
Insolvency in Romania – Solution for Avoiding Company Bankruptcy in the Context of Economic Crisis

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The lack of a propitious economic environment made the number of companies in Romania that became insolvent to progressively grow from one year to another, even though average sales registered in the year of starting the procedure were larger than the ones in previous years.

The performed study presents on one side the evolution of companies in insolvency in Romania in the crisis period and on another side determining factors of their activity's continuity. The companies surviving the crisis are the ones that managed to reinvent themselves and identify new sales niches for their products and services, but one of the greatest disadvantages of these companies in insolvency remains the negative image outlined around them.

The insolvency procedure represents only one confirming instrument of a factual situation, respectively the one of Romanian companies' powerlessness in paying their increasingly higher debts. The year of 2008 had a prominent evolution in the number of bankruptcies in Romania, especially after the instauration of the economic crisis, many creditors abusively using this insolvency procedure that in the current economic conditions is opened too easily, affecting the economic performance, even the companies' survival.

In conclusion, the recovery must be thought as a process that begins before the respective company reaches insolvency, exactly to avoid this, and the choice of solutions must take into consideration the multitude of factors influencing the respective company.

Keywords: *insolvency procedure, bankruptcy, debts, activity's continuity, economic crisis.*

Introduction

Significant changes to the insolvency procedure were made so far, first in 2008, when Government Emergency Ordinance 173/2008 was passed, and in 2012 by organizing the activity of insolvency practitioners. Such changes refer to: guiding the debtor towards a reorganization of its business activity and rescuing it from being wound-up; appointment of the official receiver by the creditors that hold the majority of receivables; clarifying the asset appraisal and recovery proceedings; regulating the activity regarding the organization of the activity of insolvency practitioners. The insolvency procedure is regulated by Law no. 85/2006. According to this law Insolvency is a “state of the debtor’s patrimony characterized by insufficient monetary funds available for the payment of certain, liquid and eligible debts.”

The general procedure provided under the laws applies to the following categories of debtors undergoing insolvency or imminent insolvency: trading companies, cooperatives, cooperative organizations; agricultural companies; economic interest groupings; any other private legal entity that also carries out business activities.

The simplified procedure provided by this law applies to insolvent debtors which fall under one of the following categories:

- a) natural person vendors acting individually;
- b) family associations;
- c) vendors that are part of the categories indicated for the general procedure that meet one of the following conditions:
 - i. they own no assets;
 - ii. their articles of incorporation or accounting records cannot be found;
 - iii. their director is missing;
 - iv. their headquarters no longer exist or do not match the address in the trade register;

- d) debtors that are part of the categories provided in paragraph (1), which failed to present the documents provided in article 28 paragraph (1) letters b), c), e) and h) by the legally provided deadline;
- e) companies wound up before the statement of claim was filed;
- f) debtors that declared in their statement of claim the intention to go bankrupt or which are entitled to benefit from the judicial reorganization procedure provided by the laws.

Literature review

Over the years the assessment of insolvency has been defined in several ways. Before 1985 the method to determine whether a company was solvent was the “cash flow test” (Milman & Durrant, 1999). Thus, a company that was unable to pay its debts when due was deemed insolvent although it could sell (recover) sufficient assets in order to pay all debts. After 1985 the “balance sheet test” was added to the “cash flow test”, and in this case a company was deemed insolvent if its liabilities exceed its assets, although such company could pay its debts on time. Many specialists in economy placed particular emphasis on the financial ratio analysis for classifying failed and non-failed companies or for assessing the business performance of a company. Among them, at worldwide level, it is worth emphasizing the importance of the research of Altman (1968) and Ohlson (1980), which have emerged as the most popular bankruptcy prediction models. In Romania, the pioneering authors in the field of bankruptcy prediction models were Măneucă and Nicolae who, in 1996, developed the first score function [4] using Pearson correlation coefficient-as statistical method. The need to forecast bankruptcy risk was the subject matter for investigation of numerous specialists in the area. Thus, we underline the importance of the research of Ion Anghel - Model A, and Băileșteanu (1998) - Model B. Bankruptcy risk has been and still is a sensitive area where specialists aimed at researching and elaborating a mathematical model that answers the question “Is the undertaking going bankrupt or not?”. Leading causes of corporate failure can be classified into economic, financial, neglect, fraud or disaster (Anderson, 2006).

