

Resolving insolvency

- Creditors of firms facing insolvency in Japan have higher recovery rates than in other economies.
- *Doing Business* recorded 12 reforms aimed at improving insolvency proceedings between June 2012 and June 2013 and 92 in the past 5 years.
- The Philippines made the biggest improvement in the efficiency of insolvency proceedings in the past year.
- The Czech Republic has made the most progress toward the frontier in regulatory practice in resolving insolvency since 2009.
- Common features of insolvency reforms in the past 5 years include passing new bankruptcy laws, eliminating formalities and tightening time limits of insolvency proceedings, and regulating the profession of insolvency administrators.
- OECD high-income economies had the biggest increase in the recovery rate in the past 5 years, while Europe and Central Asia had the most insolvency reforms.

For more information on good practices and research related to resolving insolvency, visit <http://doingbusiness.org/data/exploretopics/resolving-insolvency>. For more on the methodology, see the section on resolving insolvency in the data notes.

The financial crisis tested insolvency frameworks around the world. In the United States the number of business insolvency filings rose from 39,307 in 2008 to 55,645 in 2009. Though the number of new cases fell after 2009—to 51,259 in 2010 and 43,470 in 2011—not until 2012 did the system return to precrisis filing levels.¹ In Western Europe corporate insolvency filings rose 22% between 2008 and 2009, with the biggest increases in Ireland (81%) and Spain (77%).²

Western Europe is still far from returning to its precrisis numbers. At the end of 2011 corporate insolvency filings were still 17% higher than in 2008. Between 2008 and 2012 Spain recorded one of the biggest increases—182%. In 2012 alone the number of corporate insolvency filings in Spain jumped from 5,666 to 7,780.³ The increase in corporate insolvency filings in Ireland between 2008 and 2012 was nearly as staggering—118%. But Ireland has shown some improvement, with only negligible increases between 2011 and 2012.⁴

Weaknesses of insolvency regimes become apparent during crises. When a weak insolvency framework does not provide for effective formal and out-of-court mechanisms to address financial distress, more debts remain unresolved and more companies languish, unprofitable but with their assets unavailable to their creditors and little chance of turnaround. An insolvency framework that allows debtors and creditors to find solutions through fast, inexpensive, transparent procedures can facilitate debt repayment, encourage lending and lead to a higher survival rate for viable enterprises. A recent study shows that Brazil's 2005 reform, which established greater protection for secured

creditors, led to a significant reduction in the cost of debt and an increase in both short-term and long-term debt.⁵

To analyze the efficiency of insolvency frameworks across economies, *Doing Business* measures the time, cost and outcome of insolvency proceedings involving domestic entities. The time for creditors to recover loans is recorded in calendar years. The cost of proceedings is recorded as a percentage of the value of the debtor's estate. The recovery rate for creditors depends on whether the distressed company emerges from the proceedings as a going concern or its assets are sold piecemeal. The rate is recorded as cents on the dollar recouped by secured creditors through reorganization, liquidation or debt collection (foreclosure or receivership) proceedings. If an economy had no reorganization, liquidation, receivership or foreclosure cases over the past 5 years, it receives a "no practice" classification—meaning that creditors are unlikely to recover their money through a formal legal process, in or out of court. Rankings on the ease of resolving insolvency are based on the recovery rate, which is affected by the time, cost and outcome associated with the most likely insolvency procedure applicable to the indicator's case study in each economy.

Doing Business analyzes 1 of the 4 types of procedures that may apply to an insolvent firm: reorganization, liquidation, receivership and foreclosure. These procedures differ in 3 main ways: the extent to which they allow secured creditors to recover their debt, the likelihood that a viable business will continue operating as a going concern after insolvency proceedings and the extent to which the concerns of unsecured creditors are addressed.

