

# Doing Business

## Closing a business

Ahmed, the former owner of a clothing shop in Abu Dhabi, made some bad business decisions that forced him to close shop last year. Hesitant to strike out on his own again, he has been looking for a job—to no avail. “No one wants to hire me,” he complains. “There’s a stigma to having a business that went bankrupt.” It was worse in past centuries. The penalty for declaring bankruptcy in ancient Rome was slavery or being cut to pieces. The choice was left to the creditor. By the Middle Ages the treatment of insolvent debtors had softened. In Northern Italy bankrupt debtors hit their naked backside against a rock 3 times before a jeering crowd and cried out, “I declare bankruptcy.” In England bankrupt debtors were often pilloried or thrown into prison and occasionally had an ear cut off.

Attitudes toward bankruptcy are one major obstacle for reformers drafting bankruptcy laws. But there are other good reasons why few bankruptcy reforms take place. First, bankruptcy reforms are complex: they typically involve making changes not only in the bankruptcy code but also in the code of civil procedure and the administration of the judiciary. That may take years. Second, in developing countries a large share of businesses are in the informal sector, and bankruptcy is not a priority reform. Only 10 economies undertook significant bankruptcy reforms in 2006/07.

It’s not that reforms are not needed—in many countries creditors recover almost nothing (table 11.1). And everyone agrees on the goals of a good bankruptcy regime. The first goal is to maximize the total value of proceeds received by creditors, shareholders, employees and other stakeholders. Businesses should be rehabili-

tated, sold as a going concern or liquidated—whichever generates the greatest total value. The second is to rehabilitate viable businesses and liquidate unviable ones. In other words, bankruptcy law should be neither hard on good businesses nor soft on bad ones. The third is to provide for a smooth, predictable transition in the priority of claims as the company moves from a good financial state to a bad one—and thus reduce investors’ risk. That goal is achieved by maintaining the absolute priority of claims in bankruptcy.

Why reform bankruptcy? Bankruptcy reform is less glamorous and takes longer than setting up a one-stop business registry. But having laws that deal effectively with troubled businesses helps get entrepreneurs to the one-stop shop in the first place. Easier exit means easier entry. One study shows that reforms to encourage a fresh start

TABLE 11.1  
Where is it easy to close a business—and where not?

<b>Easiest</b>	Recovery rate	<b>Most difficult</b>	Recovery rate
Japan	92.6	Liberia	7.8
Singapore	91.3	Mauritania	7.8
Norway	90.7	Suriname	7.4
Canada	88.8	Venezuela	6.6
Finland	88.2	Philippines	4.2
Ireland	87.1	Haiti	3.1
Denmark	87.0	Micronesia	3.1
Netherlands	86.7	Congo, Dem. Rep.	2.9
Belgium	85.5	Zimbabwe	0.1
United Kingdom	84.6	Central African Republic	0.0

Note: Rankings are based on the recovery rate: how many cents on the dollar claimants (creditors, tax authorities and employees) recover from the insolvent firm. See Data notes for details. Source: *Doing Business* database.

have raised rates of new business creation by 8–9%.<sup>1</sup> The freedom to fail, and to do so through an efficient process, puts people and capital to their most effective use. The result is more productive businesses and more jobs.

That’s not all. A functioning bankruptcy system

reassures creditors that if things go wrong, they stand a good chance of getting their money back. So they are more likely to lend, and to require less collateral than they would otherwise.

### Who is reforming?

China was the top reformer in bankruptcy in 2006/07. Its Enterprise Bankruptcy Law, 12 years in the making, took effect on June 1, 2007. The law, China’s first regulating the bankruptcy of private enterprises since 1949, significantly strengthens creditors’ powers. Secured creditors with claims created after the law was passed now rank first in payment priority, even over tax and new wage claims. Another first for China: a reorganization procedure for restructuring insolvent companies. The introduction of creditors’ meetings and committees gives creditors more say. Finally, the new law introduces bankruptcy administrators to operate insolvent companies during bankruptcy proceedings.

Five countries in Eastern Europe and Central Asia join China as top reformers this year (figure 11.1). Georgia, the number 2 reformer, passed a new law that maximizes the value of debtors’ assets, sets shorter time limits, regulates bankruptcy trustees and strengthens creditors’ rights. In place of a liquidation process that takes 3.5 years on average, the law establishes bankruptcy procedures that should take less than 1 year in the event of reorganization and just 6 months if the business is slated for liquidation. That would allow Georgia to enter the top 10 list on the speed of resolving bankruptcy (table 11.2).

