

The Challenges of Bankruptcy Reform

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Abstract

The 2008 financial crisis was followed by a global economic downturn, credit crunch, and reduction in cross-border lending, trade finance, remittances, and foreign direct investment, which adversely affected businesses around the world. The consequent increase in the number of firm insolvencies in the financial and corporate sectors highlights the importance of efficient

bankruptcy laws. This paper summarizes the theoretical and empirical literature on bankruptcy design, discusses the challenges of introducing and implementing bankruptcy reforms, and presents examples of how policymakers are trying to use the current economic downturn as an opportunity to engage in meaningful reform of the bankruptcy process.

This paper—a product of the Finance and Private Sector Development Team, Development Research Group—is part of a larger effort in the department to study bankruptcy reform. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted at lklapper@worldbank.org.

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The Challenges of Bankruptcy Reform

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1. Introduction

The 2008 global financial crisis has resulted in declining demand for goods and services, decreasing availability of external finance, declining investments, and reductions in remittances, forcing firms around the world to face insolvency. For instance, in 2009, the number of corporate bankruptcies in Japan was 13,306, an increase of 4.9% from 2008 (Teikoku Databank, 2010ⁱ); the number of corporate bankruptcies in the U.K. was 94,135, an annual increase of 5.88% (Ministry of Justice, 2010ⁱⁱ); and the number of corporate bankruptcies in Germany was 32,687, which represents an 11% annual increase from 29,291 insolvencies in 2008, though the volume of debt more than doubled (Statistisches Bundesamt Deutschland, Jahrbuch, 2009ⁱⁱⁱ). In the United States in 2009, 60,837 businesses declared bankruptcy, representing a 40% increase in filings from 2008 (American Bankruptcy Institute, 2010^{iv}).

During previous financial crises in Russia, East Asia, and Argentina, attention turned to the importance of bankruptcy laws that supported the efficient resolution of financial distress (Claessens, et al., 2003). This same shift of attention is happening today, as policymakers have become concerned about the effectiveness of existing bankruptcy laws, which encompasses both the usefulness of reorganization and liquidation laws, as well as efficiency of the judicial system to uphold the laws in court.

Despite the frequency of insolvency and firm closure, the usage of legal procedures associated with bankruptcy vary significantly around the world, due to differences in legal traditions, accounting standards, regulatory frameworks, and macroeconomic factors (Claessens and Klapper, 2005). For instance, bankruptcies are less common in countries with concentrated banking systems and in firms with single banking relationships, and are more common in firms with more complex capital structures (Babchuck, 1988). Furthermore, the laws in some countries

only allow for the liquidation of bankrupt firms and provide limited protection for entrepreneurs and managers of bankrupt firms. Other countries have more bankruptcy options (such as reorganization and out-of-court mediation), though the effectiveness of these laws in practice varies across countries (Lee, Peng and Barney, 2007).

In a narrow context, the efficient resolution of insolvency depends on the ability to reorganize viable firms and to liquidate the unviable ones at low cost. Ideally, only the best users of economic resources would continue as active companies, while less performing companies would be taken-over by more capable owners or liquidated through assets sales. In reality, however, there are many constraints to the efficient reallocation of capital. Primary among these constraints are existing legislation.

Since the liquidation of assets and the distribution of the raised capital among creditors is a collective enforcement procedure, bankruptcy law aims to solve this collective action problem. When a debtor becomes insolvent, creditors have incentives to engage in a “run on the bank,” enforcing their individual claims as quickly as possible, even if the result is a reduction in the overall value obtained. To prevent this scenario from occurring, bankruptcy law should provide a mandatory and orderly mechanism for the reallocation of insolvent assets (Jackson, 1982).

More generally, the resolution of bankruptcy is an important example of the broad institutional context within which firms in specific countries operate (Peng, 2003; Scott, 1995). This embraces the formal as well as informal societal rules that affect entrepreneurs. This includes the design of bankruptcy laws, the structure of capital markets, and the perception of stigmas related to personal responsibility (Lee, Peng and Barney, 2007).

This paper proceeds as follows. Section 2 discusses the importance of enacting strong bankruptcy regimes for private sector development and growth. Section 3 reviews the impact of

the recent financial crisis on the resolution of bankruptcy and analyzes some recent bankruptcy law reforms from around the world. Section 4 concludes.

2. Features of a Well-Functioning Bankruptcy Regime

2.1 The Importance of Bankruptcy Regime Design

The literature suggests that firm exit is a necessary condition for economic growth: when innovative activity in an industry increases, firms' overall survival rates often decrease, but those that do survive tend to be stronger (Audretsch, 1991; Porter, 1990; Nickell, 1996, Klapper, et al., 2006). For instance, bankruptcy reforms in South Korea after the 1997 economic crisis contributed to productivity growth by allowing inefficient firms to exit, encouraging new entries and stimulating surviving firms to become more efficient (Lim and Hahn, 2003). In other words, higher competition supported by lower downside risk and lower bankruptcy cost would entice inefficient firms to exit (Ahlstrom and Bruton, 2004).