Bankruptcy risk is an internal risk of undertakings and arises because of the inability to make due payments on time. The laws in force also define and differentiates between cash flow insolvency (in Romanian, “insolvență”) and balance sheet insolvency (in Romanian, “insolvabilitate”), where the former is characterized by insufficient funds to pay the certain, liquid and overdue debts (Law no. 85, 2006 on insolvency proceedings), while the latter by the likeliness for the inability to pay the due liabilities to arise. The current economic crisis proves that the results of the investigation studies concerning the prediction of bankruptcy risk are insufficient (Dumitrescu, 2010).

Insolvency may be: obvious – when the debtor failed to pay its debt towards the creditor, after 90 days from the due date. Obvious insolvency is presumed, and the presumption is relative; imminent – when it is proven that the debtor will not be able to pay the overdue debts on their due date with the money available on such due date. The request for commencement of insolvency procedure will be settled by the court that has jurisdiction – the tribunal or the commercial court that acts as venue for the area where the debtor’s headquarters are located when the insolvency request is filed. Commencement of insolvency procedures may be requested by: the insolvent debtor – under the law, it shall ask for commencement of insolvency proceedings within maximum 30 days from the date the corporate failure occurred. Failure to file the request for insolvency or filing such request with delay¹, exceeding by more than 6 months the 30-day

¹ The debtor’s request in accordance with article 28 paragraph (1) must be accompanied by the following documents:

- a) balance sheet certified by the director and the censor/auditor, trial balance for the month previous to the date the request for insolvency is registered;
- b) a full list of all the debtor’s assets, including all accounts and banks through which the debtor transfers its funds; for the encumbered assets the data in their respective registers will be indicated;
- c) a list of the names and addresses of creditors, regardless of the type of their receivables: certain or conditional, liquid or non-liquid, due or not due, contested or uncontested, indicating the amount, the cause and the preference rights;
- d) a list comprising the payments and transfers of assets carried out by the debtor during the 120 days before the statement of claim is registered;
- e) a list of current activities to be performed during the observation period;
- f) profit and loss account for the year before the claim is submitted;
- g) a list of members of the economic interest grouping or, as applicable, of the shareholders with unlimited liability, for unlimited companies and limited partnerships;
- h) a statement whereby the debtor declares its intention to undergo the simplified or reorganization procedure, in accordance with a plan, by restructuring its activity or by complete or partial winding-up of its estate in order for its debts to be settled; if such statement is not

period legally provided, represents the crime of wrongly causing bankruptcy of a company (article 143 paragraphs 1) and the penalty is imprisonment from 3 months to one year or payment of a fine. If the debtor's request meets the legal requirements, the syndic judge will issue a resolution for commencement of the general or of the simplified procedure, as applicable; the creditors – that hold against the debtor a receivable amounting to at least RON 45,000 or to 6 national gross average wages/employee (in case of employees) and which has been a certain, liquid and overdue receivable for more than 90 days. Moreover, the creditor must first set off the mutual debts that it has to the debtor and only if the result of the set-off is a certain, liquid and overdue receivable of at least RON 45,000 it may request that insolvency procedure be started. The syndic judge will send the debtor a copy of the request for commencement of insolvency procedure within 48 hours from registration of the request of the creditor entitled to make such claim. The debtor must acknowledge or object to the existence of insolvency within 10 days from the receipt of this copy. If the debtor challenges the existence of insolvency and such challenge is denied afterwards, it will no longer be entitled to claim judicial reorganization.