Armenia passed a new law that incorporates time

limits into the reorganization procedure. Secured creditors no longer vote on a reorganization plan unless the plan involves their pledged property. But the law explicitly prohibits the debtor’s owners from voting as well, so creditors will have a greater say. Hungary passed a law that in most cases grants secured creditors absolute priority to the proceeds from the sale of their collateral. Croatia introduced educational and professional requirements for bankruptcy trustees and shortened timelines.

In April 2007 Uzbekistan issued a decree on voluntary winding-up of companies outside regular bankruptcy. The decree simplifies procedures and provides that if the tax authority does not conduct a tax inspection in time, the company pays only its self-assessed taxes. The decree also exempts financial assistance by the company’s owners from income taxes and sets out the

FIGURE 11.1  
Top 10 reformers in bankruptcy

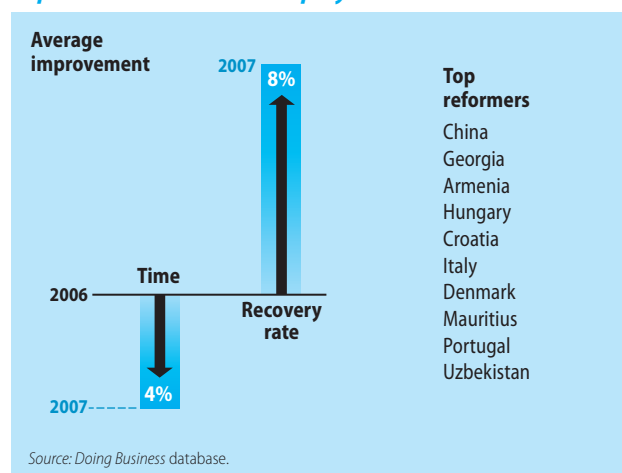


TABLE 11.2  
Where is bankruptcy the most efficient—and where the least?

Time (years)

Least		Most	
Ireland	0.4	Ecuador	5.3
Japan	0.6	Indonesia	5.5
Canada	0.8	Haiti	5.7
Singapore	0.8	Philippines	5.7
Belgium	0.9	Belarus	5.8
Finland	0.9	Angola	6.2
Norway	0.9	Czech Republic	6.5
Belize	1.0	Maldives	6.7
Iceland	1.0	Mauritania	8.0
Spain	1.0	India	10.0

Cost (% of estate)

Least		Most	
Colombia	1.0	Dominican Republic	38.0
Kuwait	1.0	Marshall Islands	38.0
Norway	1.0	Micronesia	38.0
Singapore	1.0	Philippines	38.0
Brunei	3.5	Solomon Islands	38.0
Finland	3.5	Venezuela	38.0
Georgia	3.5	Sierra Leone	42.0
Japan	3.5	Ukraine	42.0
Korea	3.5	Liberia	42.5
Oman	3.5	Central African Republic	76.0

Source: Doing Business database.

procedure for notifying the company's creditors.

Three rich economies improved their bankruptcy systems. Italy reformed for the second year in a row. Italian trustees now have broader discretion to maximize recovery for creditors in asset sales. This is expected to result in more sales of companies as going concerns. Denmark granted the courts more power to oversee trustees and make sure they act efficiently; this has already shortened bankruptcy proceedings. Portugal created fast-track procedures for the voluntary liquidation of businesses. Now an entrepreneur can wind up a company at the registry office. The changes, similar to the recently adopted fast-track provisions for starting a business, are intended to reduce the administrative burden of voluntary closings.

Mauritius made debt enforcement easier by passing the Borrower Protection Act 2007. Before, asset sales took place through a long "sale by levy" process that failed to realize the assets' market value. The new law allows land and buildings to be sold at private auction (table 11.3). Mauritius was Africa's only reformer. Three regions—Latin America, the Middle East and North Africa and South Asia—saw no reforms.

