

RESOLVING INSOLVENCY ISSUES: COMPETITIVENESS OF BUSINESS ENVIRONMENT OF SELECT COUNTRIES

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ABSTRACT

Resolving insolvency which indicates the ease of exiting the business, is an important element of any business cycle. An important objective of any insolvency regime is to keep the corporate operating viable and impede hasty liquidation. The availability of reorganization proceedings, successful negotiation and realization of money by the creditors, reduction in time and cost and a qualitative judicial process are the important components of a good insolvency framework. The present paper analyzes the insolvency resolution status of the selected countries and the effects it makes on the business environment. It also analyses the reformative steps taken by the economies for improving this indicator, to boost the confidence of the investors.

Keywords: Liquidation, reorganization, recovery rate

INTRODUCTION

The business environment of any nation is extensively studied by the foreign investors when they think about investing and starting a corporate in that country. A strong system for resolving the insolvency if prevalent in a country, would strengthen the business environment by reducing the cost of debt, the time required for repayment, increasing the credit limit, reduction in the failures, and reducing the time and cost involved in the proceedings.

According to Crimizi et al. (2010), there are three main objectives of any insolvency law. First is transparency which comprises of a system of publicizing and maintaining the index of the judgements, procedure for registering, securing interest and a notice of the proceedings of insolvency. Second is predictability that is to be fair, clear and simple. If it is not achieved, it results in more cost as the extra credit cost will be increased for compensating the uncertainty by the financial Institutions. Third is efficiency which of course is difficult to quantify and measure. Thus, efficient insolvency resolution would involve reorganization of the viable corporates and liquidation of the unviable firms.

LITERATURE REVIEW

Favara et al. (2012) argued that firms' equity risk is lowered if there is debt reorganization. Countries favoring debt reorganization have lower equity-bonds-return volatility. The relations become weak if the insolvency procedure of a country favors the liquidation. Demirguc et al. (2016) examined the effect of the ability to have long term debts over the growth volatility at the level of the firm. They found that countries with better financial systems prefer long term finance as against short-term finance as the refinancing risk is reduced. Visaria (2009) examined the introduction of the tribunals in states in India and the links in claim and overdues and found that tribunals decreased delinquency of loans and interest rates. Bruno et al. (2009) found that soft bankruptcy laws lead to liquidation. This in turn results in low investment, however rich investors can invest irrespective of law. It makes the exit of the poorer investors possible and reduce the demand of labor and wages. Ludek (2008) studied the impact of the strongness of bankruptcy laws over the liquidation cases in a situation of default where the creditors could not liquidate the firm. A positive correlation was revealed between them and it was found that soft bankruptcy laws should be preferred if the cost of liquidation is very high. Menezes et al. (2014) explained that the rules for a failing business determines the investors' support for new businesses. Effective insolvency regimes make the banks and lenders more willing as they know that they would be able to recover some part of their investment if the business fails. This stresses the importance of efficiency in solvency regimes. Rodano et al. (2011) found that the reorganization procedure in Italy led to the increase in the rate of interest on the financing of loans. Ponticelli et al. (2016) studied the effects of similar bankruptcy law with variation in the enforcement by the courts, in Brazil. They found that variation in enforcement influences the reforms of the financial sector in terms of investment and availability of credit. Thus, the countries with weak judicial systems will have more defaults.

OBJECTIVE OF THE STUDY

The objective of the study is to analyze the status of insolvency resolution while doing the business and the reformative steps taken by the selected countries in this regard.

RESEARCH METHODOLOGY

Outcomes of the proceedings of insolvency which are enumerated by the World Bank in their reports of 'Doing Business' and are widely accepted have been included in this research. A sample of 6 countries is studied. These are India, China, Pakistan, Singapore, Japan and USA. The ranks under the parameter 'resolving insolvency' of "Doing Business Report" for the selected countries out of 190 countries are India (52), China (51), Pakistan (58), Singapore (27), Japan (3), and USA (2).

ANALYSIS

Indicators of resolving insolvency

The indicator 'resolving insolvency' is judged on the basis of rate of recovery - which is expressed in terms of cents on dollars, time taken to resolve the insolvency - expressed in number of years, cost of the process - which is expressed as a percentage of the estate and the quality of the judicial process index.