Reorganization has the advantage of addressing debts of all creditors, secured and unsecured, and allows viable businesses to continue operating as a going concern. This is the most economically efficient outcome for the *Doing Business* case study, since it assumes a company that is viable. Liquidation also addresses the concerns of all creditors collectively, though the business is usually shut down upon the completion of proceedings. In receiverships, where a secured creditor takes over the operation of the debtor's company to protect its collateral, the business may continue operating as a going concern. But the secured creditor is in full control of the process, not allowing unsecured creditors to participate at all. At the same time, the receiver is obligated to pay unsecured creditors if there are sufficient funds after the secured creditor has been paid in full. Finally, foreclosures may maximize the interests of secured creditors but do not allow the continuation of the business and ignore the concerns of unsecured creditors.

The highest recovery rates are recorded in economies where reorganization is the most common insolvency proceeding

(figure 19.1). Recovery rates vary significantly among economies where liquidation is the most common procedure because of major differences in the legal institutions (such as courts and insolvency representatives) applying the insolvency framework. Individual debt enforcement proceedings (receiverships and foreclosures) result in comparatively high recovery rates for secured creditors, though unsecured creditors receive nil returns. Finally, *Doing Business* has observed 19 “no practice” economies, where the recovery rate is recorded as zero.

WHO REFORMED IN RESOLVING INSOLVENCY IN 2012/13?

Between June 2012 and June 2013 *Doing Business* recorded 12 reforms aimed at making resolving insolvency easier (table 19.1). Most reforms were recorded in Europe and Central Asia and Sub-Saharan Africa.

Promoting reorganization was a common feature of several recent reforms. Croatia established an expedited out-of-court restructuring procedure with strict

timeframes, while Moldova introduced the option of prepackaged reorganizations. Rwanda instituted a moratorium on enforcement actions during reorganizations, and Ukraine adopted a new insolvency framework that strengthened protections of secured creditors, introduced debt-equity swaps and streamlined the insolvency process.

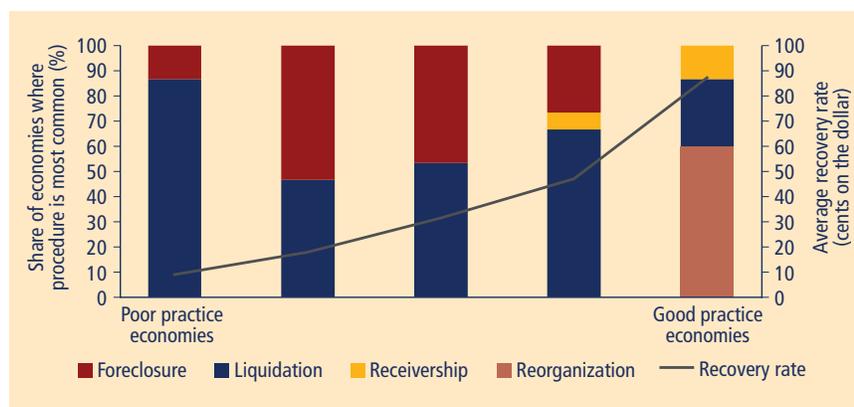
Italy made its restructuring proceedings more accessible and flexible. Debtors can now take advantage of a moratorium on creditor collection actions to allow sufficient time to negotiate and develop a restructuring plan. Before this change, debtors applying for restructuring proceedings had to propose a plan at the time of commencement, which discouraged many from seeking restructuring and caused them to pursue liquidation instead. As a result of the reform viable businesses have a better chance of coming through restructuring and continuing to operate as a going concern.

WHAT HAVE WE LEARNED FROM 5 YEARS OF DATA?

In the past 5 years *Doing Business* recorded 92 insolvency reforms in 62 economies (figure 19.2). These reforms have different purposes and objectives and can be classified into 2 categories: foundational and evolutionary. Foundational reforms create an insolvency framework or establish new insolvency procedures and usually require legislative action. Evolutionary reforms improve existing procedures by strengthening the legal framework or the institutions applying it, to achieve the most economically efficient outcomes.