The general insolvency procedure implies going through several stages:

submitted until expiry of the period set forth in paragraph (2), the debtor is presumed to agree with the initiation of a simplified procedure;

- i) a brief description of the methods it is contemplating for a turnaround of its activity;
- j) a statement at own risk, certified by a notary public or by a lawyer, or a certificate from the register of agricultural companies or, as applicable, from the trade register office that has jurisdiction over the area where the professional domicile/registered office is located, indicating whether it was previously subject to the procedure provided by this law during the 5 years before the statement of claim is submitted;
- k) a declaration at own risk certified by a notary public or a lawyer indicating that it has never received a final sentencing for forgery or for crimes provided by Competition Law no. 21/1996 and that the directors, managers and/or shareholders have never been finally sentenced for fraudulently causing bankruptcy, fraudulent management, breach of trust, fraud, embezzlement, false testimony, forgery or crimes provided by Law no. 21/1996, during the last 5 years before the procedure starts;
- l) a certificate for admission to trading on a regulated market of the securities or other issued financial instruments

If the debtor does not hold, when the statement is registered, any of the information provided under letters a)-f) and h), it will be able to register such information with the court within 10 days; if it fails to do so, its claim will be deemed an acknowledgement of insolvency, and in this case the syndic judge will issue a decision in favor of commencement of the simplified procedure, as per article 1 paragraph (2) letters c) or d).

- a) the observation stage: takes place from the date the general procedure starts until confirmation of a reorganization plan or commencement of bankruptcy proceedings;
- b) the judicial reorganization stage: takes place from the date the reorganization plan is confirmed until the insolvency procedure is closed following fulfillment of the payment obligations undertaken in the confirmed plan or commencement of bankruptcy procedures. A judicial reorganization claim cannot be filed by the legal entity debtors that were subject to such procedure during the 5 years before the decision to start the procedure is ruled.
- c) the bankruptcy stage : starting with the date bankruptcy procedure is initiated and until the procedure is closed. If bankruptcy proceedings start, the amounts that result from winding up the debtor's estate will be paid in the order of priority provided in articles 121 and 123 of Law no. 85/2006.

Research Methodology

Causes for insolvency

The causes that may lead to insolvency come from both inside and outside of the company, as follows:

- a) Inside factors
 - i. Ineffective management:
 - increase of costs at a much faster pace than that of the increase of production;
 - continuous decrease of the mark-up due to an abundance of similar products and services on the market;
 - increase of the number of complaints from customers. If their number exceeds 5% of the total number of customers, this means a drop in the quality of services/products, which will trigger numerous agreements being terminated;
 - taking bank loans without analyzing how they would actually be repaid given the current national and international economic circumstances. A company may become unable to pay its debts after taking loans in order to upgrade to the latest technology, as this would cause a

financial imbalance of the company, namely a significant increase of indebtedness, for both the principal amounts of bank loans and the related accessories;

- failure to pay in due time the debts to national budget, which leads to payment of penalties and default interest;
- permanently having operating losses, the main cause for the existing debts;
- failure to recover receivables from bad payers, the main cause for this being the bankruptcy of such customers which generates a low amount of liquidities. Thus, a 10% decrease of the cash flow in one quarter, despite the business staying constant, is a first warning sign. The customer fluctuation rate is also a warning sign -losing customers faster than attracting new ones;
- absence of any actual and efficient measures to decrease the company's total expenditures;
- absence of a long and medium term strategy to render the company's activity profitable, by taking actual measures at management, marketing, financial and human resources level, considering the circumstances on the market.

ii. Human resources:

- rapid growth of wage-related expenses, with an improper ratio between the increase of wage-related expenses and the company's achievements, on the one hand, and, on the other hand, the increase to over 10% - 15% of the number of unproductive employees in the overall staff;
- payment of bonuses to employees not fit to their individual contribution;
- absence of a strict control of the activities and expenditures made per cost centers, together with the company's legal advisor (e.g. the company's lawyer).
- after a certain period employees develop routines, perform their tasks mechanically, without creativity, and reject everything new. The company whose employees perform the same activities for long period (more than 5 years) has high chances to leave the market. An effective management

must know how to take employees out of this comfort zone and present them with new challenges.

b) Outside factors:

- increase of purchase prices of raw materials and consumables;
- customers being oriented to cheap products of a lower quality;
- companies' payment behavior getting worse – longer period required for recovering the receivables or even loss of such amounts;
- liquidity issues worsened because of the problems on the supply chain, considering that several companies became unable to pay their debts because they themselves were unable to collect the debts from their own customers.

