Insolvency in Selected OECD Countries: Outcomes and Regulations

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This article describes levels and long-term trends of business and individual insolvency in a country-comparative perspective. The developments are interpreted with respect to the characteristics (and the existence) of statutory insolvency rules.

Long-term developments of insolvencies

Figure 1 depicts the long-term development of all insolvencies, business and personal. The countries selected are those for which longer-term data exist *and* where the reported data differentiate between cases of business and personal insolvency. In order to make meaningful comparisons, the raw data on insolvencies must be normalised. Such a normalisation may take into account different country specificities, like population, number of businesses or average business size in terms of employees. Throughout the article the number of insolvencies is related to one million inhabitants.

All countries show fluctuations and a more or less pronounced upward trend. The exception is Sweden where only a (strong) fluctuation but not an upward trend is visible. The insolvency figures for the US and Canada are not only much higher than they are for the other countries, but they also seem to exhibit a higher growth dynamic. The latter is not the case, however, as the compound annual growth rates are highest by far for Germany (9.6 percent), while the other countries rank between 4.3 percent (Canada, with the lowest) and 6.4 percent (Australia).

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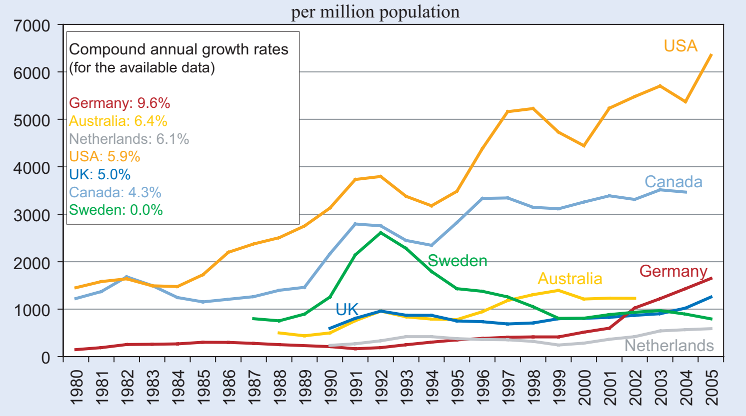
Business insolvencies

Figure 1 comprises two quite different cases of insolvency, those of businesses and of individuals, and, thus, may not be too meaningful. Figure 2 is only about business insolvency. Sweden is a remarkable case, exhibiting a virtual eruption and later a strong decrease in business insolvencies between 1988 and 1998. Next to Sweden is France, with a long-term upward trend of business insolvencies and an amplitude – the latter occurring approximately in the same period as in Sweden.

Figure 1

Total Insolvencies (Business and Individual), 1980–2005

per million population



Source: American Bankruptcy Institute (2005) and national statistical sources.

The developments in the remaining countries can be seen more easily when Sweden and France are excluded from the picture (Figure 3). The most striking feature is the high degree of fluctuation in all countries – plausibly related to the country-specific business cycle. Obvious trends exist for Germany, Canada and the US. Business insolvencies in Germany have been on a nearly continuous and strong rise since the beginning of the 1990s (reunification with East Germany). By contrast, a downward trend is

Figure 2

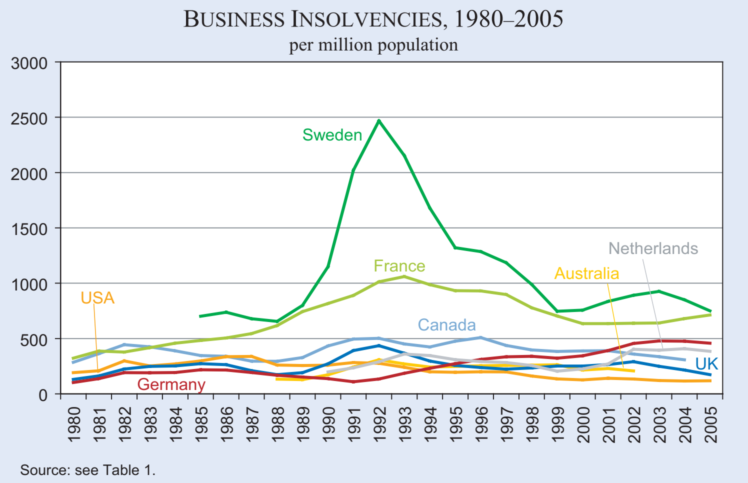
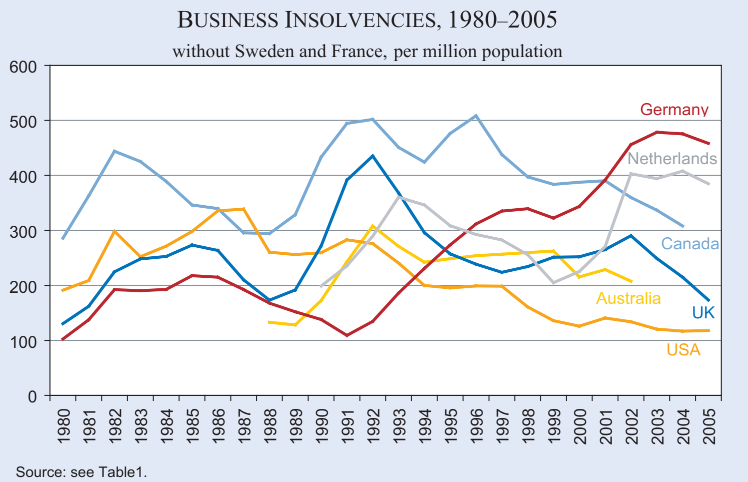


Figure 3



iour of firms is affected by the law in a multitude of ways. Moreover, not only the number of insolvency cases but also the quality of the outcome – from a debtor, a creditor and a social point of view – is affected. Box 1 lists some of the areas influenced by the law.