Economies undertaking foundational reforms usually have no formal insolvency regime, and creditors mostly rely on individual proceedings as a means of debt enforcement in cases of debtor default. Individual court proceedings such as foreclosures can be effective for returning secured creditors' investment but do not allow the reorganization and rescue of a viable business, which maximizes the economic value of debtors' assets. To address these problems, most economies have adopted insolvency frameworks with one or more collective debt proceedings.

FIGURE 19.1 Higher recovery rates are more likely in economies where reorganization is the most common insolvency proceeding



Note: Poor practice economies are the 15 lowest-ranked economies on the ease of resolving insolvency, excluding “no practice” economies. The second column represents the 15 economies ranked from 135 to 149 on the ease of resolving insolvency. The third column represents the 15 economies ranked from 88 to 102. The fourth column represents the economies ranked from 40 to 54. Good practice economies are the 15 top-ranked economies. The line refers to the average recovery rate for the 15 economies represented by each column. Reorganization is the process aimed at restoring the financial health and viability of a debtor's business so that it can continue to operate as a going concern. Liquidation is the process of assembling and selling the assets of an insolvent debtor in order to dissolve it and distribute the proceeds to its creditors. Liquidation may include a piecemeal sale of the debtor's assets or a sale of all or most of its assets as a going concern. Receivership is the process of appointing a receiver to take custody of the business of a defaulting debtor for the benefit of secured creditors. Foreclosure is the process of taking possession of a mortgaged property as a result of the debtor's failure to keep up mortgage payments in order to sell the property and distribute the proceeds to its creditors. Source: *Doing Business* database.

TABLE 19.1 Who made resolving insolvency easier in 2012/13—and what did they do?

Feature	Economies	Some highlights
Increased the likelihood of successful reorganization	Israel; Italy; Moldova; Rwanda; Ukraine	Italy extended moratorium protections to the period when restructuring plans are being prepared, granted priority to postcommencement financing and allowed debtors under restructuring to participate in public tenders.
Regulated profession of insolvency administrators	The Bahamas; Belarus; Moldova; Ukraine	The Bahamas clearly defined professional requirements, duties, powers and remuneration of insolvency practitioners and liquidators.
Eliminated formalities or introduced or tightened time limits	Moldova; Rwanda; Tanzania; Ukraine	Moldova shortened statutory periods for several stages of insolvency proceedings, including the maximum duration of liquidation and restructuring procedures, and reduced opportunities for appeal.
Established or promoted reorganization, liquidation or foreclosure procedures	Democratic Republic of Congo; Djibouti	The Democratic Republic of Congo and Djibouti established clear frameworks for 3 proceedings—preventive settlement, composition with creditors and liquidation.
Strengthened the rights of secured creditors	Italy; Ukraine	Ukraine allowed creditors to file claims after statutory deadlines and granted secured creditors the right to veto proposed rehabilitation plans.
Introduced framework for out-of-court restructurings	Croatia; Mauritius	Croatia established a prebankruptcy settlement procedure.

Source: *Doing Business* database.

Nearly a third of the reforms in the past 5 years were foundational. Two economies with recent foundational reforms are the Democratic Republic of Congo and Djibouti. The Democratic Republic of Congo established new legal frameworks for liquidation and reorganization proceedings in 2012, implementing provisions of the Organization for the Harmonization of Business Law in Africa's Uniform Act Organizing Collective Proceedings for Wiping Off Debts. Djibouti adopted a new