Lower bankruptcy costs can also stimulate inefficient firms to exit and encourage greater entrepreneurial activity and new firm creation. For instance, the earlier introduction of bankruptcy codes in England and in the United States may have supported the more dynamic private sector entry and exit seen in those countries (Di Martino, 2002). To the contrary, in Italy and France, the commercial code introduced by Napoleon in 1807 reinforced the severity and the penal character of medieval legislation that discouraged firm failures (Bignon and Sgard, 2007). Qualitative evidence suggests that in England the devices and instruments provided by legislators were more effective than Italian equivalents in attracting a larger number and higher quality of new entrepreneurs. Furthermore, quantitative evidence shows that English procedures assured creditors higher dividends and shorter waiting-time than in Italy.

In a scenario of high bankruptcy costs, inefficient firms would be reluctant to file for bankruptcy and would continue to operate at a financial loss (Gimeno, Folta, Cooper, and Woo, 1997). In any economy, letting some failing firms exit is essential to economic health (Ahlstrom and Bruton, 2004; Khanna and Poulsen, 1995), and can be beneficial for the society as a whole (Miller and Reuer, 1996; Venkataraman, 1997). In Spain, firm exits actually have a positive impact on total industry factor productivity (Callejon and Segarra, 1999). Similar findings have been reported about post-1997 Asia (Ahlstrom and Bruton, 2004; Carney, 2004; White, 2004).

Previous literature also shows that well functioning bankruptcy regimes are necessary to ensure financial discipline in successful market economies (Smaoui and Boubakri, 2004; Nellis, 2003). For instance, since the ease of bankruptcy determines the maximum downside risk of a venture, only high-risk entrepreneurs will be willing to make significant investments in start-ups in countries with unfriendly bankruptcy regimes. Thus, by limiting downside risks and increasing upside gains entrepreneurship is encouraged, leading to an increase in and the number and variety of people pursuing entrepreneurial activities (Lee, Peng and Barney, 2007). Indeed, data from a Eurobarometer survey^v show that the fear of bankruptcy is one of the most important reasons given by individuals for not forming their own businesses, although the extent of the deterrent effect varies across countries (Armour and Cumming, 2007).

Speedier court resolutions can also reduce uncertainty for entrepreneurs, creditors, and management, and improve assets value and transparency. Actions that expedite court procedures include minimizing dependence on the courts (through appointment of a receiver for distressed companies, e.g. Georgia), establishing special courts (e.g. India, Thailand, Indonesia and Uganda), and limiting appeals and introducing time limits (Djankov et al., 2008).

Currently, in many countries, the existing bankruptcy regimes do not perform very well (Djankov et al., 2008). A survey on debt enforcement of practitioners from 88 countries indicates that bankruptcy procedures are time-consuming, costly and inefficient (i.e., unable to preserve the business as a going concern). In only 36 percent of countries, the business is preserved as a going concern, and an average of 48 percent of the business' value is lost in debt enforcement. In a well – functioning bankruptcy system, the regime would ensure that the highest total value is achieved for the distressed firm. In other words, whether the firm should be closed down, liquidated piecemeal, sold as a going concern, or reorganized should depend on which option creates the most value for its creditors and shareholders. Some portion of firm value should be preserved for shareholders, even in bankruptcy. Otherwise, shareholders may do anything to prevent bankruptcy, including undertaking high-risk projects when the corporation is under distress (Hart, 2000). Shareholders that don't exercise caution can lead to bankruptcies with high administrative costs and long delays, and the sales of viable businesses.

At the same time, ensuring the right incentive structure is critical. During this most recent crisis, for example, Germany revisited its long-standing rule *requiring* company management to file for bankruptcy in certain situations, or face imprisonment. While this rule was originally instituted to ensure a level of debtor discipline and creditor confidence, the financial crisis prompted a fear amongst some policy-makers that declining asset values would create widespread *de facto* balance-sheet insolvencies and prompt managers to put otherwise viable companies into insolvency proceedings. As a result, the filing requirement was amended to be less stringent (see Table I).

While there is no blueprint for optimal bankruptcy systems, there are several important principles that underlie the design of a good bankruptcy regime (Hart, 2000; UNCITRAL, 2005):

- Provide certainty in the market by ensuring a transparent and predictable insolvency law, while at the same time maintaining the flexibility required to allow viable companies to reorganize;
- Maximize the value of assets and preserve the insolvency estate to allow equitable distribution to creditors. For instance, recovery rate varies among the economies from 4.4 cents on the dollar claimants in Philippines to 92.5 cents in Japan (World Bank, 2010);
- Strike a balance between liquidation and reorganization;
- Ensure equitable treatment of similarly situated creditors, recognize existing creditors' rights, and establish clear rules for ranking priority claims;
- Provide for timely, efficient, and impartial resolution of insolvency. For instance, Ireland provides the fastest bankruptcy procedure – less than 4 months – whereas in many developing countries the process takes many years: Mauritania – 8 years, India – 7 years, and Maldives – more than 6 years (World Bank, 2010).

