Measureable Results!
Doing Business Project Encourages Economies to Reform Insolvency Frameworks

Over the past 10 years, nearly 100 economies have reformed their insolvency regimes as a result of many factors, such as financial crises and to some extent the IFC/World Bank Doing Business project (Box 1). In the aftermath of the global financial crisis, governments around the world implemented extensive insolvency reforms aimed at strengthening regulatory mechanisms for resolving insolvency cases—to stimulate entrepreneurship and generate a more efficient allocation of market resources. This SmartLesson discusses two of the main best practices that stem from the key reform areas: determination of business viability, and introduction of reorganization proceedings.

Background

The IFC/World Bank data collection efforts on the Resolving Insolvency indicator are of paramount importance, because these data help economies identify areas of much-needed reforms. The 2008 financial crisis hit small and medium businesses worldwide, pushing many to the edge of bankruptcy with a series of aftershocks that contracted credit financing, dampened market demand, and tightened cash flows. For instance, from 2008 to 2009, the number of businesses that filed for Chapter 11 in the United States soared from 6,971 to 11,785, and the number of businesses that filed for Chapter 7 increased from 560,015 to 819,362.1

The upsurge of bankruptcy cases worldwide has challenged insolvency regimes in unprecedented ways. The increase in the number of firms in financial distress underscores the need for a transparent and predictable insolvency legal framework for reorganizing viable firms and liquidating unviable ones in a cost-effective and timely manner. It also calls for an efficient judicial system, equipped with specialized insolvency courts and administrators, to avoid case backlogs and bottlenecks. In response to these urgent needs to strengthen insolvency frameworks, 71 economies have initiated a series of insolvency reforms since 2008.2 The number of insolvency reforms recorded by Doing Business has almost tripled, increasing from 10 reforms worldwide in Doing Business 2008 to 29 in Doing Business 2012.

The Resolving Insolvency indicator examines the time, cost, and outcome of insolvency proceedings involving domestic businesses that operate in 185 economies. The data are derived from questionnaire responses received from local insolvency practitioners and verified through the study of laws and regulations in conjunction with public information on bankruptcy systems. The ranking on the ease of resolving insolvency is based on the recovery rate, which is a function of time, cost, and other factors such as lending rate and the likelihood that a company will continue to operate as a going concern. The recovery rate is recorded as cents-on-the-dollar recouped by creditors through reorganization, liquidation, or debt enforcement (foreclosure) proceedings.

Lesson 1: Determine the viability of businesses facing insolvency

A key characteristic of a good insolvency regime is its ability to maximize an economy’s growth and employment prospects by differentiating between viable and unviable businesses. For a business that

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2 Major insolvency reforms counted according to the Doing Business methodology.
Box 1: IFC/World Bank Doing Business Project

At the time of its launch in 2002, the Doing Business project covered five indicator sets for 133 economies. Currently, the project surveys 185 economies, ranking them on 10 different indicator sets. The primary goal is to measure the business regulatory environment for domestic small and medium enterprises. By collecting comparable global data and ranking economies on the ease of doing business, the project encourages governments to reform their business regulations to be more conducive to doing business.

IFC and the World Bank publish the country rankings in annual Doing Business reports. This promotes competition among different states and inspires governments to expand their reform efforts even further. Numerous economies have used the reports as a tool to inform their regulatory reform efforts. Many governments, especially in low- and middle-income economies, take Doing Business rankings seriously and actively direct their reform efforts toward improving their rank.

The Investment Climate Department at IFC provides local governments with technical assistance on the Doing Business reform preparation and implementation. The IFC/World Bank Doing Business subnational project also assists several countries with improving business regulations on a regional level. The IFC/World Bank Doing Business project serves as a data platform for developing client engagement and generating reforms.

is sustainable, this determination prevents premature liquidation, thus preserving the firm as an agent of future growth, protecting employees’ jobs, and safeguarding the network of suppliers and customers. For a business deemed unviable, a fast and low-cost liquidation proceeding permits an effective reallocation of resources to more productive and efficient sectors of the economy. Therefore, determining the viability of a business is the crucial first stage in resolving insolvency—keeping viable firms in existence and helping unviable firms make way for new firms, thereby promoting healthy competition in the economy.

