Doing Business 2015

Going Beyond Efficiency

Resolving insolvency

Measuring the strength of insolvency laws

- *Doing Business* introduces a new component of the resolving insolvency indicator set this year, the strength of insolvency framework index. This indicator tests whether each economy has adopted internationally recognized good practices in the area of insolvency.
- The good practices underlying the new indicator are based on 2 sources—the World Bank's *Principles for Effective Insolvency and Creditor/Debtor Regimes* and the United Nations Commission on International Trade Law's *Legislative Guide on Insolvency Law.*
- OECD high-income economies have the highest average score on the strength of insolvency framework index. South Asia is the region with the lowest average score on the index.
- Economies that have reformed their insolvency laws in the past several years score substantially higher on the strength of insolvency framework index than economies with outdated insolvency provisions.
- Economies with better insolvency laws as measured by *Doing Business* tend to have more credit available to the private sector.

The word *bankruptcy* often evokes negative associations with failure and shame. And fear of bankruptcy and its consequences can deter potential entrepreneurs from starting a new business venture. According to a recent survey on entrepreneurship, people from a range of social and demographic groups rank the possibility of going bankrupt as the greatest fear associated with starting a business, above irregular income and lack of job security.[1] Yet evidence suggests that the exit of firms from the market is a necessary condition for economic growth, and efficient exit frameworks may in fact encourage greater entrepreneurial activity and new firm creation.[2] Moreover, businesses started by previously failed entrepreneurs can grow faster than those started by first-timers.[3]

While reducing the stigma associated with bankruptcy may be difficult, policy makers can minimize the negative effects of business failures and take advantage of their positive effects by adopting efficient and well-functioning bankruptcy laws. Several studies show a strong link between bankruptcy laws and credit market development, as reflected by such aspects as collateral eligibility requirements, access to loans to finance investments, access to long-term debt and the level of firms' financing relative to their size.[4] And studies on the effects of bankruptcy reforms show that speeding up the resolution of debt disputes may increase the probability of timely repayment; that increasing the protection of creditors and their participation in bankruptcy proceedings may lead to a lower cost of debt and a higher aggregate level of credit; and that introducing reorganization proceedings may reduce the rate of business failure.[5] Moreover, efficient bankruptcy regimes with orderly procedures for the sale and distribution of debtors' assets can have a positive effect on loan terms, leverage ratios and bank recovery rates.[6]

Bankruptcy laws play such an important role because they promote predictability for both creditors and entrepreneurs—by establishing the rules for the worst-case scenario. They allow entrepreneurs to determine the maximum risk associated with a failed venture.[7] And they allow creditors to calculate the maximum risk associated with an unpaid loan. Collection of debt through bankruptcy proceedings may be the least attractive option for any creditor, because these proceedings involve several creditors trying to enforce their claims against the same debtor.[8] So, having transparent, enforceable rules on the types of decisions that creditors can influence during bankruptcy proceedings, on the priority of creditors and on other important issues is critical for lenders—and becomes a key factor for them in fixing interest rates and maturity terms for loans.[9]

AN EXPANDED FOCUS FOR THE INDICATORS

The *Doing Business* indicators on resolving insolvency measure the efficiency of insolvency (bankruptcy) frameworks around the world. Until this year the focus was on capturing the time, cost and outcome of the most likely in-court proceeding involving a domestic debtor in each economy. These 3 measures were then used to calculate the recovery rate—how much of its loan a secured creditor would be able to recover at the end of the proceedings.