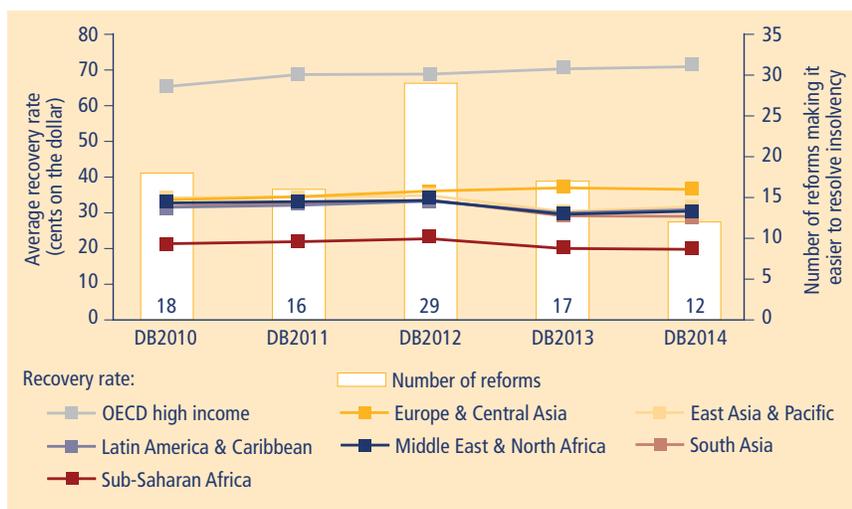
Commercial Code that largely follows the provisions in that act.

Economies undertaking evolutionary reforms already have insolvency frameworks with one or more collective proceedings, but aspects of these frameworks need improvement. A successful insolvency framework consists of more than comprehensive laws and regulations—it encompasses established practices related to insolvency proceedings

as well as effective institutions in charge of implementing regulations and maintaining established practices, such as applicable courts and insolvency representatives. Evolutionary reforms improve regulations and institutions and remedy problems identified through practice.

Just over two-thirds of the reforms in the past 5 years were evolutionary. Such reforms include creating specialized bankruptcy courts, expediting insolvency proceedings, making business operations during reorganization easier and regulating the profession of insolvency representatives.

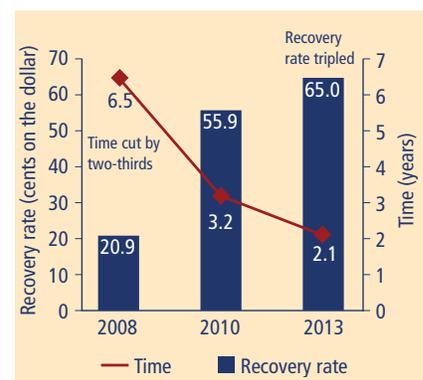
FIGURE 19.2 OECD high-income economies have consistently had the highest recovery rate



Note: To ensure accurate comparisons, the figure shows data for the same 183 economies for all years, from DB2010 (2009) to DB2014 (2013). The economies added to the *Doing Business* sample after 2009 and so excluded here are Barbados, Libya, Malta, Myanmar, San Marino and South Sudan. This figure uses regional classifications for 2013.

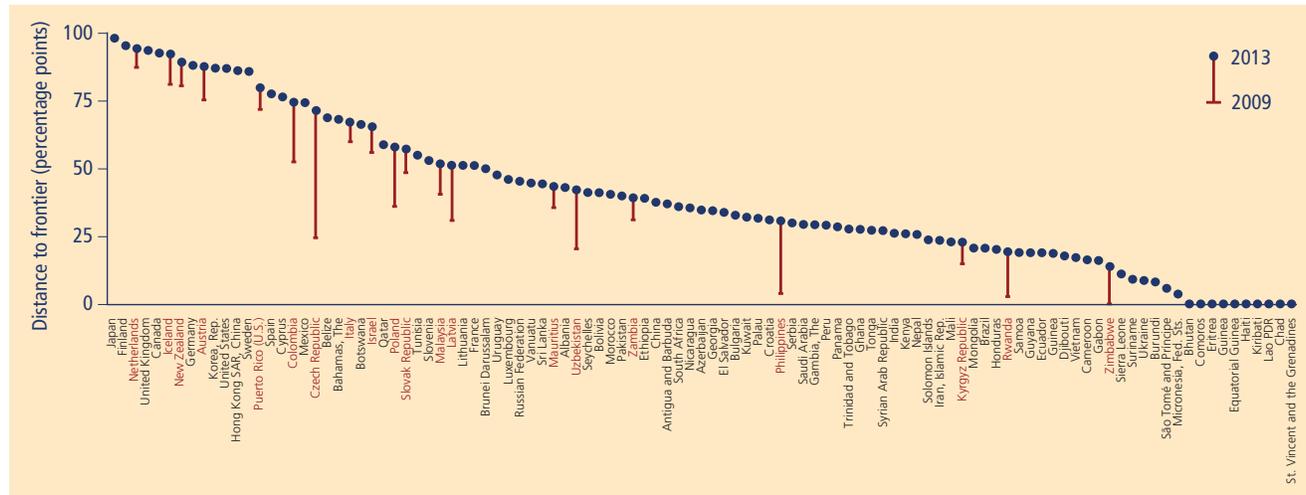
Source: *Doing Business* database.