In about half of the economies studied for Doing Business 2013, insolvency laws establish objective criteria to determine the type of proceeding to be initiated based on the viability of a business. The majority of economies across all regions resort to the use of courts to decide whether a business should be liquidated. For example, in Hong Kong SAR, China, Section 178 of the Companies Ordinance (Chapter 32) specifies the standards to determine the viability of an insolvent firm, and the court makes the final decision based on that regulation.

Recovery rates tend to be higher when specialized insolvency administrators make the final decision on firms’ financial conditions and their operational viability (Figure 1). Analysis reveals a positive and statistically significant correlation between the use of insolvency administrators and the creditors’ recovery rates. The average recovery rate of economies where insolvency administrators determine the viability of firms is more than 10 percent higher than that of economies that use other mechanisms to distinguish viable from unviable businesses. Only about 4 percent of low-income economies grant an insolvency administrator the right to make a final decision about the future of businesses in distress, whereas 20 percent of high-income economies do so. No economies in Europe and Central Asia or South Asia grant this power to insolvency administrators, while 27 percent (the highest rate) of high-income OECD and Middle East and North Africa economies use insolvency administrators to determine firm viability.

Lesson 2: Introduce a reorganization proceeding.

Doing Business data show that introducing an efficient reorganization proceeding allows economies to advance in the ranking for ease of resolving insolvency. In the context of insolvency proceedings, the ultimate goal of reorganization is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations. In some cases, reduction of the scope of the business or sale of the entire business as a going concern would also be considered reorganization.

Figure 1: Recovery Rates with/without Insolvency Administrators

Note: The recovery rate and whether an insolvency administrator makes the final decision on a company’s viability are positively correlated at a statistically significant level of 5 percent, after controlling for income level.


Though the Doing Business report does not provide direct reform and policy recommendations to governments (this is done by other IFC and World Bank units), it does signal to policymakers what needs to be done to improve their debt enforcement mechanisms. (For an example of how the Doing Business data can be used as a tool to aid the reform process, see Box 2.)
Incorporation of a reorganization proceeding in an insolvency framework helps add dynamism to the economy and promote the development of an active entrepreneurial culture. By preventing the unnecessary liquidation of viable firms, reorganization offers a turnaround opportunity for productive businesses facing insolvency. Furthermore, reorganization encourages an entrepreneurial culture of innovation through the introduction of a system that does not punish failure when viable firms can still be saved. For example, creditors receive higher recovery rates from businesses that keep operating as going concerns than from firms that are sold piecemeal. Continued operation also results in the preservation of more jobs, supply chains, and customer networks.

Globally, the average recovery rate of economies that widely use a reorganization proceeding to preserve viable firms is more than two times higher than the recovery rate of economies where liquidation or foreclosure is the most commonly used proceeding. In most cases, reorganization allows companies to continue operating as going concerns. This significantly improves insolvent businesses’ asset value compared to piecemeal sale of assets, which is usually conducted in a liquidation proceeding. According to the Doing Business data, only 6 percent of low-income economies tend to use reorganization proceedings to save viable businesses in distress, and they have an average recovery rate of 15.6 cents on the dollar. Conversely, viable insolvent businesses undergo reorganization in 66 percent of high-income economies, and the average recovery rate is 61.8 cents on the dollar.