Importantly, it should be noted that these principles must be considered in the context of the unique political structure, legal culture, and economic and social framework of each country. Considering the political, economic, social, and judicial differences between countries, a “one size fits all” approach is not wise and workable in this area of law (Gromek, Broc and Parry, 2006)

2.2 The Importance of Legal and Judicial Efficiency

The evolution of the bankruptcy framework depends on the balance of political powers in a particular country, causing the bankruptcy regimes to differ significantly even among developed countries (Westbrook, 2002). A study of 37 high-income and developing countries finds that

during the 1990s, bankruptcies were higher in countries with Anglo-Saxon legal systems, greater judicial efficiency, market-oriented financial systems (characterized by multiple banking relationships), and overall greater economic development (Claessens and Klapper, 2005). These results confirm earlier findings that the legal environment is the main regulator of bankruptcy and transactions between entrepreneurs (Guislain, 1995).

For example, an analysis of publicly listed firms that filed for bankruptcy under new bankruptcy laws introduced during the East Asian financial crisis finds that seeking bankruptcy protection is higher in countries with strong creditor rights and greater judicial efficiency (Claessens, Djankov, and Klapper, 2003). This study highlights the importance of establishing a balance between protection of creditors' rights (such as the sale of assets in the case of default), which is essential for firms' access to finance, and identification and reorganization of viable enterprises.

Differences between debtor-friendly regimes and creditor-friendly regimes also influence a firm's decision to use in or out-of-court reorganizations. In this regard, distressed firms are more likely to use in-court reorganizations in debtor-friendly regimes (White, 1993). A study of 169 financially distressed firms finds that firms that settle out-of-court have more intangible assets, a larger percentage of debt owed to banks, and fewer lenders (Gilson et al., 1990). On the other hand, an earlier study shows that firms that resolve financial distress out-of-court are more likely to remain highly leveraged and are more prone to experience further financial distress (Gilson, 1997). Bankruptcy laws might also affect the ex-ante behavior of firm managers and owners in operating and financing the firm (La Porta et al., 1997). Debtor friendly laws might encourage managers to seek bankruptcy protection from their creditors at an earlier point, which may increase the likelihood of the firm's survival and may ultimately benefit its claimants. Such

laws, however, also allow incompetent managers to keep their jobs. Therefore, the bankruptcy regime should encourage the behavioral incentives that require that all responsible parties incur some costs for the firms' poor performance. These costs usually take the form of a reduction in creditors' claims value or negative consequences for the managers.

These disincentives become extremely important in preventing imprudent investments, enhancing contractibility, and distributing loans with too high probability of default (Rajan and Zingales 1995, White 1993). However, when the personal costs are too high they discourage public bankruptcy filings in favor of private negotiations. For instance, studies of distressed firms in the United States (Gilson 1989, Gilson and Vetsuypens 1994) find that after a bankruptcy filing managers receive significantly lower salaries and bonuses (on average, managers receive only 35% of their previous gross income), and more than half of the sampled managers are fired. Since new management may be unfamiliar with the company and unable to ensure a smooth transition, the creditors will suffer higher costs of resolution during distress.

In addition to reputational and financial losses, entrepreneurs and managers suffer psychological costs—referred to as *stigma*—when filing for bankruptcy (Shepherd, 2003). Individuals from different countries are likely to differ in the level of stigma they experience upon bankruptcy (Hofstede, 1980). For instance, in a study of eight countries, individuals that reported an aversion to 'uncertainty' were significantly less likely to be business owners, presumably because of fear of failure (McGrath, MacMillan, and Scheinberg, 1992).

The importance of efficient bankruptcy laws is highlighted by evidence showing that creditors and debtors change their behaviors when there are improvements in bankruptcy procedures, such as laws dictating each side's rights in resolving disputes stemming from contract violation. In the absence of bankruptcy law, even when coordinated liquidation would

maximize the returns to the creditors as a group, each creditor has an incentive to collect the debt privately before other creditors. Because the firm's assets are sold in an ad hoc approach, the resulting first-come, first-served ordering of creditors' claims will prompt an inefficient liquidation (Longhofer and Peters, 2004).

