CASE STUDY ON THE REORGANIZATION OF COMPANIES WITH THE APPLICATION OF HAIRCUTS ON RECEIVABLES

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Abstract
The paper addresses aspects of the insolvency procedure, in the current domestic and international economic context in which companies operate economically in the event of bankruptcy. Bankruptcy laws are essential for a well-functioning economy, which, if well designed, facilitates better risk-sharing and offers better incentives not only to avoid bankruptcy but also to avoid further distortions.
A company in insolvency, during the observation, reorganization or bankruptcy period is subject to the provisions of the Law on insolvency and insolvency prevention procedures.
We have presented a case study that captures the purpose of the insolvency procedure versus contradictions and legislative gaps concerning the reorganization of companies applying the haircut of receivables.

Keywords
Reorganization procedure; haircut of claims; reorganization plan; debtor.

JEL Classification
G33, K33, M40

Introduction

The international collaboration of states has created modern regulations in addressing the global phenomenon of insolvency. In this context, giving a second chance to the honest debtor and supporting it in its business recovery efforts becomes the fundamental principle of company reorganization.
There is a strong argument that a bankruptcy procedure should deliver an ex post efficient outcome, that is, it should maximize the total value (measured in money terms) available to be divided between the debtor, creditors and possibly other interested parties, e.g., workers (Hart, O., 1999).
The identification of the most efficient insolvency system has been an important element, which has resulted in the on-going adaptation and modernization of state laws, and Romania has not made an exception. The Bankruptcy Code, adopted in the United States in 1979 and substantially modified in 1984, aims at supporting traders/ consumers in restructuring their financial activity, enabling a new start (U.S. Bankruptcy Code, 2019).
At European Union level, more than 200,000 businesses are affected annually by bankruptcy, which leads to the loss of more than 1.7 million jobs each year. Reorganization

through insolvency is perceived as a contradiction because the public perception leads us to the idea of the definitive collapse and liquidation of the company.
Since the middle of the last century, however, there has been a change of the main direction. In the US law, the reorganization procedure was introduced in order to save a company; in terms of its social impact, the continuation of commercial relations and the fees collected to the budget would be more valuable if the company were kept in operation than in the case of liquidation/ bankruptcy. The reorganization of companies thus becomes an essential attribute of the free, functional market economy, a feature that justifies free competition.
The central role of bankruptcy in modern capitalist economies is to encourage reorganization (Stiglitz, J., 2003).
Recent debates divide insolvency proceedings into two broad categories: those favoring creditors, which encourage the liquidation of the insolvent debtor, with the main example of the UK legislation, and those favoring debtors, giving insolvent debtors a chance to redress, illustrated by the US legislation.
The Romanian legislation on insolvency has taken over, adapted and implemented the "best practice" rules at international level, in particular the recommendations of the World Bank, synthesized both in the *Principles of Insolvency Effectiveness and Creditor/ Debtor's Rights*, and in the *Report on the Observance of Standards and Codes (ROSC)* and the *European Commission Recommendations* and the *UNCITRAL Legislative Guide*.
In terms of business restructuring, internal rules (Law 85/2006 on insolvency proceedings, which was amended in 2014) are based on the recommendations, rules and interpretations inspired by the European Commission's communications:
- December 2012 - European Commission Communication to the European Parliament, the Council and the Economic and Social Committee, entitled "A new approach to business failure and insolvency";
- March 2014 - European Commission Communication entitled "The Commission recommends a new approach to rescue business and give honest entrepreneurs a second chance".

Brief introduction of the terms analyzed in this study
Insolvency is the state of the debtor's patrimony characterized by insufficient funds available for the payment of its due debts.
The list of creditors includes all claims/debts incurred before the opening date of the current, due proceeding, under condition or litigation, accepted by the legal administrator, following verification.
Reorganization is the procedure that applies to the debtor (legal person), in order to pay its debts in accordance with the list of creditors. The reorganization procedure involves drawing up, approving, implementing and complying with a plan, called reorganization plan.
Under the Romanian insolvency law (Law 85/2014 on Insolvency Prevention and Insolvency Proceedings), *the reorganization plan* shall indicate the recovery prospects in relation to the possibilities and specificities of the debtor's activity, the available financial means and the market demand for the debtor's offer. It shall include:
a. The payment list of the claims/debts entered in the list of creditors,
b. The due date for the implementation of the plan, which may not exceed 3 years, calculated from the date of its confirmation by the syndic judge,
c. Other measures for its implementation, namely:
   i. The debtor's operational and/or financial restructuring;
   ii. Modification of the share capital structure;
   iii. Downsizing, by liquidating some assets from the debtor's patrimony, etc.

