*** *D20, D57, D62*

## Introduction

In the economic context of current competitive market and from the European integration perspective, even large companies may have problems. Because of their administrators or directors who are unable to cope with difficult problems by taking effective and timely measures, companies cannot keep the position they have in their fields and end up lacking liquidity, recording declining profits or excessive debt. Unless recovering quickly, even viable companies lose the market moment and especially the possibilities of generating liquidity and creditors, bondholders, investors, executives and employees are forced to seek solutions to recover various duties towards society.

Unfortunately, the facts show us how many companies are insolvent. Statistics of the Romanian companies that manage to successfully emerge from insolvency is only 2%, 98% of companies going bankrupt.

In terms of finance and accounting, liquidation forbids starting any economic activity since the decision of dissolution of the entity. In order to liquidate the company it will be used and will be determined the values of liquidation or forced sale, namely: the amount that can be charged reasonably from the sale of a property in a period of time too short to be consistent with the time specified in the definition of market value. The

liquidation value shall be calculated based on the sale of individual assets as quickly as possible, taking into account the costs associated with liquidation (commissions, fees, administrative costs, legal fees and taxes etc.).

**Practices encountered in the pre-modern period**

The regulation of collective procedures has known a long historical evolution, driven by trying to adapt the right to the economic and social realities of different eras. Over time, the legislature followed through regulation different purposes. Thus, in a first stage, it was intended to punish trader who did not honoured its commitments, later the main purpose was to protect creditors unpaid, for in times more recent the legislature to be concerned mainly to secure the survival of businesses that have the resources to recover themselves (Guyon, 2003). The ultimate purpose was envisaged also by the Romanian legislature, even if not exclusively, in the current regulation of the insolvency procedure. Unlike other legislations (Guyon, 2003) in which the economic and social considerations prevail over legal factors so as the main goal of the legislation being to save the company, seeking future viable solutions to the expense of liabilities payment in our current legislation has been trying to satisfy both interests of creditors and the debtor's so as to carry liability coverage, when possible, through the reorganization of the debtor's activity.

Collective procedures are not an innovation of modern legislation, but they, better said bankruptcy, have been known since antiquity. Legal regulation regarding collective procedures presents itself today as a result of a continuous process of evolution, beginning with the old ROMAN law, a process which is nothing but an adaptation of the law to the time reality. Thus, the old Roman law consecrated the first regulation of the legal situation of the debtor which later led to the legal institution of bankruptcy. Incidentally, the term "failure" has a Latin etymology, from the verb *"fallo-fallare"* which means to miss, being wrong and deceiving.

But the origin of the modern institution of bankruptcy can be found in the Italian cities statutes from the late 15$^{th}$-century, especially in the Statute of Geneva in 1498 and those of Florence, Milan and Venice. These proceedings were of a criminal nature and were limited to traders. In the conception of that era, who failed to meet its commitments was deemed to be a criminal *(faillitus, ergo fraudator)* and could go to prison (Guyon, 2003) or subject to dishonourable measures. One of these degrading ceremonies consisted in destroying the counter in public, meaning the bank on which goods were exposed ("*banca rotta"*). Incidentally, this expression in Italian, *"banca rotta"* stands both for the Anglo-Saxon origin of the term for failure – "bankruptcy" and for the notion of insolvency.

A first legislative regulation of the institution of bankruptcy was made in 1673 Ordinance promulgated by Louis XIV regarding the land trade, but which included provisions on „Failure and bankruptcy". The Ordinance specifically regulated conditions for opening the procedure, its progress under the administration of a syndic or director chosen among the creditors, cases of annulment of acts concluded prior to the onset of the procedure as well as penalties applicable to the debtor, some of which of corporeal nature.

Also in the English law of that age the emphasis was placed on the repressive nature of bankruptcy proceedings. Thus, by regulating this matter carried out in 1543, applicable only to traders, was provided confiscation of the debtor's goods and its imprisonment, if creditors could not be satisfied with the goods seized.

**Regulations of the modern age**

In modern age, the French Commercial Code in 1807 made the first comprehensive and systematic codification of bankruptcy. Legal provisions were rigorous and of great severity, under the influence of Napoleon, dissatisfied with the outrageous behaviour of some army suppliers (Guyon, 2003). Thus, bankrupt lost the right to manage his assets, was incarcerated in debtors' prison or detained at his home during the procedure and the rights of bankrupt's wife were also eliminated. All bankrupt's goods were seized, this losing the right to administer or to take advantage of them. Bankrupt also suffered numerous professional and civil decays, and composition and rehabilitation were difficult to obtain. The regulations of bankruptcy contained in the French Commercial Code of 1807 were taken over by the Romanian Commercial Code of 1887.

This conception on bankruptcy pays particular attention to the protection of creditors in order to recover their claims and punish the debtor bankrupt, on which procedure causes a number of effects on non-patrimonial character – prohibitions and decays– destined to exclude him from trading. Nevertheless it has been considered that this legal regime of bankruptcy was excessively severe and leaded to disastrous results, affecting inevitably the possibility to satisfy debtors. Inconveniences were aggravated by the fact that syndics were not professionals, their jurisdiction being insufficient and their honesty often doubtful. Therefore, traders most often avoided bankruptcy with the intervention of the Court of first instance, by holding an amiable liquidation, in agreement with their creditors (Guyon, 2003).