To the contrary, efficient bankruptcy laws give order to the sales and distribution of assets of insolvent firms and can positively affect loan terms (such as spreads, rates, and collateral requirements), leverage ratios, and bank recovery rates (Davydenko and Franks, 2008; Acharya, et al., 2008). For instance, the introduction of Debt Recovery Tribunals in India reduced delinquency in loan repayment rates by between 3 and 11 percent and interest rates fell by up to 2 percentage points (Visaria, 2006).

2.3 Additional Challenges for Insolvent Firms

2.3.1 In Middle-income Countries

As they are undertaking reform to 'catch-up' their insolvency systems with international best practice, middle-income countries will also have to consider addressing some of the emerging issues facing developed countries in insolvency reform. Specifically, issues such as the treatment of corporate groups (where an enterprise consists of two or more legal entities), which even the most advanced insolvency laws do not contemplate (Uttamchandani, 2008) and the treatment of insolvencies that span two or more jurisdictions, thereby creating complex issues of asset recovery, jurisdiction and regulatory oversight (Uttamchandani, 2008). While these issues may be overly complex for small undeveloped economies, India, China, Turkey, and other middle-income countries wrestling with basic questions, may also have to tackle these more challenging ones at the same time.

In particular, given the dramatic increase in foreign direct investment in these countries over the past few years, large insolvencies will increasingly have transnational dimensions. This will put the countries' insolvency systems into direct contact with systems from advanced countries, necessitating clear rules of engagement. In Europe, for example, the Parmalat case underscored the need for courts in multiple jurisdictions to coordinate efforts in winding up an insolvent estate and for insolvency administrators appointed in one jurisdiction to have clear guidelines under which they could seek recognition from local courts in other jurisdictions. Because of the increased integration that some middle-income countries have achieved with the global economy, they will no longer have the luxury of limiting their insolvency regimes to purely domestic considerations.

2.3.2 In Labor-Intensive Firms

There has been little empirical work addressing the specific challenges of labor intensive firms in the bankruptcy process, despite the growing importance of service-oriented firms. For instance, how does the relationship between a firm and its employees affect the choices made by an insolvent firm? Indeed, bankrupt firms routinely cite employee retention as a critical concern (Berk et al., 2010; Berkovitch et al., 1997).

The literature suggests that the process of corporate bankruptcy varies by labor intensity (Wang, 2009). First, labor intensive firms increase their leverage more sharply prior to bankruptcy compared with capital intensive firms, relying on borrowing to finance firm growth instead of undertaking typical restructuring activities. In conjunction with their increased borrowing, labor intensive firms postpone bankruptcy longer after initial cash flow shortfalls, but

file more quickly after suffering shocks to fundamentals (such as declines in sales and revenues). Second, labor intensive firms are more likely to be liquidated during the bankruptcy process.

2.3.3 In Small and Medium- sized Enterprises (SMEs)

Most literature considers the importance of bankruptcy codes to address the needs of creditors that lend to large, capital intensive firms. However, good bankruptcy systems can also be important for smaller and labor intensive service firms. For instance, 80 percent of U.S. firms that filed for bankruptcy reported assets under \$1 million, and 88 percent reported having fewer than 20 employees (Warren and Westbrook, 1999). In additions, SME's are especially vulnerable to macroeconomic and financial shocks; for example, SME insolvencies in Denmark, Italy, Spain, and Ireland exceeded 25 percent between 2007 and 2008 (OECD, 2009).

However, despite the importance and the complexity of small business as a contributor to the economy, there has been little academic research on the effect of bankruptcy legislation on SMEs. In many jurisdictions, different bankruptcy procedures are available for corporate and individual debtors, or distinguish between debtors who are 'traders' (individual or corporate) or consumers (Armour and Cumming, 2007).

Lenders to small businesses often require that the owner provide a personal guarantee to the loan, such as a second mortgage on his house (Berkowitz and White, 2004; Djankov et al., 2002). Guarantees of this sort put the personal assets of the firm's owner on the line and blur the distinction between the assets of the firm and those of the owner; in other words, the limited-liability of the firm no longer applies to this particular loan. In addition, personal bankruptcy laws would apply to this firm in the case of default. A survey of a sample of individuals from the United States who filed for bankruptcy during the 1980s estimates that around 20% had debts

from a failed business (Sullivan, et al., 1989). While the personal guarantee of a firm's owner might encourage a level of financial discipline, in countries without a personal bankruptcy framework, a single business failure could doom an owner to a lifetime of outstanding debt (Uttamchandani and Menezes, 2010) and effectively prevent them from re-entering the market as seasoned entrepreneurs (Armour and Cumming, 2005).

3. Bankruptcy Regimes during the Crisis

3.1 Bankruptcy Regime as One of the Main Tools for Entrepreneurship Recovery

The 2008 global financial crisis is causing a sharp increase in bankruptcies around the world. Ensuring that viable companies can continue to operate as going concerns and preserving jobs has become especially important. In response, policymakers are debating whether existing bankruptcy regimes adequately address current business' demands.