Review of the insolvency phenomenon in Romania

In case of bankruptcy, market conditions when the assets are sold may change critically, either to a drop of prices and thus of the debt coverage ratio, or to a postponement of the sale and thus increase of procedure expenses. The experience shows that in most cases of forced liquidation, bidders count on a drop of prices considering the special selling conditions.

In addition to this fact of cashing in a lower amount of receivables, other negative effects of bankruptcy are less quantifiable but nevertheless just as real:

- following the shutdown of activity, employees will be laid off. Such loss of jobs will have a direct and negative influence on the welfare of their families.
- after the corporate patrimony is appraised and sold, it is very likely for the patrimony to be sold “piece by piece”, thus losing the use for which the very functional asset was created – the company.
- it is less likely for the company to be replaced by another tax payer of the same size under the current economic circumstances in the near future.

At the end of the period of economic growth, insolvency affected about 2.5% of the active companies, according to reports from the trade register (an average of 540,000 companies). The effects of the above-mentioned insolvency causes amplified gradually between 2009 and 2010

when Romanian economy experienced recession, as for two years in a row the GDP was lower than the one in the previous years.

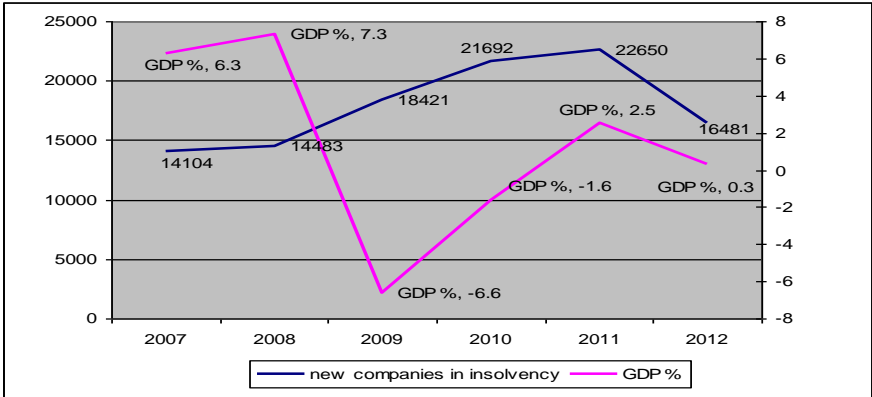


Figure 1: GDP and new companies insolvency number evolution
Source: National Statistics Institute: 2011 Annual Statistics Directory; Coface Study on Insolvency in Romania

The fact that the GDP resumed its upward trend in 2011 did not succeed to attenuate the growing number of insolvencies, without however changing the trend. This uncorrelated evolution in 2011 is explicable, on the one hand, due to the structure of the GDP growth in 2011 (i.e. the main area contributing to the GDP growth was agriculture, due to an exceptional year) and, on the other hand, to the delays specific for the Romanian judicial system (the time required for settling insolvency claims is usually 3 months – which means that there is a gap of approximately one quarter between the schedule of insolvency commencement and that of the GDP evolution). A second consecutive year of economic growth led to a drop in the number of insolvency cases and a comeback to the normal correlation. (Figure nr.1)

A segmentation of the number of insolvencies per the 7 geographical regions plus Bucharest shows the same correlation with the GDP evolution as the one at national level, with two exceptions in 2011, which confirm the lack of national correlation in 2011, namely the N-E and N-W regions, where the share of agriculture in the GDP is above the national average, and the impact of the exceptional agricultural year had a bigger immediate impact than in the case of the other regions. (Figure nr.2)