This year *Doing Business* has introduced an important change in methodology for the resolving insolvency indicators. Besides measuring the recovery rate, it now also tests whether each economy has adopted internationally recognized good practices in the area of insolvency. A new indicator, the strength of insolvency framework index, measures good practices in accordance with principles developed by the World Bank and the United Nations Commission on International Trade Law (UNCITRAL)—the World Bank's *Principles for Effective Insolvency and Creditor/Debtor Regimes* (referred to here as the "World Bank principles") and UNCITRAL's *Legislative Guide on Insolvency Law* ("UNCITRAL guide").[10]

The purpose behind expanding the scope of the methodology is to capture multiple aspects of the insolvency framework in each economy. The new strength of insolvency framework index measures the quality of insolvency laws, while the previous methodology (recovery rate) captures the insolvency practice. Thus the expanded methodology will provide a more complete and balanced view of the insolvency framework in each economy by addressing both the quality of the law and the efficiency of its implementation. One of the findings this year is that economies with a higher quality of insolvency laws as measured by the strength of insolvency framework index experience on average higher recovery rates.[11] Additionally, while the previous methodology focused mainly on secured creditors, the new index widens the reach of the resolving insolvency indicator set to debtors and unsecured creditors.

Both the World Bank principles and the UNCITRAL guide avoid using the term *bankruptcy* and instead use the broader term *insolvency*. The 2 guidebooks generally agree on the objectives of an effective and efficient insolvency regime, and both provide specific recommendations on each of these objectives (the UNCITRAL guide, a multivolume publication, covers a multiplicity of options). The good practices tested under the new indicator are closely linked with the objectives identified in both guidebooks and follow the provisions elaborated in them (table 12.1).

The strength of insolvency framework index measures whether each economy has adopted internationally recognized good practices in 4 areas: commencement of insolvency proceedings, management of the debtor's assets, reorganization proceedings and creditor participation in insolvency proceedings. Each of these topics is addressed by a separate component index through several questions.

- The *commencement of proceedings index* measures what type of proceedings (liquidation, reorganization or both) debtors and creditors can initiate and what standard is used to declare a debtor insolvent.
- The *management of debtor's assets index* measures whether, during insolvency proceedings, a debtor can continue transactions essential to the survival of the business and terminate contracts that are overly burdensome; whether preferential and undervalued transactions made by the debtor prior to the commencement of insolvency can be avoided; and whether the debtor can obtain new financing during insolvency proceedings to support its continuous operation.
- The *reorganization proceedings index* measures whether and how creditors vote on a reorganization plan and what protections are available to dissenting creditors.
- The *creditor participation index* measures whether creditors participate in important decisions during insolvency proceedings, such as appointment of the insolvency representative and sale of assets during the proceedings; whether creditors have access to information about the debtor and the proceedings; and whether creditors can object to decisions affecting their rights, such as approval of claims submitted by other creditors.

The information used to compile the strength of insolvency framework index was provided by private and public sector insolvency practitioners in each economy with reference to the applicable laws and regulations. The *Doing Business* team analyzed both primary and secondary sources in evaluating to what extent insolvency laws in each economy accord with internationally accepted good practices. Based on this analysis, the team assigned a score for each of the 4 component indices. The sum of these 4 scores is the score on the strength of insolvency framework index. (For a more detailed description of the scoring methodology, see the data notes.)

WHERE ARE GOOD PRACTICES MOST COMMON?

OECD high-income economies have the highest scores on average on the strength of insolvency framework index and on each of the 4 component indices (figure 12.1). Among the economies in this region, Germany and the United States have the highest scores. Europe and Central Asia has the second highest average score on the strength of insolvency framework index, though there is a substantial difference between the average score of Eastern and Central European economies and that

TABLE 12.1 Objectives of an effective insolvency regime as identified by the World Bank principles and the UNCITRAL guide and measured by the resolving insolvency indicators