Ineffective procedures for dealing with bankruptcy can deepen and prolong a crisis. Low demand may make firms reluctant to restructure and regain their health, affecting the health of the banking sector and further restricting credit to firms that may be recovering. Distress among financial institutions can also reduce the incentives for firms to repay their loans. The bankruptcy processes – which are generally already under strain during normal times – can be completely overwhelmed (Demirgüç-Kunt, 2009).

During 2009, the number of corporate bankruptcies in Japan was 13,306 (up 4.9% from 12,681 in 2008, Teikoku Databank, 2010^{vi}), in Great Britain 94,135 (5.88% growth compare to 2008, Ministry of Justice, 2010^{vii}), and in Germany, the number of corporate bankruptcies was 32,687, which represents 11% annual increase, whereas the volume of debt more than doubled (Statistisches Bundesamt Deutschland, Jahrbuch, 2009^{viii}). In 2009, 60,837 businesses in the

United States declared bankruptcy, representing a 40% increase in filings from 2008 (American Bankruptcy Institute, 2010^{ix}).

The World Bank's Financial Crisis Survey shows that in the EU, the use of bankruptcy procedures was less frequent than the use of state aid and debt restructuring. On average, 8.3 percent of European firms applied for state aid in the previous 12 months (as of June – July 2009), whereas, only 2 percent of all surveyed companies filed for bankruptcy. When considering only the subsample of firms with overdue payments, the proportion of firms that filed for bankruptcy increased to almost 6 percent, with the highest percent in Hungary (9.9%) (Correa and Iooty, 2010).

In light of widespread financial distress, many researchers have expressed concern that the costs of direct intervention of governments, such as giving assistance to individual companies, comes at a significant fiscal obligation to taxpayers. In addition, it prevents meaningful restructuring, encourages the private sector to expect similar assistance, gives incentive for imprudent risk-taking incentives, and paves the way for more frequent and costlier crises in the future (Caprio et al., 2008; Demirguc-Kunt and Serven, 2009; Demirguc-Kunt et al. 2008).

Encouraging bankruptcy reform could also be effective to encourage new entrepreneurship during a financial crisis. Policymakers drew an important lesson from the 1997 East Asia Financial Crisis in which several countries began reconsidering their corporate bankruptcy laws when existing bankruptcy systems did not allow the corporate sector to rehabilitate during long term economic recession (Armour and Deakin, 2001). When illiquidity spread across the region, South Korea, Malaysia, and Thailand were forced to modify their laws to favor the rehabilitation of distressed firms, as an alternative to liquidations (Carruthers and

Halliday, 2007). Indonesia and Thailand also introduced specialized courts to implement bankruptcy procedures.

Prior to the reform, Thai judicial procedure was fraught with large transactions costs: Bankruptcy cases dragged on for more than two years on average, and there was no specialized court to implement expedited procedures. The law lacked provisions for debtors in possession financing and an automatic stay to protect assets. The law also did not explain how creditors and managers should prepare and implement a restructuring plan. As a result of reforms in Thailand, both creditors and debtors experienced immediate financial gains from the new bankruptcy procedures (Foley, 1999).

Many other examples suggest that by restructuring viable businesses and quickly liquidating nonviable ones, well-functioning bankruptcy regimes can reallocate and remobilize resources, thus speeding up the recovery from the crisis. For instance, according to Bergoening et al., 2007, Chile's bankruptcy reform was the main reason for its relatively quick recovery from a deep recession in the early 1980s. Gine and Love (2008) came to the same conclusion regarding Colombia's bankruptcy reform in 1999, which began in the middle of the financial crisis that spread across Latin America. They show that the reform significantly improved the efficiency of the bankruptcy process by streamlining reorganization proceedings.

Even among countries that have existing bankruptcy laws, additional mechanisms might be created in the times of global or regional economic downturn. For example, the Mexican and East Asian crises spurred the introduction of the "London rules" or, "prepackaged" bankruptcies, which encourage all creditors to sign out-of-court agreements reached among the majority of creditors prior to the bankruptcy filing, and which sometimes include formal arbitration rules, making it possible for an out-of-court system to circumvent formal judicial process and its

attendant costs (Demirgüç-Kunt, 2009). Lately this instrument has been used by many countries. For instance, Italy now allows distressed companies to seek an agreement with creditors before filing for bankruptcy, which permits the companies to continue operating.