FIGURE 19.3 The Czech Republic made insolvency proceedings more efficient



Source: *Doing Business* database.

FIGURE 19.4 The Czech Republic has advanced the most toward the frontier in resolving insolvency in the past 5 years



Note: The distance to frontier scores shown in the figure indicate how far each economy is from the best performance achieved by any economy on the resolving insolvency indicators since DB2004 (2003). The scores are normalized to range between 0 and 100, with 100 representing the frontier. The data refer to the 183 economies included in DB2010 (though for practical reasons the figure does not show all 183). Barbados, Libya, Malta, Myanmar, San Marino and South Sudan were added in subsequent years. The vertical bars show the improvement in the 20 economies advancing the most toward the frontier in resolving insolvency between 2009 and 2013.

Source: *Doing Business* database.

The Czech Republic provides a good example of successful evolutionary reforms, achieving some of the biggest improvements in the past 5 years as measured by *Doing Business* by continuously strengthening its insolvency framework. A new insolvency law went into effect in 2008 and declared reorganization the preferred method of resolving insolvency. Liquidation and reorganization proceedings were streamlined, and insolvency representatives became subject to educational and professional requirements as well as stricter government oversight.

Application of the new regulations identified some inefficiencies that led to further reforms in 2009 and 2012. By 2011 reorganization was the most common insolvency procedure in the Czech Republic, and survival of distressed but viable companies was the prevailing outcome. By 2013 the time to complete insolvency proceedings had fallen by 4.4 years compared with 2008 (figure 19.3). The recovery rate of creditors in the Czech Republic more than tripled over the past 6 years (from 20.9 cents on the dollar in 2008 to 65.0 cents on the dollar in 2013).

Examples like the Czech Republic, as well as many other economies, show that meaningful improvements to insolvency systems require sustained, continuous efforts. Foundational reforms can produce results, but they are often insufficient to facilitate the most economically efficient outcomes of insolvency proceedings—the reorganization of businesses that are economically viable and the liquidation of businesses that are not. By implementing both foundational and evolutionary reforms over the past 5 years, economies have significantly narrowed the gap with the frontier in regulatory practice in resolving insolvency (figure 19.4).

In many cases effects of reforms are not immediately evident, and it may take several years before they can be quantified. An absence of instant results should not discourage economies from adopting further reforms and continuing to improve the insolvency framework. A good example is the Philippines, the economy that made the biggest improvement in the efficiency of insolvency proceedings in 2012/13. The new insolvency law that led to this improvement—the Financial

Rehabilitation and Insolvency Act of 2010—was adopted in July 2010, but its impact was felt in the resolving insolvency indicators only in 2012/13.

NOTES

This topic note was written by Fernando Dancausa, Rong Chen and Olena Koltko.

1. United States Courts: Bankruptcy Statistics, <http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx>. Statistics represent business filings under Chapter 11 and Chapter 7 of the U.S. Bankruptcy Code.
2. Creditreform 2010. <http://www.insolvencyjournal.ie/stats>. Statistics represent corporate insolvency filings that include both liquidations and reorganizations.
3. Instituto Nacional de Estadística, <http://www.ine.es/>. Statistics represent corporate insolvency filings that include both liquidations and reorganizations.
4. Creditreform 2012. <http://www.insolvencyjournal.ie/stats>. Statistics represent corporate insolvency filings that include both liquidations and reorganizations.
5. Funchal 2008.