World Bank principles	UNCITRAL guide	Resolving insolvency indicators
Integrate with a country's broader legal and commercial systems	Provision of certainty in the market to promote economic stability and growth	
Maximize the value of a firm's assets and recoveries by creditors	Maximization of value of assets	New indicator tests whether the value of the debtor's assets can be preserved by continuing contracts of the debtor essential to survival of its business, by rejecting overly burdensome contracts, by invalidating preferential and undervalued transactions and by obtaining post-commencement financing.
Provide for the efficient liquidation of both nonviable businesses and businesses whose liquidation is likely to produce a greater return to creditors and reorganization of viable businesses		Existing indicators test whether viable businesses can be reorganized and whether businesses in liquidation can be sold as a going concern.
Strike a careful balance between liquidation and reorganization, allowing for easy conversion of proceedings from one proceeding to another	Striking a balance between liquidation and reorganization	New indicator tests whether creditors and debtors have access to both liquidation and reorganization proceedings and what the basis is for declaring a debtor insolvent.
Provide for equitable treatment of similarly situated creditors, including similarly situated foreign and domestic creditors	Ensuring equitable treatment of similarly situated creditors	New indicator tests how similarly situated creditors vote on a reorganization plan and what treatment they receive under the plan.
Provide for timely, efficient, and impartial resolution of insolvencies	Provision for timely, efficient and impartial resolution of insolvency	Existing indicators test how long the proceedings take and how much the proceedings cost for the creditors.
Prevent the improper use of the insolvency system		New indicator tests the basis for commencing insolvency proceedings.
Prevent the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments	Preservation of the insolvency estate to allow equitable distribution to creditors	This principle is tested by the strength of legal rights index.[a]
Provide a transparent procedure that contains, and consistently applies, clear risk allocation rules and incentives for gathering and dispensing information	Ensuring a transparent and predictable insolvency law that contains incentives for gathering and dispensing information	New indicator tests the level of creditor participation during insolvency proceedings, including their ability to request information and to challenge decisions directly affecting their rights.
Recognize existing creditor rights and respect the priority of claims with a predictable and established process	Recognition of existing creditor rights and establishment of clear rules for ranking of priority claims	New indicator tests whether post-commencement creditors receive priority over existing creditors. This principle is also tested by the strength of legal rights index.[b]
Establish a framework for cross-border insolvencies, with recognition of foreign proceedings	Establishment of a framework for cross-border insolvency	Because *Doing Business* focuses on domestic entities and transactions, the indicators do not test this principle.

a. The strength of legal rights index (part of the getting credit indicator set) tests whether the insolvency framework includes automatic stay (moratorium) provisions, which suspend all individual creditor actions during insolvency.

b. The strength of legal rights index tests the level of priority of secured creditors' claims as compared with other claims—tax claims, employee claims, judgments.

Source: Analysis based on World Bank (2011b) and UNCITRAL (2004).

of Central Asian economies. Economies that have recently reformed their insolvency laws—such as Bulgaria, Romania, the former Yugoslav Republic of Macedonia and Montenegro—have the region's highest scores, having implemented many of the good practices measured by the index as part of their reform efforts.

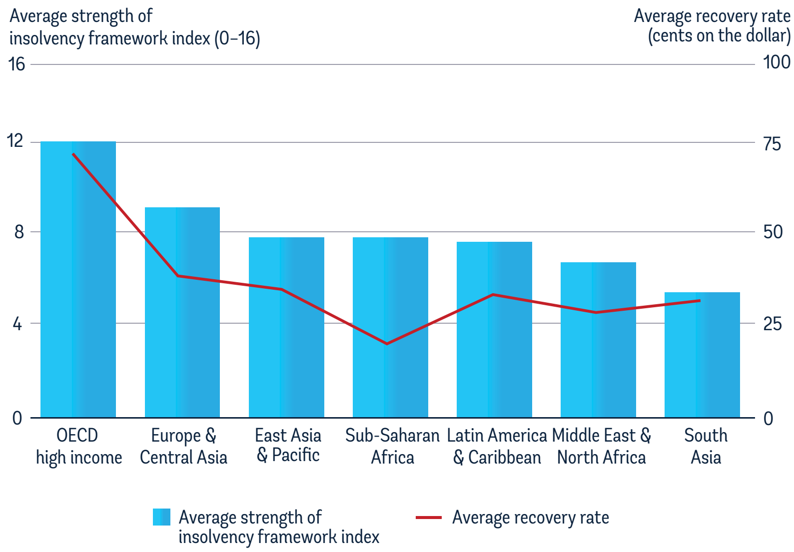
East Asia and the Pacific and Sub-Saharan Africa are tied with the third highest score. Economies with some of the highest scores in Sub-Saharan Africa are those that adopted the OHADA (Organization for the Harmonization of Business Law in Africa) Uniform Act Organizing Collective Proceedings for Wiping Off Debts. In East Asia and the Pacific there is great variation in the strength of insolvency frameworks. Economies that have recently amended their insolvency laws, such as China, Cambodia and the Philippines, receive high scores, while other economies have no formal insolvency framework, such as Palau and the Marshall Islands.