Miller and Stiglitz 1999 and Stiglitz 2002 proposed the use of “super-bankruptcy” to enhance recovery and provide protection against large macroeconomic shocks. By keeping existing management in place and forcing debt-to-equity conversions, the super-bankruptcy mechanism aims to prevent liquidations that occurs as a result of a system-wide crisis and does not punish existing managers who become victims of external macroeconomic shocks. The downside of such a policy is the moral hazard of protecting firm managers and owners (who caused the problems in the first place) and the incentive it gives to creditors to charge higher interest rates in normal times because their loan is at risk (Demirgüç-Kunt, 2009). Evidence from the East Asian crisis suggests that adopting super-bankruptcy was inefficient; there were not too many liquidations as a result of the crises, and, if anything, too many unviable firms were allowed to continue their operations for too long (Claessens et al., 2005). For instance, in France, giving priority to creditors lending money to distressed companies over previous secured creditors (“super priority”) made it easier for such companies to obtain new loans and continue operating (Hart, 2000).

3.2 Reforming Bankruptcy around the World

During normal times, proposed reforms to bankruptcy laws might face opposition from lobbies of judges, administrators and lawyers poised to derail change (Djankov, 2009). However, during financial crises, policymakers might be forced to addresses weaknesses in their

insolvency codes in response to an increase in loan defaults and business closures. Table 1 summarizes a number of recent reforms introduced following the 2008 financial crisis:

Table 1. Examples of Bankruptcy Reforms, 2008-2010

Country	Year	Reforms	Objective/Outcome
Bolivia	2008	Bolivia made the bankruptcy process more complex by suspending applications for voluntary restructuring. The only remaining option is a bankruptcy procedure that typically takes many years. The reform was intended to prevent viable businesses that were hit by the financial crisis from exiting the market (World Bank, 2009).	The reform worsened the situation for distressed firms wishing to seek resolution. Many companies, which would have otherwise been able to recover, were forced in long liquidation procedure. (World Bank, 2009)
Czech Republic	2009	The new Insolvency Act introduced reorganization as the preferred method for resolving insolvency, established an electronic insolvency register and set new qualification standards for trustees. (Osicka, T., Kucerova, I., Mestanek, P., 2008)	According to a 2009 EBRD assessment, the Czech Republic's insolvency system, in contrast to previous evaluations, was deemed as "highly compliant" with current international standards. The assessment noted that new law positively affected the areas of assets of the estate, creditor rights, and reorganization (EBRD,2009a).
Estonia	2008	In December 2008, Estonia enacted a new Restructuring Act, which, is modeled on the U.S. Chapter 11 approach, as well as on the German Insolvenzordnung and the Finnish Saneerauslaki. The new Act is intended to help financially troubled firms avoid liquidation and optimize the possibility of retaining their reputation and the trust of their creditors. The act enabled distressed companies on the verge of insolvency to reorganize themselves, restructure their debt, and apply other measures to regain financial health and restore profitability. Control of the troubled firm remains in the hands of the management and late-pay penalties, as well as other court-centered activities, are halted (EStandards Forum, 2010).	According to Sorainen, 2009, creditors may find the new Act attractive because it offers them a clear non-bankruptcy means of maximizing the amount they are able to collect from a debtor. The new reorganizations regime may prove attractive to investors, who would be interested in purchasing debt or equity in financially distressed firms (U.S. Department of Commerce, 2010). Following the reform, bankruptcy costs in Estonia are an average of 9% of the estate, compared to a regional cost of 13.4%. The average recovery rate is 37.5 cents on the dollar in Estonia, compared to an average of 28.3 cents in the region (World Bank, 2009).
France	2008	The reform improved the insolvency process by encouraging pre-insolvency workouts and by ending the requirement for estimation of the value of assets by a public auctioneer.(World Bank, 2009)	The new legislation has as its main purpose to promote restructuring rather than bankruptcy proceedings (Lucheux, J-M., Pusch, O., 2009).
Germany	2009-2010	Germany enacted temporary relief during the financial crisis, which will be effective only until December 31, 2010. It eliminated its law requiring managers of potentially viable companies to file for bankruptcy in case of overindebtedness, where business survival is more likely than in the case of illiquidity. The current law allows these companies to continue to operate. Moreover, in July 2010, the German Federal Ministry of Justice issued an internal draft bill of the Act to Facilitate Further the Restructuring of Companies,	A recent study finds that the fallout from the financial and economic crisis caused more than 34 percent of the bankruptcy applications filed in 2009; it is expected that insolvencies will reach a new record in 2010 (Wirtschaft Konkret, 2010).