As a reaction against the rigor of the French Commercial Code, the 19$^{th}$-century marked a period of indulgence. Thus, penalties applicable to traders became less severe and body constraint on trade matters and debtors imprisonment were suppressed, in a general manner. Law of 4 March 1889 introduced in France, along with bankruptcy, a new procedure, the judicial liquidation, reserved for good faith debtors. However, difficulties arose due to World War I, the 1929 crisis and the weakening of the commercial morality have made visible inconveniences of some less severe solutions. Subsequent normative texts are thus marked by greater severity and concern for an increased efficiency in the matter.

In the second half of the 20$^{th}$-century, the legal regime applicable to traders in difficulty has been significantly changed. Thus, in the context of economic development, it was admitted that difficulties faced by traders in their activity are not always attributable to them; they do not necessarily represent the consequence of poor business administration. Also, the economic crisis and job crisis have resulted in a change of perspective: the disappearance of the company in difficulty does not affect only the unpaid creditors. It was understood that prevention of difficulties should be emphasized and, especially, that the company must be saved, that viable economic activity and jobs must be kept. This change in orientation has led to a distinction between the proceeding leading to the liquidation of assets and that of legal reorganization, which is characterized by the continuation of the activity. Moreover, most contemporary legislations govern procedures which combine

tracking difficulties with a phase of treatment, leading to recover healthy businesses and to liquidate of unprofitable ones.

**Regulations of the procedure in Romania**

Also in Romania were recorded over time changes in the treatment of traders in difficulty. Thereby, in the old Romanian law, mainly by customary nature, non-payment of debts led not only to the execution on goods but also on the individual debtor who may lose their freedom. The debtor who did not pay his debt may become the property of the creditor, along with land they worked or with the whole family (Ceterchi, 1980).Also, the first Romanian written laws, pravilele, regulated "varta", namely debtors' prison intended as a coercive measure to pay debts. Only in the 19th-century we can speak in Romania of regulations with very well coagulated rules in bankruptcy. Thus, the 1817 Caragea Code included a chapter entitled "For borrowing and debt" and the 1817 Calimach Code included a chapter for "the order of creditors' contest" in which the bankruptcy proceedings were called "treatment of creditors' contest". These codes have been inspired by the provisions of the French Civil Code of 1804 and the Austrian Civil Code of 1811.

The first complete Romanian regulation on bankruptcy is considered the one contained in the 1840 Commerce Register of the Romanian Country, which was a translation of the French Commercial Code provisions regarding bankruptcy. The provisions on bankruptcy were contained in the Second Book of this Register. Since 1964, the Commerce Register was applied also in Moldavia. Being inspired by the Italian Commercial Code of 1882 which in turn took the conception from the French Commercial Code of 1807 on bankruptcy, the Romanian Commercial Code of 1887 enrolled in the tradition of the era, providing the application of the procedure only for traders and maintaining punitive and infamous nature of bankruptcy against the bankrupt debtor. According to the provisions of Book III "About bankruptcy", Articles 698-888 of the Commercial Code, bankruptcy represented a foreclosure procedure with a single, collective, competitive and egalitarian character, that aimed the assets of the trader debtor which ceased his commercial debts and that was designed to meet the claims of all its creditors (Carpenaru, 1998).The bankruptcy proceedings may be initiated by the debtor's declaration (Art.703 Commercial Code), at the request of creditors holding commercial claims (Art.704 Commercial Code) or even by default (Art.705 Commercial Code). The Bankruptcy Court Decision was likely to produce both economic effects, materialized in debtor's de-notification, chargeability of all debts, suspension, only to the mass of creditors, of the interest, and non-patrimonial effects, which illustrates the repressive nature of the procedure such as deprivation of freedom (Art. 731 Commercial Code) or limiting the freedom of movement of the individual bankrupt (Art.716 Commercial Code).

## Conclusion

The main disadvantages of bankruptcy proceedings governed by the Commercial Code, as amended, were the major emphasis on the proceedings' punitive and infamous function and the absence of preventive measures and insufficient measures to revive the debtor, means by which one could avoid bankruptcy and creditors' claims could be made in more favourable conditions. Also in the initial regulation contained in the Commercial Code, bankruptcy administration was entrusted to a syndic, often lawyer, appointed by the court with the consent of the creditors, which in practice proved to be a solution inadequate to the purpose of the procedure. Following the amendment of the Commercial Code by Law of 20 June 1895 bankruptcy administration was entrusted to a syndic-judge. This solution was equally challenged in the doctrine of the age and in practice, because the syndic-judge was a professional magistrate however who did not possessed sufficient economic and business administration knowledge.

After 1990, when Romania returned to the market economy, it has been trying to give a new regulation to the institution of bankruptcy, appropriate to the new economic context and in accordance with the contemporary view on the treatment of companies in difficulty. Thus it came to Law no. 64/1995 regarding the reorganization and judicial liquidation procedure[1].The adoption of this law in matters of collective proceedings was a lengthy one. Once adopted, Law no. 64/1995 was significantly and repeatedly amended, even being republished in 2004[2], the texts of law were being renumbered.

In 2006 was adopted a new legal regulation, Law no. 85/2006 on insolvency proceedings, which expressly repealed Law no. 64/1995, republished, with subsequent amendments, representing a change in the essence of the Roman right of collective proceedings. From a procedural point of view, in response to conflicting opinions and difficulties revealed by the legal doctrine and practice, the essential innovation of law, as is clear from its title, is the merger of all of the above procedures into one, the insolvency procedure.

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[2] Published in the Official Journal no. 1066 of 17 November 2004