The region with the lowest average score on the strength of insolvency framework index is South Asia. Very few economies in the region have insolvency laws that facilitate the continuation of the debtor's business during insolvency proceedings. Economies in the Middle East and North Africa score only slightly better. Only 2 economies in this region have a reorganization framework, and many lack a designated insolvency law; instead, provisions related to insolvency are found in company laws and commercial codes.

In Latin America and the Caribbean some economies have well-developed insolvency laws, such as Brazil, Mexico and Colombia, for example, all of which score relatively high on the strength of insolvency framework index. But most of the smaller economies in the region, particularly island economies, still use winding-up provisions in companies acts that have not been amended for several decades.

This analysis shows that economies that have reformed their insolvency

FIGURE 12.1 OECD high-income economies have well-developed insolvency frameworks and the highest recovery rates



Source: Doing Business database.

laws in the past several years score substantially higher on the strength of insolvency framework index than economies that rely on old insolvency provisions in companies acts and commercial codes.

WHAT ARE RELATIVE STRENGTHS AND WEAKNESSES?

The strength of insolvency framework index can be a meaningful instrument for governments to use in reforming their insolvency system, because it enhances the ability to identify areas where each economy can improve. The data for the component indices point to 2 areas where many economies can improve: reorganization proceedings and creditor participation (figure 12.2). There is also room for improvement in the management of the debtor's assets, to facilitate continuous operation during insolvency.

A third of the economies covered by *Doing Business* have no formal judicial reorganization framework. This means that preservation of insolvent businesses in these economies is virtually impossible, so that the only option for an insolvent debtor is to sell its assets.

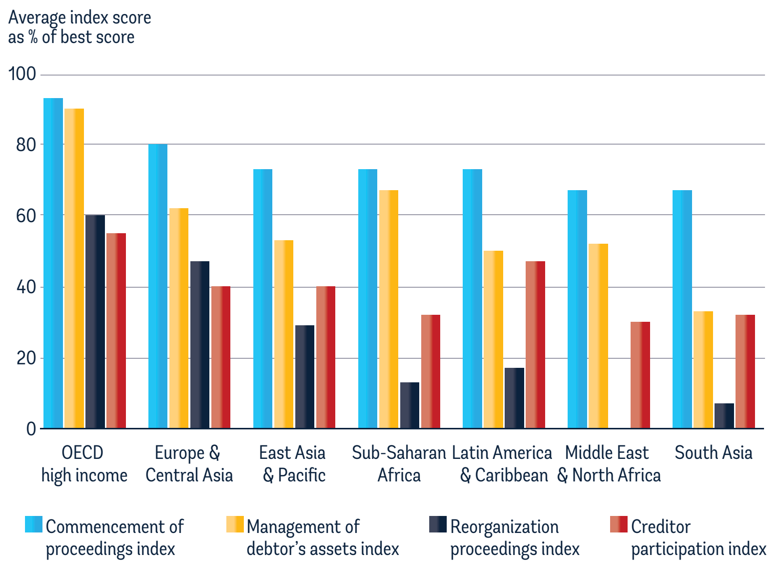
More than 40% of economies lack specific provisions in their insolvency laws that would allow debtors to maintain contracts supplying essential goods and services during insolvency proceedings. While some of these economies require utilities to continue providing services to insolvent customers, for many debtors this is not enough to ensure continuous operation. For example, a manufacturing company must have raw materials to continue operating. And a retail business cannot operate without merchandise. If suppliers can cancel their contracts as soon as a debtor becomes insolvent, the debtor's business operations must stop, greatly reducing the value of its assets.