Table 1

Comparative Analysis of Rate of Recovery, Time, Cost and Judicial Process Quality

S No.	Countries	Rate of recovery (Cents on dollar)	Time (years)	Cost (%)	Judicial process quality index (0-16)
1	India	71.6	1.6	9.0	7.5
2	China	36.9	1.7	22.0	13.5
3	Pakistan	41.7	2.8	4.0	11.5
4	Singapore	88.7	0.8	4.0	8.5
5	Japan	91.8	0.6	4.5	13.0
6	USA	81.0	1.0	10.0	15.0

Source: Compiled data based on updation till May 1, 2018.

Following inferences are drawn from the above Table 1.

1. Rate of recovery

The rate of recovery is taken as cents on the dollar which is recovered by the secured creditors through the judicial reorganization, liquidation or the enforcement proceedings.

In India, after the introduction of Insolvency and Bankruptcy Code (IBC), the recovery rate went up to 71.6 cents on the dollar as against 26.5 cents earlier. This shows the positive impact of the code on building the confidence of the investors. Japan has the highest recovery rate of 91.8 cents on a dollar, which is almost equal to the best performing country under this parameter - Norway, which has 92.9 cents per dollar recovery. China has the lowest recovery rate with 36.9 cents on a dollar followed by Pakistan with 41.7 cents on a dollar. This indicates that the rate of recovery is quite low in China and Pakistan and more than 50% of the investments could not be recovered in case of insolvency. Thus, India is moving ahead on this parameter.

2. Time taken for recovery

Time refers to the period which is taken for the company to recover their credit and it is expressed in years. Singapore and Japan take less than one year that is 0.8 years and 0.6 years respectively, which is very near to the best performer Ireland with 0.4 years. The maximum time taken by Pakistan is 2.8 years. China takes 1.7 years which is almost equal to what India takes i.e.,1.6. Before the introduction of the Insolvency and Bankruptcy Code, India used to take 4.3 years which has significantly reduced to 1.6 years, which is an impressive achievement. India is moving towards the countries having good performance in this parameter.

3. Cost incurred on the proceedings

The cost parameter refers to the cost which is incurred on the proceedings. It is the percentage of the value of the estate of the debtor. The cost of proceedings is maximum in China which is 22% and minimum in Pakistan and Singapore with 4%. India has 9% cost which is almost equal to the cost in United States which is 10% and less than South Asian average of 9.9 % which indicates that in India the cost of proceedings is less than China but still it has to go a long way to reach Norway who is the best performer in this parameter with 1% cost.

4. Index of the judicial process quality

The judicial process quality index has a total score of 16 which is divided into 4 indicators having various questions on which the quality is judged. A high score is indicative of a better quality of judicial process.

Table 2

Comparative Analysis of Index of the Judicial Process Quality

COUNTRIES	TOTAL (0 -16)	The commencement of proceedings (0-3)	Debtors' asset management (0-6)	The process of reorganization (0-3)	The participation of creditors (0-4)
India	7.5	2.0	4.5	0	1.0
China	13.5	3.0	6.0	2.5	2.0
Pakistan	11.5	2.5	5.5	1.5	2.0
Singapore	8.5	3.0	4.0	0.5	1.0
Japan	13.0	3.0	6.0	3.0	1.0
USA	15.0	3.0	6.0	3.0	3.0

Source: Compiled data based on updation till May 1, 2018.

I. Commencement of proceedings index has got 3 parts

- A.** Whether the debtor can start both liquidation and the reorganization proceedings or not: It was found that in all the countries that are China, Japan, Pakistan, Singapore and USA, the debtor could start both liquidation and reorganization, but in India debtors could only start the reorganization process.
- B.** Whether creditors can start the insolvency proceedings or not: it was found that in China, Japan, Singapore and USA, the creditors can start both reorganization and liquidation proceedings. In Pakistan they can go for only liquidation and in India they cannot go for any of the proceedings.
- C.** The standard which is used to commence the proceedings, whether it is the liquidity test where debtors are not able to pay their debts as they mature, or the valency test where the liability of the debtor exceeds its assets or both is judged: India, Pakistan, China, Singapore and USA use the liquidity test standard whereas in Japan both the standards are used.

II. Management of debtor's assets

It ranges from 0 to 6. A higher figure denotes better treatment to the debtors' assets from the point of view of stakeholders of the company. It is judged from six angles.

- Can the debtors continue to perform contracts essential for their survival?
In Pakistan, Japan and USA, debtors can continue to perform but not in India, China and Singapore.
- Can the debtors reject very burdensome contracts?
All the countries that are India, China, Pakistan, Japan, Singapore and USA give the debtors this privilege.
- Can the transactions which were preferential before the proceedings be avoided after the association of proceedings?
All the countries under study i.e., India, China, Japan, Pakistan, Singapore and the USA can do so.
- Can undervalued transactions be avoided?
Again, all the countries that are India, Pakistan, Japan, Singapore and USA give this privilege.
- Are there any special provisions in which the debtors can get the finance for functioning during the proceedings?
Here also all the countries that is India, China, Pakistan, Japan, Singapore and USA give this privilege to the debtors.
- Has the post commencement finance a priority over the unused creditors during the distribution of the assets?