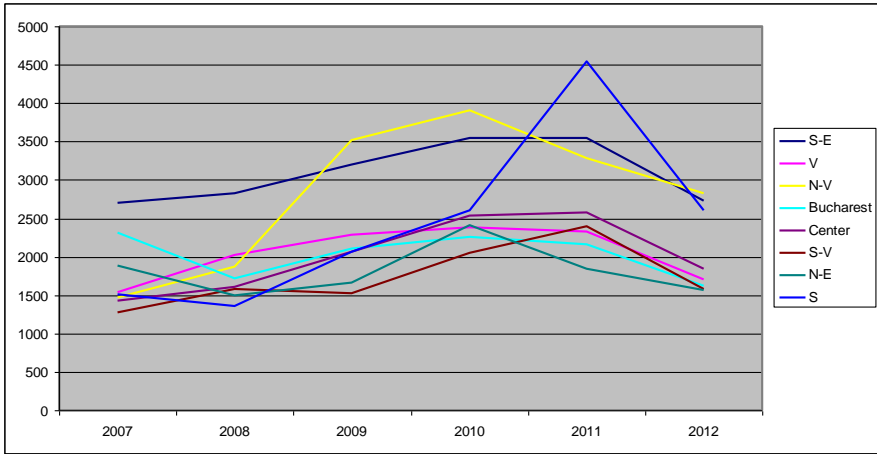


Figure 2: Regional evolution of new insolvency companies number
Source: National Statistics Institute: 2011 Annual Statistics Directory; Coface Study on Insolvency in Romania

The negative effects of commencement of insolvency proceedings, given the economic crisis, are also amplified by the low entrepreneurial appetite these days, which does not manage to compensate in figures for the number of companies that were wound up voluntarily or as a result of bankruptcies. (Figure nr.3)

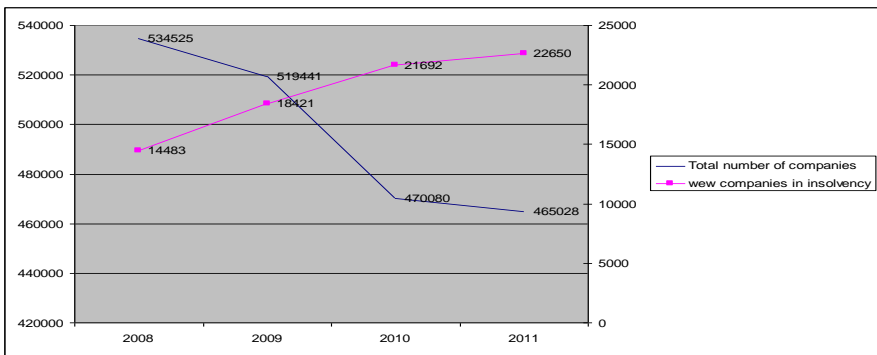


Figure 3: new companies in insolvency vs total number of companies
Source: National Statistics Institute: 2011 Annual Statistics Directory; Coface Study on Insolvency in Romania

Under these circumstances, we may notice a growth of insolvency cases to almost 5% of the total number of Romanian companies in 2011.(Figure nr.4)

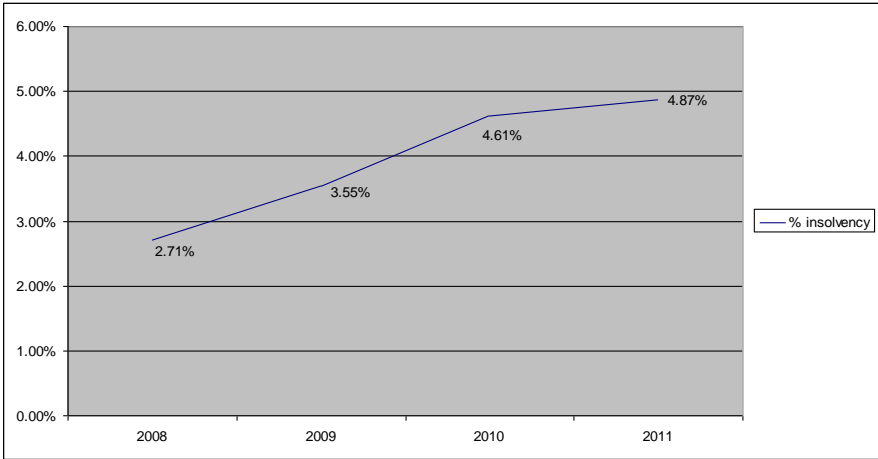


Figure 4: evolution of yearly new companies in insolvency percentage
Source: National Statistics Institute: 2011 Annual Statistics Directory; Coface Study on Insolvency in Romania