Many economies do not allow creditors to participate in important decisions throughout insolvency proceedings. Among the first and most important decisions made after insolvency proceedings begin is the appointment of an insolvency representative, who often has the authority to act on behalf of the debtor and make key decisions about the management of its assets. Almost 60% of economies exclude creditors from the process of choosing the insolvency representative. Lack of meaningful participation can affect creditors' confidence in the system, making them less cooperative and more litigious and thus prolonging the proceedings.

The data for the component indices also point to economies with particular strengths in the areas measured. For example, Germany is one of 51 economies that receive full points on the commencement of proceedings index. The country has unified insolvency proceedings, which means that when a debtor or creditor files for insolvency, there is no requirement to specify whether liquidation or reorganization is requested. But a debtor may submit a reorganization plan together with its insolvency petition or at a later stage, and creditors may request the insolvency administrator to prepare a reorganization plan based on the financial evaluation of the company. The standard for initiating insolvency proceedings is flexible and includes both illiquidity (inability to pay debts as they mature) and overindebtedness (the debtor's assets no longer cover existing liabilities). The German insolvency framework also allows the commencement of insolvency proceedings when illiquidity is imminent, which may encourage debtors to file for insolvency before their financial circumstances become too dire.

Japan is one of 26 economies that receive full points on the management of debtor's assets index. Reorganization and liquidation proceedings in Japan are covered by 2 separate laws. Both laws include provisions that facilitate the continuation of the debtor's business during insolvency. For example, both prohibit the termination of

FIGURE 12.2 Two areas where many economies can improve are reorganization proceedings and creditor participation



Source: Doing Business database.

contracts on the sole ground that the debtor has become insolvent and allow the debtor (or an administrator or trustee in bankruptcy) to decide which contracts should be continued during insolvency and which should be terminated. This allows the business to receive essential goods and services that will enable it to survive while eliminating overly burdensome obligations that may threaten its operation. Both laws also allow the avoidance of preferential and undervalued transactions concluded before the commencement of proceedings.

In addition, in both liquidation and reorganization proceedings the debtor (or an administrator or trustee in bankruptcy) is allowed to take new loans if necessary for continuation of the business, though approval of the court may be required. New loans are treated as common benefit claims and receive preference over the claims of general unsecured creditors but not over those of secured creditors, whose preference remains unchanged. Such provisions on post-commencement financing permit a debtor in financial difficulties to continue operating while they also recognize and preserve the priority of existing creditors with preferential claims.

Cambodia is one of 17 economies that receive full points on the reorganization proceedings index. In 2007 Cambodia adopted a new insolvency law that, among other features, introduced a reorganization procedure. Under the new law, when a reorganization plan is proposed, all creditors whose rights are impaired or modified by the plan vote on whether to approve or reject it. This includes secured and preferential creditors, because they may represent a substantial share of the value of the debt and their participation may be necessary to achieve successful reorganization. But creditors whose rights are not affected do not have the right to vote, as this would grant them unnecessary influence. For the purposes of voting on the plan, creditors are classified into different classes based on their interests (secured claims, tax claims, unsecured claims). All creditors within a class must be treated equally, and at least one class must approve the plan. To ensure equitable treatment of dissenting creditors, the Cambodian law requires that they receive at least as much under the reorganization plan as they would receive in liquidation.

Despite Cambodia's adoption of a modern and comprehensive insolvency law, however, recovery rates remain very low. As this example illustrates, a modern law is not enough to achieve an efficient insolvency practice; effective implementation and a developed judiciary framework are also essential.