Here also all the selected countries show a positive response.

III. Reorganization proceedings index

This index ranges from 0 to 3 and higher values are indicators of parity with practices accepted internationally.

- Whether the reorganization plan is done by the creditors whose rights are affected or by all or by none.

It is found that in Japan and USA, the reorganization plan can be initiated by the creditors with affected rights, in Pakistan and Singapore all can initiate the reorganization plan and in India and China none can do this.

- Whether the dissenting creditor gets as much under reorganization as they would get in the liquidation.

It was found that in Pakistan, Japan and USA they get as much on the reorganization as they get in liquidation but in India, China and Singapore they would not get the same amount.

- Whether the creditors are divided into classes while voting and are treated equally or not. It was observed that in Japan and the USA the creditors are treated equally and are divided into classes while voting but in India, China, Pakistan and Singapore this is not the case.

IV. Participation of creditors

It moves on a scale of 0 to 4 with higher values referring to more participation of creditors.

- Whether the approval of creditors is required to appoint the insolvency representative or not.

It was found that except for the USA, all other countries that are India, China, Pakistan, Japan and Singapore, the creditors approval is not required.

- When the assets of the debtors are sold, whether it requires creditors approval or not.

It was observed that except in Pakistan all other countries that are India, China, Japan, Singapore and USA do not require the creditors approval when the assets of the debtors are sold.

- Whether the creditors can get the final information about the debtors.

It was observed that in India, China and USA they can get the information but not in Pakistan, Japan and Singapore.

- The rights of creditors to object to the decision of rejecting or accepting their claims.

It is found that in Pakistan, Japan, Singapore and USA the creditors have the right but in India and China they do not have the right to accept or reject the claims.

The USA (15), China (13.5) and Japan (13) are highly rated on the scale of 0-16 whereas India (7.5) has the lowest score. Out of the parameters, 'the proceedings commencement' and 'the assets management of the debtor' is still acceptable, but the 'process of reorganization' and the

‘participation of creditors’ are very low on the scale. Thus, India needs to work on all the parameters with special attention on the process of reorganization and the participation of creditors.

REFORMATIVE ACTION OF THE COUNTRIES

Pakistan made insolvency easier by introducing the procedure for the reorganization. The continuation of the business of the debtors during the proceedings of the insolvency was also improved. China improved the process of insolvency by bringing a new reorganization procedure through a bankruptcy law. The creditors’ committees were formed and rights were granted to the secured creditors. The insolvency procedure was streamlined with establishing rules for credit priority after the commencement of proceedings. The role and involvement of creditors was also increased in the proceedings of insolvency. Japan formed the Enterprise Turnaround Initiative Corporation (ETIC) for helping in the revitalization of the companies who had insecure debts but professionally managed. Singapore also made the resolution of insolvency easier. A new scheme of arrangement procedure was established. It had an element of reorganization of debtors in possession.

India's process of resolving insolvency was made simpler by upgrading the process of effectiveness in 2010. This resulted in the decrease in time required for the proceedings. In 2018, India adopted Insolvency and Bankruptcy Code. It is India's first comprehensive legislation on corporate insolvency. The main focus is to have time bound short duration processes and reorganization. For example, under the Fast-Track Corporate Insolvency Resolution Process (FTIR), the process has to be completed within 90 days and maximum grace time of 45 more days, for mid-sized corporations. A new procedure for corporate reorganization was introduced for the debtors. The ‘carrying on’ of the business of the debtors was made possible along with the proceedings of insolvency. India strengthened its procedure by bringing the reorganization proceedings in use. India significantly made the insolvency resolution difficult by not permitting the descending creditors to get as much in reorganization as they would get in liquidation. Thus, the path of reorganization has also been made available as an alternative to liquidation. This has proved to be a significant step towards boosting the investors’ confidence in Indian judiciary.

CONCLUSION

A comparison of India with other countries revealed that India has made evident progress in the recent years as its recovery rate has considerably improved and is nearing towards Singapore and USA in this area. The time and cost involved in the judicial process shows an average improvement. India needs to work on the index of the quality of the judicial process where strict measures need to be taken especially in the areas of participation of creditors and the process of reorganization.

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