Use of insolvency proceedings greatly varies across and within regions. For instance, 45 percent of OECD economies use reorganization as the most common insolvency proceeding to save viable firms and have an average recovery rate of 83 cents on the dollar, as opposed to 57 cents on the dollar with liquidation (Figure 2). In East Asia and the Pacific region, the average recovery rate for economies where viable businesses undergo reorganization is 82 cents on the dollar, more than twice that in economies that predominantly use liquidation or foreclosure to resolve similar insolvency cases. However, other regions, such as South Asia and Sub-Saharan Africa, lag behind, with less than 5 percent of their economies using reorganization proceedings to save viable firms. This is, in part, because of the necessity to develop a strong institutional framework with active links between judicial courts and insolvency institutions. Effective implementation of reorganization requires a well-functioning insolvency regime to allow financial institutions to continue providing credit to the market and play an active role in the reorganization of firms. (See also Box 3.)

Conclusion

A sound insolvency regime can be an effective tool for fostering an efficient allocation of resources in an economy, thus increasing creditors’ recovery rates and decreasing the cost and time needed to resolve insolvency cases. Evidence from the Doing Business data on the global practices for resolving insolvency reveals the importance of two prerequisites: 1) determining the viability of businesses facing financial difficulties. In February 2010, the government of Chile enacted Law 40.416, introducing economic insolvency advisors endorsed by the Superintendence of Bankruptcies to determine the viability of firms in financial distress. Upon the request of a small or medium firm, the economic insolvency advisor conducts a study of the firm’s financial situation and recommends reorganization if the firm is found to be viable, or liquidation if it is deemed unviable.

Box 2: Streamlining the Process in Chile

Chile provides a good example of recent reforms designed to streamline the process of determining the viability of businesses facing financial difficulties. According to the Legislative Guide on Insolvency Law (United Nations Commission on International Trade Law, 2005), liquidation usually results in the dissolution or disappearance of a debtor that is a commercial legal entity and discharge of a natural person debtor. Although generally requiring the sale or realization of assets to occur in a piecemeal manner as quickly as possible, some insolvency laws permit liquidation to involve the sale of the business in productive units or as a going concern; under other laws that is permissible only in reorganization.

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viability of businesses in order to establish an appropriate insolvency proceeding, and 2) introducing reorganization proceedings, as a complement to liquidation ones, to prevent premature termination of viable firms.

In addition to these prerequisites, many economies have implemented other important reforms to improve insolvency resolution mechanisms, such as specifying the professional or academic qualifications of insolvency administrators, introducing or shortening time limits of insolvency procedures, and strengthening the rights of secured creditors. Economies vary significantly in their social and economic needs, so there is no “one-fits-all” insolvency reform. IFC/World Bank reform units need to work closely with client economies to diagnose their inefficiencies in resolving insolvency and help them develop appropriate reform strategies to make resolving insolvency faster, cheaper, and more efficient.

Box 3: Dramatic Improvement in Latvia

Latvia has been closely monitoring its progress on the Resolving Insolvency indicator, and its bankruptcy specialists have been working over the years to advance Latvia’s ranking. The country’s recent insolvency reforms exemplify an introduction of the reorganization proceeding into the insolvency legal framework.

Since 2007, Latvia has introduced successive reforms to streamline insolvency proceedings and strengthen its regulatory framework. On November 1, 2010, Latvia passed its new Insolvency Law introducing reorganization to complement the existing liquidation proceeding. To do so, Latvia extended the responsibilities of insolvency administrators, making them liable for damages caused to the state, debtors, or creditors and putting them in charge of communicating with creditors. The law restored the debtor’s ability to settle its obligations and introduced a wide range of methods to keep a viable company operating as a going concern by, for example, increasing the debtor’s capital share.

As a result of these successive reforms, Latvia experienced the biggest improvement worldwide on the ease of resolving insolvency. From 2009/10 to 2010/11, creditors’ recovery rate increased from 32 cents on the dollar to 56 cents.

One of the important goals of a fully developed insolvency framework is to maximize the value of an insolvent estate and optimize the results for the parties involved in insolvency proceedings. It is desirable to have different insolvency proceedings available under legal frameworks to support flexible and practical arrangements that recoup more investments for creditors.

The Doing Business team thanks contributors for providing survey data.