Two countries made bankruptcy more difficult in 2006/07. Botswana amended its Insolvency Act to give wage claims preference over the claims of secured credi-

TABLE 11.3  
**Increasing creditors' rights—a popular reform in 2006/07**

<b>Granted priority to secured creditors</b> China, Hungary, Uzbekistan
<b>Introduced or shortened time limits on bankruptcy procedures</b> Armenia, Georgia
<b>Established reorganization procedure</b> China, Georgia
<b>Set up one-stop shop for voluntary liquidation</b> Portugal, Uzbekistan
<b>Introduced professional requirements for trustees</b> Croatia, Georgia
<b>Strengthened trustees' role</b> Denmark, Italy
<b>Allowed sale at private auction</b> Mauritius

Source: Doing Business database.

tors. This could dampen creditors' interest in extending credit. Meanwhile, Argentina stripped bankruptcy judges of jurisdiction over labor lawsuits and exempted such claims from the automatic stay applicable to claims. Now labor suits are to be concluded at the labor courts before presentation to the bankruptcy court for verification. Argentina also enhanced employees' right to demand payment of wage claims out of a distressed company's assets. A company must set aside 1% of its gross revenue to satisfy labor claims—even if it failed to turn a profit.

## What to reform?

Forty countries have implemented bankruptcy reforms since 2003 (figure 11.2). Many of these reforms were long overdue. That's especially so for poor and middle-income countries, where bankruptcy laws are 40 years old on average. In contrast, rich countries have laws that average 5 years in age. By now the largest emerging economies—such as Brazil, China, India, Indonesia, Thailand and Vietnam—have all introduced significant bankruptcy reforms. Eight types of reform were most effective:

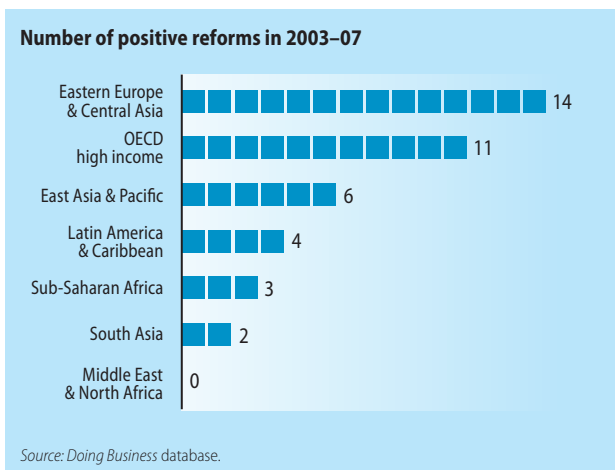
- Minimize dependence on the courts.
- Establish specialized courts.
- Shift power to creditors.
- Limit appeals.
- Introduce time limits.
- Use the Internet to post decisions and publicize auctions.
- Introduce floating charges.
- Develop the trustee profession.

## Minimize dependence on the courts

In many countries, improving bankruptcy means improving the courts. The reason is that winding up or reorganizing a company often depends on the judicial system, with courts and court-appointed trustees directing proceedings. Thirteen of the top 25 economies on the ease of closing a business also rank among the top 25 on the ease of enforcing contracts.

One solution is to minimize the involvement of judges. In some economies with efficient bankruptcy, courts play only a limited role, if any. In Australia, Hong Kong (China), Singapore and the United Kingdom secured creditors can appoint a receiver to take control of a distressed company. This happens without any court involvement. The receiver then manages the company in preparation for selling its assets. More often than not the business is sold as a whole unit. The recent reforms in Georgia and Mauritius are based on the same idea. Other countries—such as Portugal and Uzbekistan in 2006/07—have made voluntary liquidation an administrative process.

FIGURE 11.2

**Few reforms in South Asia, none in the Middle East****Establish specialized courts**

Other economies—including the Dominican Republic, Georgia, Moldova, Tanzania, Thailand and Uganda—have made it easier to process bankruptcy cases by creating specialized commercial or even bankruptcy courts. Specialization increases efficiency.<sup>2</sup> Judges can more easily gain expertise in bankruptcy and will be better equipped to deal with issues of insolvent businesses. Bosnia and Herzegovina and Ghana have created bankruptcy sections within commercial courts, with specially trained judges and innovative management systems to deal with court backlogs.

**Shift power to creditors**

Many economies have altered the roles and responsibilities of stakeholders in bankruptcy proceedings. Those that have strengthened the power of creditors include China, France, Indonesia, Korea, FYR Macedonia, Poland, Puerto Rico, Romania, Serbia, Slovakia, the United States and Vietnam. In Poland the creditors' committee now decides whether a business should be reorganized or liquidated. In France, Korea and Slovakia the creditors' committee votes on reorganization plans. Before, the court made the final decision.