		which would result in significant amendments to the German Insolvency Code and thereby facilitate the in-court restructuring of German companies. The draft bill has met with broad political support and highly positive feedback in the market, making it likely that it will become law within the next few months (Meier, W., Kern, M., Schauenburg, C., 2010).	
Italy	2005-2008	The amendments to the Bankruptcy Law, Royal Decree No 267 of 1942, aimed to introduce efficient pre-bankruptcy procedures, an automatic stay period of 60 days, and the possibility of paying secured creditors less than the full amount of debt. At the beginning of the crisis, in October 2008, the Law No.166 allowed the insolvency procedure to be extended to companies within the corporate group of the debtor parent entity, as well as those who provide services to the debtor on an exclusive basis. Alongside this, the amendments enable debtors to pursue immediate asset disposal plans. (EStandards Forum, Insolvency Framework, Italy, 2010)	The main goal of the reform was the simplification of business restructurings. Prior to the reform, insolvency procedures were predominantly aimed at liquidating insolvent enterprises (Novarese, 2009).
Kuwait	2009	Reform enabled restructuring of companies facing financial difficulty or insolvency. The assets of any local companies declared bankrupt will be valued based on current market values, with priority on any profits designated to repaying government loans. Any assets left after repayment of the loans should go to company shareholders, followed by companies and individual creditors who have an equal claim. (World Bank, 2010)	The Hawkamah-World Bank-OECD survey, based on the Principles and Guidelines for Effective Insolvency and Creditor Rights Systems developed by the World Bank, scored nations according to a 155 point system, with higher scores denoting stronger insolvency regimes. Kuwait achieved a score of 104 out of 155, which is below the OECD average of 124, but above the MENA average of 88. (Saidi, N., 2009)
Lithuania	2008	The reform shortens time limits on bankruptcy procedures by eliminating the minimal term of 3 months, which must be passed in order for the creditors to apply to a court. The reform also aims to secure the interests of the creditors, i.e. to transfer control of the company to the administrator in order to prevent directors or owners from unfairly selling or hiding the assets of the bankrupted company. This transfer also establishes higher standards of responsibility for the persons executing the procedures of the bankruptcies. (World Bank, 2009)	Currently in Lithuania, it takes an average of 1.5 years to complete a bankruptcy proceeding (in contrast to 1.7 prior to the reform), whereas the average time for the region is 3.1 years and the time required in OECD states averages 1.7 years. It costs an average of 7% of the estate in Lithuania, compared to an average regional cost of 13.4% and an OECD average of 8.4%. (EStandards Forum, Insolvency Framework, Lithuania, 2010)
Malawi	2009	The new Companies Regulation that took effect in June 2009 has made the mechanism for payment of liquidators more transparent. The new regulation sets a cap on the liquidator's fees: 5% of the value of the estate. Before, liquidators had the discretion to set their own fees, usually at around 10% of the value of the estate. Malawi is also undertaking a comprehensive overhaul of its insolvency and secured transactions laws, expected to be completed in 2011. (World Bank, 2010)	According to the 2010 Doing Business Report, Malawi became the top reformer in closing business procedures. The reduction of the bankruptcy costs and strengthening of creditors rights were two main goals of the reform. As a result, of the reform, the overall cost of the insolvency procedure in Malawi fell from 30% of the value of the estate to 25%. Moreover, the secured creditors, rank-ordered based upon investment registration dates, received the first priority in recovering money.

Middle East	2009-2010	The crisis forced 11 MENA jurisdictions to establish dialog in order to reinforce the bankruptcy regime in the region. In May 2009, in Abu Dhabi, representatives from Egypt, Jordan, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Sudan, the United Arab Emirates and West Bank and Gaza signed a joint declaration on intended reform in the region. (the “Abu Dhabi Declaration”) as part of a WorldBank/ OECD/ INSOL International/ Hawkamah sponsored Forum on Insolvency Reform in MENA (FIRM). Countries agreed to set up public-private partnerships to strengthen and unify their bankruptcy regimes. The insolvency laws in operation within the Dubai International Financial Centre have been proposed as a basis for the unification, as it offers cost-effective, efficient and timely mechanisms for dealing with insolvency and creditor/debtor rights issues (Saudi Gazette, 2010).	Reform of bankruptcy and creditor rights is aimed at improving economic efficiencies and strengthening market resilience in times of crisis (Saudi Gazette, 2010).
Poland	2008	Poland amended its bankruptcy law to permit the option of reorganization prior to bankruptcy by introducing prepackaged reorganizations and regulating the receiver profession. (World Bank, 2010). Also the U.S. Department of Commerce's 2009 Country Commercial Guide to Poland stated that the courts are generally slow, but that reforms to the insolvency regime are ongoing. It noted that the new Bankruptcy Law permits filings by either the troubled firm's board of directors or by creditors (U.S. Department of Commerce, 2010)	Poland was among the Eastern European and Central Asian countries that led the world in insolvency and credit reforms. As a result, the average costs of bankruptcy procedures dropped 2% and the recovery rate grew for 2%. (World Bank, 2009).
Romania	2008	As a result of the rising number of insolvency cases, the government increased the cost of the liquidation procedures attempting to stop falling market (The Diplomat, 2010). A November 2008 amendment to its insolvency law requires 1.5% of the amount recovered from each insolvency procedure to go to a fund for reimbursing the expenses of insolvency administrators. The aim was to ensure that insolvency administrators are paid even when debtors have no assets, but the reform put additional constraints on closing businesses. (World Bank, 2010)	The number of insolvencies rose by 25% in 2009 compared to 2008. A collapse in sales, mostly in the residential market, forced 3,600 real estate and construction companies to enter into insolvency. The reform reduced the amount creditors recover in cases where the company has assets and increases inefficiency in cases where few or no assets are available (The Diplomat, 2010).
Russia	2008-2009	Russia's insolvency regime has undergone significant reform in 2008-09. The reform introduced a set of professional requirements for administrators. Moreover, the enforcement issues have been addressed with the introduction of a non-judicial procedure for foreclosures, aimed at simplifying and expediting the process. (EBRD, 2009b)	The 2010 EBRD report discloses that legislative changes were expected to result in substantial improvement in the position of secured creditors. (EBRD, 2010) The costs of a bankruptcy proceeding are of 9 % of the estate in Russia, compared to an average regional cost of 13.5 %. (World Bank, 2009)
Tajikistan	2010	The changes to the law “On Bankruptcy” reduced statutory time limits and the costs of proceedings. (USAID, 2009)	The reform is expected to reduce the time required for closing a business from three to two 2 years, decrease the cost of bankruptcy from 9% to 2% of total asset values, and increase the ratio of funds recovered for investors from 25.4 cents to 35 cents per U.S. dollar. (USAID, 2009)

