Chapter 13

Financial Distress and Bankruptcy Costs

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ABSTRACT

Since the crisis of the 1930s and the early work of writers such as Fitzpatrick (1932), the problem of failure has become a field of investigation and research in its own right. According to Franks and Sussman (2005), a firm is defined as being in distress once the local branch or regional credit manager decides to transfer a status report to the monitoring unit of economic enterprises or responsible financial diagnosis. Such decisions may occur, especially for SMEs, in the case of violations of certain terms (non-payment of interest exceeding the overdraft limit...) or following a poor assessment of the future of the firm by directors of credit (by reference to indicators such as high debt and low profitability). The objective of this chapter suggests analyzing the processes of the financial distress of companies and their impact.

INTRODUCTION

Like all crises, business failure is perceived as a problem only by those who are directly or indirectly the victims and must bear the consequences. The failure is not the exclusive domain of small and medium companies, it can affect all, regardless of their size, even those that are publicly traded.

The risk assessment of business failure has long been a central concern of researchers and professionals in this field. Failure situations affect the existence of a company and are a very high cost to banks in case of partial or complete loss of funds lent, and also a major risk to other creditors, who, as a result, can fail too. In its common and legal sense, the failure covers a range of situations that contribute to the disappearance of the company mainly because of serious financial problems that lead to insolvency. Blazy and Al (1993) define the failure as “the situation from which a rehabilitation proceeding is opened against a business.” Liang and Al (2003), Hol and Al (2002) suggest that failure is a situation where the cash flows generated by the companies fail to meet their obligations to their financial and non-financial partners. Sharabany (2004) believes that there’s failure in all three cases: the activity of the company is discontinuous: either this activity does not generate adequate returns, or is the subject of a judicial declaration of insolvency. Pompe and Bilderbeek (2004) Pindado and Rodrigues (2001), Atiya (2001) and Varetto (1998) argue that the

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notion of failure is normally related to credit risk, since it is the banks who say that a company is insolvent when they refuse to lend them money.

Due to the fact that it involves several scientific disciplines, business failure has long been analyzed indirectly without creating a real current of homogeneous theoretical and empirical thinking, resulting in a specialised literature that makes of failure a fully fledged research topic.

The identification of the root causes of failure is not obvious. It is always difficult to exclusively list the factors causing the failure. The causes are numerous, and their conjunction endangers the survival of the company. The importance of this phenomenon and its impact on the overall economy, lead to a desire to know the causes and origins to explain them and be accordingly able to take preventive measures.

A variety of causes have been presented in various works. However, the majority of them agrees that two broad categories of factors can be identified:

- Microeconomic causes are endogenous causes. They represent a specific internal risk, and are rooted in the core functions of the business, mainly the production, the marketing or the organization.
- Macroeconomic causes are exogenous factors which are, in some cases, the major causes of business failure. Since the eighties, it was found that regardless of financial ratios, there are other economic variables related to the economic environment and whose relevance is unquestionable in the explanation of the phenomenon of failure and the determination of its causes.

As a first step, we will conduct an analysis of the process of financial distress of companies to better understand the path of failure under the financial, economic and legal perspectives. Then, we will examine the costs of the financial distress and their impact on companies.

THE PROCESSES OF THE FAILURE

Historically, the failure problems have attracted the attention of both economists and lawyers because they are a key social issue. They therefore try to delimit the scope involving the concept of failure to give it a clear definition. However the variety of situations related to the application of this phenomenon has made the task difficult.

It is only with the crisis of the 1930s and the early works of authors such as Fitzpatrick (1932) that the problem of failure has become a fully fledged field of research. Like any other phenomenon, the failure was analyzed in different ways and by different disciplines. The most significant contributions came from legal, economic, financial, strategic, organizational and managerial sciences (Guilhot, 2000).

Definition and Cycle of the Financial Distress

Wruck (1990) defines financial distress as a situation where cash flows are insufficient to cover current obligations. These obligations may include payables, expenses of litigation or interest payments. According to Baldwin and Scott (1983), when the situation of a company deteriorates to the point where it can not meet its financial constraints, the company enters into a state of financial distress. These same authors assert that this is the result of a poor economy, a decline in their performance and low quality of their managements. Modigliani and Miller (1959) showed that only efficient firms, effective and efficient, are ready to support a relatively large debt because they are able to meet their obligations without problems. Jensen (1986) argues that debt acts as a disciplinary mechanism on the leaders and has a positive impact on business performance. According to Finet (2001), the granting of debt results from the difficulties experienced by the company. It becomes part of the weakening of its operating performance, its capital as well as its