Strengthening creditors' rights—for example, by establishing creditors' committees—increases their confidence in the bankruptcy process. A bankruptcy case is likely to result in the continuation of the underlying business in countries that allow creditors to appoint or replace an administrator and have access to the administrator's report. In contrast, such an outcome occurs in only 34% of countries that do not grant creditors such rights.

Several economies have given priority in bankruptcy claims to creditors. Bosnia and Herzegovina, China, Finland, FYR Macedonia and Vietnam granted a higher priority ranking to secured creditors. France gave a “super secured” position to creditors that lend money to distressed companies, making it easier for such companies to obtain new loans and continue operating.

**Limit appeals**

Another solution is to limit procedural appeals. In El Salvador the wait for a first-instance court to hand down its decision in a debt enforcement case can last up to 3 years. Appeals may drag the litigation out for another year or more. In both El Salvador and Slovenia, where the initial decision can be appealed to 2 higher levels of courts, restricting appeals to just 1 would speed bankruptcy proceedings. In Spain appeals no longer suspend debt recovery.

Restricting the number of appeals, or allowing debt recovery to proceed even when there is an appeal, is a simple way to make bankruptcy more efficient.<sup>3</sup> When used as a delay tactic, appeals reduce recovery rates, which depend on how quickly the business or its assets are sold.

**Introduce time limits**

FYR Macedonia, Poland, Portugal, Serbia, Slovakia, Spain and the United States have all either introduced or shortened statutory deadlines for bankruptcy proceedings. Imposing time limits also makes bankruptcy cheaper: reforms in Bulgaria, Estonia and the United Kingdom have halved bankruptcy costs. But some countries have bucked the trend. Thailand abolished a 1999 regulation limiting appeals, making it easier for debtors to abuse the appeals process and prolong bankruptcy.

**Use the Internet to post decisions and publicize auctions**

Where court reform is difficult, reformers can take advantage of the Internet. Croatia has launched a website, called “Judges Web,” where the court posts information on decisions in bankruptcy cases and announcements of asset sales. Assets are more likely to fetch a higher price, because detailed descriptions and even pictures can be posted for long periods. Before, sales would typically draw few buyers because they were advertised only on a certain day and in a certain newspaper. FYR Macedonia and Serbia plan to introduce similar websites.

## Introduce floating charges

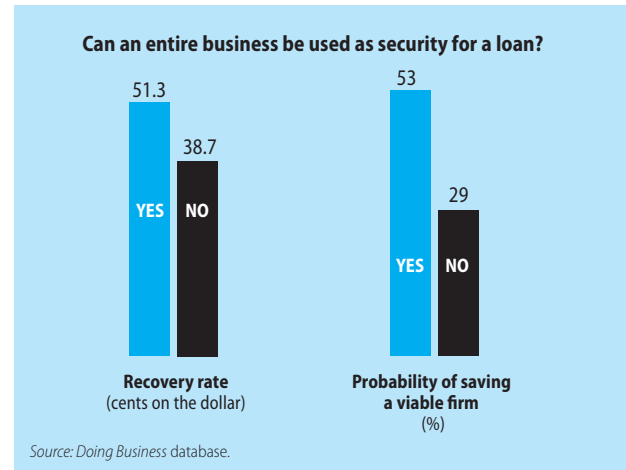
Reformers need not focus on bankruptcy law alone. Denmark and several Eastern European countries have introduced floating charges (or similar enterprise charges) over the past decade. These are instruments through which companies grant a general security—covering even future assets—over their entire business. With them, viable businesses are more likely to be sold as a going concern in liquidation and foreclosure proceedings, since the charge prevents creditors from laying claim to different assets of the company. Creditors gain maximum flexibility in enforcing their security. They also recover more: countries that allow floating charges have higher recovery rates than countries that don't allow them (figure 11.3).

## Develop the trustee profession

Finally, several middle-income countries have taken steps to develop the profession and role of bankruptcy trustees, who play an important part in reorganization. Argentina, Chile, Serbia and Slovakia require trustees to have certain educational or business qualifications and to pass an exam. Serbia established a special agency to

FIGURE 11.3

### Floating charges improve results in bankruptcy



supervise the profession and introduced ethical standards that all administrators must abide by.<sup>4</sup> Chile stopped paying trustees a fixed monthly salary and linked their pay to the proceeds realized from asset sales. That encourages trustees to maximize returns by selling distressed assets quickly and removes any incentive to drag out the bankruptcy process.

## Notes

1. Armour and Cumming (2006).
2. World Bank (2005a).
3. Djankov and others (2006).
4. Yap (2007).