Haircut on debts/claims. The debtor in insolvency proceedings may be reorganized if a part of its debts entered in the list of creditors is cancelled. This debt discharge has to comply with an essential condition, i.e. no creditor can receive less than s/he would receive in the event of bankruptcy (of course, in the situation where the assets are capitalized and the funds distributed to the creditors). By reorganization, the debtor must present to its creditors a better coverage of their claims than in the case of bankruptcy, and the added value derives from the debtor's business activities.

Main stages of company reorganization in Romania

a. Opening insolvency proceedings. The insolvency proceedings are triggered based on an application submitted to the court by the creditors or by the debtor itself.

b. Statement of the reorganization intention. If the request to initiate the procedure is filed by a creditor, the debtor shall have 10 days to declare its intention to reorganize. If the claim belongs to the debtor, the latter shall declare its intention to reorganize when it registers the application. If the debtor retains the right to manage the business, it shall carry out its activity under the supervision of the legal administrator, up to the due date of the proposed reorganization plan, called the observation period.

c. The report on the causes that generated the insolvency of the company; Conclusions about the chances of the debtors' reorganization. Within 40 days, the legal administrator shall prepare the report on the causes that generated the insolvency, indicating whether there is a real possibility of effectively reorganizing the debtor's activity. The financial-accounting information in the financial statements, together with data on the activity sector, the market evolution, etc. underlie the analysis of the debtor's situation during the observation period and during the period prior to insolvency proceedings. Subsequent to the analysis, by his/her professional reasoning, the legal administrator shall conclude whether the debtor has the material, financial, managerial, etc. basis in order to reorganize itself.

There are conceptual models of analysis in order to predict bankruptcy and to analyze the impact of the factors that determined the companies' insolvency; however, in order to substantiate/ support the debtor's reorganization decision, further analysis is needed.

The mathematical models used in order to predict the bankruptcy risk have resulted in the use of several shares/rates determined based on specific financial statement indicators, to which certain weights are allocated, so that their sum reveals a global indicator, i.e. the score. Different scores make it possible to distinguish "healthy" businesses from those in difficulty at a certain point in time, but it is unclear which variable should be modified in order to trigger/ raise the idea of relaunching the company's activities.

d. The preliminary list of creditors encompasses all claims incurred prior to the date of opening the current, due procedure, under condition or litigation, accepted by the legal administrator, following verification. It can be disputed by any interested party.

e. Evaluation of the assets from the debtor's patrimony under insolvency proceedings.

Given that the creditors' guaranteed claims/debts shall be entered in the consolidated list of creditors, the debtor's assets shall be evaluated by an ANEVAR independent assessor.

The evaluation of the debtor's asset is also important in terms of bankruptcy calculation. The bankruptcy calculation is a simulation of the hypothesis where a debtor goes into bankruptcy proceedings. The calculation is specific to the reorganization plan, in order to verify the condition that no creditor would receive through the plan less than it would receive in the event of bankruptcy.

f. Consolidated list of creditors. If the preliminary list of creditors is not contested, the amount of the claims/debts shall remain unchanged.

g. Registering the reorganization plan. Within 30 days after the publication of the consolidated list, the reorganization plan of the debtor's activity will be drawn up. It can be proposed by the debtor, by the creditors or even by the legal administrator.

h. Haircut on claims. A company in the insolvency proceedings may be reorganized, benefitting from a cancellation of the debts entered in the list of creditors.
The reorganization plan should provide for a better coverage of the creditors' claims than the distributions that would derive from the liquidation of assets in the event of bankruptcy.
i. The procedure for approving the reorganization plan. The reorganization plan shall be registered at the Tribunal, communicated to the legal administrator (if the latter does not propose it) and to the creditors and it shall be mentioned in the Trade Register, to which the debtor belongs. The Judicial Administrator shall convene the creditors' meeting within 20-30 days in order to vote on the plan.
The plan is voted on categories of claims:
- Claims that benefit from preference rights
- Salary claims
- Budgetary claims
- Claims of indispensable creditors
- Other chirographic claims.

The plan shall be accepted by a category of claims if it is accepted by the majority from the respective category of claims.
j.The confirmation of the reorganization plan shall be performed by the syndic judge within 15 days from the date when the minutes of the creditors' meeting were submitted to the court.

The purpose of insolvency proceedings versus contradictions and legal gaps in the reorganization of companies by implementing the haircut on claims
The purpose of insolvency proceedings. "The establishment of a collective procedure in order to cover the debtor's liabilities, granting it, whenever possible, the opportunity to redress its activity ..." (Law 85, 2014)
Contradictions and legislative gaps. The debtor in insolvency proceedings is entitled to a partial debt discharge through the reorganization plan. This provision is beneficial to the debtor, but the law also provides the creditors with such a solution, so that no creditor can receive within the reorganization less than it would receive in case of bankruptcy.
Debt relief helps the debtor to survive, but the fiscal effects of this solution must also be analyzed because the reorganization must not be jeopardized.
The fiscal effects triggered by the reorganization are:
- Registering the list of creditors;
- Registering the haircut on claims.