In terms of the industries' most affected by insolvencies (from the point of view of the number of companies), retail and wholesale come first (given that in this industry, in addition to the drop in consumption, the development of hypermarket and supermarket chains had a major impact). The second most affected industry is that of constructions, which was simultaneously affected by a drop in the demand and by a radical change of policy in the financial industry when it came to lending money for constructions. Consequently, the next affected industries are those significantly correlated to the two areas above: transportation and utilities production and consumption (gas, fuel, electricity and heating power).(Figure nr.5 and 6)

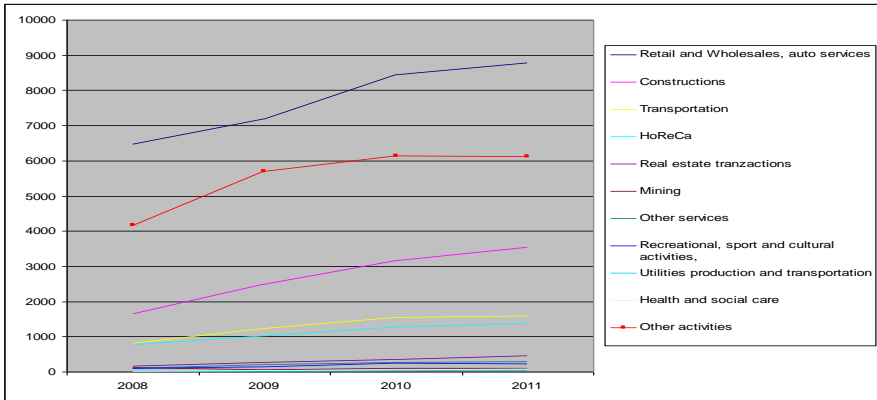


Figure 5: yearly new companies in insolvency per industries evolution
 Source: National Statistics Institute: 2011 Annual Statistics Directory; Coface Study on Insolvency in Romania

Based on a review of Romanian insolvency laws, it may be noted that the top-priority objective, from the legislator’s point of view, was to ensure the mechanisms that would facilitate a reorganization of the business that faced liquidity problems. This alternative theoretically maximizes the ability to recover the creditors receivables and also preserves the role of added-value generator for the business, diminishing the need for payment of unemployment benefits and social security to the future former employees of the insolvent company.

Regrettably, statistics come to show that in practical insolvency cases over the last 6 years in Romania reorganization is rather the exception than the rule. The chart below presents the ratio between the annual number of insolvencies and the number of approved reorganization plans.

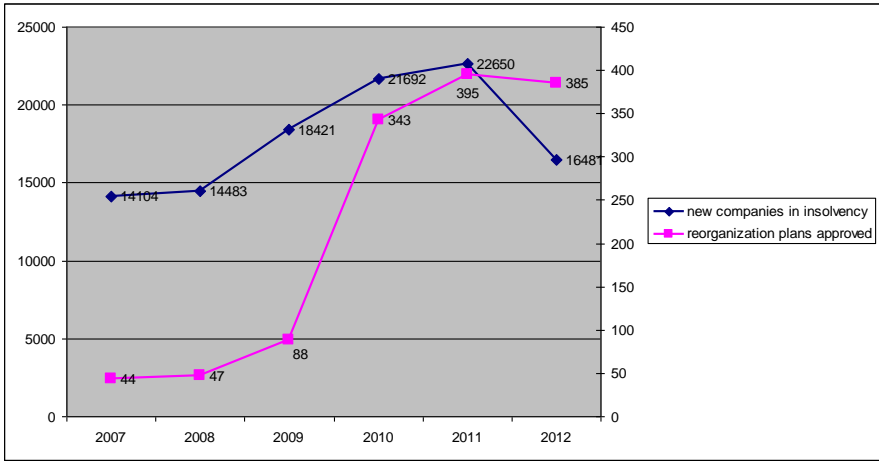


Figure 6: reorganization plans vs new companies in insolvency
 Source: National Statistics Institute: 2011 Annual Statistics Directory; Coface Study on Insolvency in Romania