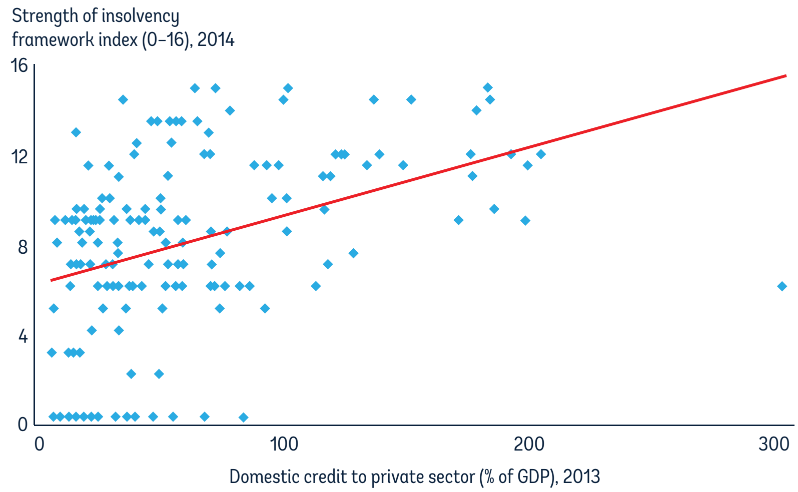
Switzerland is one of only 3 economies that receive full points on the creditor participation index. The Swiss insolvency law allows creditors to participate in many important decisions during insolvency. For example, creditors can reject the administrator appointed by the court and must approve the handling of the debtor's assets during insolvency proceedings. They can obtain copies of records related to the insolvency proceedings so as to stay informed about every stage of the process. And they have the right to object to decisions directly affecting their rights—for example, they can dispute decisions accepting the claims of other creditors.

WHAT ARE THE LINKS WITH CREDIT MARKET DEVELOPMENT?

Analysis of the data collected for the strength of insolvency framework index confirms the connection many researchers have made between insolvency laws and credit market development. Economies that score well on the index have higher levels of credit provided to the private sector by domestic financial institutions (figure 12.3).

These results suggest that the quality of bankruptcy laws is important not for its own sake but as an indication of

FIGURE 12.3 Economies with strong insolvency frameworks have higher levels of domestic credit provided to the private sector



Note: Domestic credit to private sector refers to financial resources provided to the private sector by financial corporations, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment. The correlation between the strength of insolvency framework index and domestic credit to private sector as a percentage of GDP is 0.40. The relationship is significant at the 1% level after controlling for income per capita.

Source: Doing Business database; World Bank, World Development Indicators database.

and perhaps a step toward a better-developed financial system. Where credit institutions and entrepreneurs can anticipate the outcome of the worst-case scenario—when a business fails to pay its loans and several creditors must compete for the best return—more banks will be willing to lend and more entrepreneurs will be willing to take on the challenge of starting a business.

CONCLUSION

Analysis of the data collected for the strength of insolvency framework index shows that economies with recent changes to their insolvency frameworks have better-quality laws. Among other economies, several still have no formal insolvency framework and many more rely on outdated companies acts and commercial codes for insolvency rules. Differences in regulatory quality are especially apparent in regions with emerging economies, such as Latin America and the Caribbean and East Asia and the Pacific.

The strength of insolvency framework index can be a useful tool for governments seeking to reform their insolvency laws because it helps in identifying specific areas where insolvency regulations are lacking. The results suggest that there is opportunity in many economies to improve reorganization proceedings, facilitate the continuation of businesses during insolvency and allow greater participation by creditors in insolvency proceedings.

NOTES

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1. European Commission 2012.
2. Cirmizi, Klapper and Uttamchandani 2010.
3. Stam, Audretsch and Meijaard 2006.
4. See Araujo, Ferreira and Funchal (2012) for a summary of different studies on the relationship between creditors' rights and economic development.
5. Klapper 2011.
6. Cirmizi, Klapper and Uttamchandani 2010.
7. Lee, Peng and Barney 2007.
8. Haselmann, Pistor and Vig 2010.
9. Qian and Strahan 2007.
10. World Bank 2011b; UNCITRAL 2004.
11. For more on the relationship between the strength of insolvency framework index and the recovery rate, see figure 1.7 and the related discussion in the overview.