The application/ interpretation manner of the various regulations applicable to the situation is unclear. Moreover, the different interpretations give rise to additional obligations in the debtor's task. The first contradiction concerns the nature of debt cuts, i.e. whether these debt cuts lead to the recognition of certain income; if we are talking about income recognition, it is important to know whether these incomes are taxable or not.
Implementing the reorganization in the current Romanian fiscal context
Since the fiscal law identifies only non-taxable incomes, we can only conclude that what is not taxable will be taxable. Therefore, if the income resulting from the cancellation of some debts is not classified as non-taxable, consequently, it may be taxable.
The additional obligations (profit tax) generated by the implementation of the reorganization concern:
- The registration of the consolidated list of creditors by recording the income from the cancellation of the claims from the accounting records, not recorded in the list (we are talking about those creditors of the company who have not filed claim/debt statements for the enrolment in the list of creditors)

- The registration of the reorganization plan and of the income resulted from the cancellation of the debtor's debts.

This interpretation may not necessarily be clear as long as we have other types of regulated income, such as "upfront revenues" that are not likely to generate a tax on profits or contingent debts. In practice, the opinion of the tax body is that the income from debt cancellation is taxable.

At international level, the situation is different:

- The US specific tax legislation qualifies debt cancellation as part of the category of exceptions to taxable income. For reference, these legal provisions are stipulated in the Internal Revenue Code Section 61(a)(12). This law says that "the income from discharge of indebtedness" is included in a person's gross income for the year. The tax laws also spell out specific circumstances when a person shall not have to pay tax on canceled debts. These are called exclusions, which mean that the amount shall not be included in a person's taxable income. There are several exclusions available, but only three of them apply to the situation of canceled mortgages. These three exclusions are for:
  - Debt canceled in bankruptcy proceedings,
  - Debt canceled when the person is insolvent, and
  - Debt that qualifies under the Mortgage Forgiveness Debt Relief Act.

Each of these exclusions have their own set of criteria and reporting procedures

- In Germany, the revenue from debt relief under insolvency proceedings is subject to reduced taxation.
- In France (Article 80 Loi de impôt sur le revenu) – the law provides for the forgiveness of the debts canceled through the reorganization plan.

Case study on the reorganization procedure of a Romanian company, under the proposal of a reorganization plan with haircut on claims

Going into payment default due to the non-recovery of the debts held against other companies, the debtor "A" SRL declared its insolvency, subject to the communication of the intention to reorganize.

The company entered into insolvency proceedings in October 2016.

The preliminary list was drawn up by January 2017.

After finalizing the evaluation of assets and the contestations to the preliminary list, the consolidated list of creditors from October 2017 was finalized with the following claim categories:

- Guaranteed claims
- Budgetary claims
- Chirographic claims

Under the accounting provisions, the consolidated list of creditors had to be recorded in the accounts, which generated an additional profit tax at the end of 2016.

Within 30 days from this date, the debtor proposed a reorganization plan with haircut on claims, as follows:

Guaranteed claims – paid in full by the debtor;

Budget claims – paid in full by the debtor;

Chirographic claims - which the debtor paid in proportion of 10%, in relation to the bankruptcy calculation (if the company had liquidated the guaranteed and unsecured assets, it would have covered only the guaranteed claims.

By reorganization, it was estimated that it would pay also (in addition) the guaranteed and the budgetary claims - in full - and the chirographic claims - only 10%).

The reorganization plan was approved by the creditors and confirmed by the syndic judge in December 2017.

At that point, the list being final, it had to be recorded.

Therefore, in March 2018, when the debtor was in the first quarter of the reorganization plan, it recorded a due profit tax liability equivalent at least to the tax entailed by the registration of the income resulted from the registration of the list of creditors and of the reorganization plan.
These obligations of certain, liquid and exigible nature, being huge, could cause the debtor's bankruptcy; thus, the debtor would go back into payment default and, of course, to bankruptcy.

Conclusions

The limiting factors of the reorganization procedure in Romania.

- Implementing the European Commission's recommendations on insolvency and not corroborating the insolvency regulations (including the principle of encouraging a second chance for the debtors in insolvency proceedings) with specific national (fiscal) provisions;
- The reluctance of tax authorities to cooperate and encourage the reorganization of the debtors in insolvency proceedings, the main reason being that there are no risk profile analysis models for these debtors in order to conclude upon the reorganization of the company's activity;
- Lack of impact studies on frequent legislative changes. For example, until its repeal, the Old Romanian Tax Code (Law 571/2003) was amended/ completed 138 times; since its adoption, the new Fiscal Code has been amended/ completed (Law 227/2015) 14 times over 2 years;
- Unclear / contradictory / insufficient regulations regarding the interpretation of legal provisions and the insufficient professional training of inspectors/ the abusive nature of the controls carried out by state institutions, resulting from the many litigations settled in favor of the taxpayers in the reorganization procedure.

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