Uruguay	2008	The new bankruptcy law No. 18.387 consolidated all the different procedures existing prior to the enactment of the new law in just one unique procedure called "Concurso". This procedure is applicable for all natural or legal persons but not for final consumers (Garcia, 2008). Further, the "Concurso" may result in: (1) the agreement between the debtor and the creditor; (2) the liquidation of the firm as a unity; and (3) the liquidation of the firm into parts. The new Bankruptcy Law aims to encourage companies to disclose financial difficulties in a promptly manner, to simplify the access to new insolvency procedures, to facilitate the agreement between debtors and creditors, and to preserve the viable firms (Garcia, 2008).	In Uruguay, it takes an average of 2.1 years to complete a bankruptcy proceeding, whereas the average time for the region is 3.3 years. It costs an average of 7% of the estate in Uruguay, compared to an average regional cost of 15.9% and an OECD average of 8.4%. The average recovery rate is 43 cents on the dollar in Uruguay, compared to an average of 26.8 cents in the region. (World Bank, 2009)
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As the main goals of the reforms enacted in times of crisis are to improve economic efficiencies and strengthen market resilience, the most popular trends among the reformers currently include:

- *Establishing reorganization procedures or pre-packaged arrangements* (e.g., Italy, Kuwait, Czech Republic, Poland, Estonia, Mauritius, Uruguay, Rwanda, Sierra Leone, Philippines, and France). In comparison, Bolivia suspended accepting applications for voluntary restructuring. While this reform was aimed at preventing viable businesses from exiting the market, the result was that many distressed companies that otherwise might have been able to recover were forced into a long liquidation process.

- *Introduction of shorter time limits on bankruptcy procedures* (Lithuania, Tajikistan). For instance, the Republic of Tajikistan introduced a new bankruptcy law which streamlined the bankruptcy process and reduced the time required for closing a business from three years to two. In Lithuania, reforms to commercial bankruptcy laws reduced the three-month wait-period for creditors to initiate bankruptcy proceedings to a thirty-day grace period; during the first half-year of 2009, bankruptcy procedures were initiated for 936 enterprises, which is 55 percent more than at the same time in 2008.^x

- *Introducing professional requirements for bankruptcy administrators* (Russia, Albania, and Columbia). These administrators play essential roles in insolvency procedures, by taking part in managing insolvent companies and selling the assets of nonviable ones. For example, Colombia, Russia, and Albania introduced licensing requirements for bankruptcy receivers and training courses to improve professional qualification standards.

These examples show that many governments recognize the importance of bankruptcy reform to preserve businesses as going concerns for as long as possible, as well as to strengthen creditors rights and improve the overall investment climate. However, much more work must be carried out in order for most countries to comply with international best practices that underlie the design of good bankruptcy laws.

4. Conclusion

The 2008 global economic downturn, credit crunch, and reduction in cross-border lending, trade finance, remittances and foreign direct investment, has adversely affected businesses around the world. The significant increase in the number of insolvent firms in the financial and corporate sectors highlights the importance of improving bankruptcy regimes. It is critical to examine and draw lessons from previous reforms as governments and policymakers use the current recession as an opportunity to engage in meaningful reform of the bankruptcy process.

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ⁱⁱⁱ Data available at: <http://www.destatis.de/jetspeed/portal/cms/> See also “Deutsche Welle” at <http://www.dw-world.de/dw/article/0,,5335740,00.html>

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