The number of reorganization plans presented to syndic judges is lower than 2.5% of the number of insolvency procedures that start each year.(Figure nr.7)

After interviewing various insolvency practitioners and banks that act as creditors (frequently among the creditors of insolvent companies), the following conclusions stand out, explaining the very low percentage of reorganization plans that eventually reaches the judges:

- extremely long time necessary to reach an undisputable form of the statement of assets and liabilities (settling a challenge against the quantity and quality of receivables takes an unacceptably long time due to the large period between hearings set by the courts of law)
- a quasi-inability to get an undertaking from the tax and bank creditors regarding a voluntary decrease of receivables to be obtained after the implementation of a realistic turn-around plan
- a quasi-inability to obtain the necessary funds required for finalizing the uncompleted vital investments that the implementation of a reorganization plan depends on, or to provide the necessary working capital for a turnover that is sufficient for payment of the liabilities undertaken in the reorganization plan. The reticence to provide the necessary funds characterizes both bank creditors and

commercial creditors and the shareholders of the insolvent company

- the fact that shareholders-directors of most insolvent companies lack credibility.

Conclusions

In order to recover, any company needs a REORGANIZATION PLAN – this represents the proposition for economic-financial turnaround of the company based on a coherent long-term strategy, presented by the debtor to its creditors. For the achievement of this plan and implicitly for a turnaround of the company, the reorganization plans should mainly aim at the following measures:

- choosing the customers based on solvency criteria and taking precautionary measures to cash-in the receivables (e.g. cheques and/or promissory notes personally guaranteed by the customer company's manager, material pledges);
- monitoring the financial behavior of the company's current customers, in order to minimize as much as possible the risk of overdue payments;
- granting discounts for customers that pay cash upon delivery of products;
- focusing on products that facilitate a quick sale and that require low manufacturing costs, attending to a larger extent to the customer's demands and requests;
- promoting the company and its products by commercials and advertising: press, radio, television during prime time, in order to have a more powerful impact on the audience;
- the management of the insolvent company will be ensured by the interim manager of the company that will be in charge with complete management of the company's business, including the right to dispose of the assets that are part of the debtor's estate, under the official receiver's strict supervision;
- taking action to recover the due and outstanding receivables, by referring the matter to the courts;
- increasing the rotation speed of circulating assets by avoiding the set-up of slow moving inventory and/or inactive inventory;

- ensuring a sustained growth and a positive cash flow by: implementing short-term actions and monitoring the results, periodic analysis of profit margins and of the pricing system for each product range; keeping under control the profitability limit; monitoring the performance of all activities, projects and permanently quantifying results; partial winding-up of the patrimony, namely sale of certain items that do not affect the company's activity².

Following the analysis that was carried out, we may infer that in Romania voluntarily starting insolvency proceedings does not represent (unless exceptionally) a solution for a business which has temporary cash problems to re-become viable again and also does not represent (unless exceptionally) a solution for immediately and significantly recovering the receivables towards companies with cash flow problems.

The likeliness of having viable reorganization plans may increase based on legislation amendments that refer to how the state's receivables on the statement of assets and liabilities are managed, to the court practice when solving the challenges (e.g. by creating courts specializing in commercial matters/insolvency). Matters related to the policies of creditor banks, which could be improved at the level of the entire system, have not been identified.

Last but not least, there is a critical absence of specialists/companies specializing in "company turn-around" that by their proven expertise could make up for the low credibility and capacity of shareholder-directors to convince creditors of the viability of possible reorganization plans.

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² The sale will be performed in accordance with the provisions of law 85/2006, namely by public auction held in accordance with the rules set forth in the Civil Procedure Code for selling movable assets. The sale will be organized by the interim manager under the official receiver's supervision.

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