It should be noted that even the official statistical recording of cases as "insolvency" (or "bankruptcy", for that matter) is affected (item 3 in Box 1).

Not only is business behaviour influenced by the insolvency law in many ways, the law itself is multidimensional. In order to characterise insolvency laws and to compare them across countries, Wood (1995) has identified 7 main and a total of 11 fields of properties of such laws. In a more recent attempt, David Smith and Strömberg (2005) have developed a taxonomy which entails 8 main and a total of 25 fields of properties of insolvency laws (see Box 2).

visible in the case of Canada, at least from the 1990s onwards. A clear and nearly continuous downward trend, however, has occurred in the US since the late 1980s. In 2005, the US figure for business insolvencies per million inhabitants is the lowest of the countries considered here.

The *fluctuations* of business insolvencies, as depicted in Figures 2 and 3, can largely be interpreted in terms of the business cycle. The very strong amplitude of Swedish business insolvencies, e.g., also roughly coincides with the drastic measures of fiscal reforms and restructuring of the Swedish economy. Explaining the different *levels* across countries, however, is more difficult. A plausible approach is to relate business insolvencies to the respective national insolvency laws.

One should be aware that the legal provisions for cases of business insolvency affect much more than only the number of insolvencies treated according to the officially prescribed legal rules. Instead, the behav-

Box 1

The impact of insolvency laws on business behaviour and outcome

The design (even the existence) of an insolvency law influences …

1. Business behaviour
- which legal form is chosen for the enterprise
- how a project is financed (equity or debt)
- the availability of credit and the interest rate level
- how risky the chosen projects are
- how much effort the management exerts to avoid insolvency – or whether bankruptcy is even regarded and used as a management strategy (opportunistic behaviour)
- thus, how often insolvencies occur
- how cases of insolvency are resolved
  - guided by the rules of the bankruptcy law
  - or settled by bargaining (using self-created rules)

2. Quality of the outcome
- what the quality of the procedure is, in terms of:
  - extent of premature (not necessary) liquidations (instead of restructuring and/or provision of fresh money)
  - extent of retarded (but truly necessary) liquidations
  - recovery rate for the creditors
  - potential for a fresh start of the failed enterprise

3. Registering and classification of cases of insolvency

Source: author

Box 2

Taxonomy of corporate bankruptcy codes

Basic characteristics of the laws
- National denomination of "liquidation" code
- National denomination of "reorganisation" code
- Year of last change

Verification mechanisms

Coordination mechanisms
- Automatic stay of assets in reorganisation?
- Automatic stay of assets in liquidation?
- Voting rules for approval of reorganisation plan
- Flexibility in defining voting classes in reorganisation
- Limits on debt write-downs in reorganisation
- Cram-down in reorganisations
- Creditor committees

Protection of third party claimants
- Wage guarantee?
- Procedure should aim towards preserving employment?
- Priority of wages?

Maintaining asset value
- Possession of assets in liquidation
- Possession of assets in reorganisation
- Seniority of new financing in reorganisation?
- Time limits to reorganisation?
- Time limits to liquidation?

Liquidity and disposal of assets
- Exchange of debt for other securities possible in reorganisation?
- Sales mechanism in liquidation?
- Auctioneer/trustee incentive compatible?
- Limits on whom assets can be sold/transferred to?

First-mover advantages
- Debtor has advantage in filing?
- Who submits reorganisation plan?

Source: David Smith and Strömberg (2005) .

This impressive list may even be extended, for instance by the costs of the procedure and whether the court *has* to open a procedure or can decide *not* to do so. In Germany, for example, the costs of an insolvency procedure are considered as relatively high *and* the courts may not take up the case when the remaining assets do not cover the costs of the procedure.

With the help of their taxonomy, David Smith and Strömberg (2005) provide systematically structured and detailed information about the business insolvency regulations in six countries. A similar recent attempt has been undertaken by Davydenko and Franks (2005) for four countries. Their taxonomy, however, is much more condensed. The information provided is contained in Table 1.

Table 1 also contains two lines for scores that have been assigned to the general creditor friendliness of the national insolvency rules. It is often assumed that debtor (creditor) friendly insolvency laws lead to a higher (lower) number of insolvency cases – at least with respect to the number of those cases that are treated within the established procedure (and not outside, i.e. by mutual consent between debtor and creditor(s) and according to self-created rules). The assumption is plausible because a debtor friendly law establishes property rights that are advantageous for the debtor in terms of debt write-off and the possibility for a "fresh start". Thus, an enterprise under a debtor friendly law may have stronger incentives (or weaker disincentives) to fail, and a failed enterprise may more often use the existing regulations which are – in a sense – at its disposal.

We now compare the scores for creditor friendliness with Figures 2 and 3. The UK gets high scores for creditor friendliness by both sources *and* ranks low in terms of number of insolvencies. Also France fits well into the picture. Both sources regard the creditor friendliness as low *and* France has a relatively high level of insolvencies. For Germany, the sources are unanimous concerning the relatively high creditor friendliness of the German system (before the 1999 reform). However, the number of insolvency cases has been spurred not only since re-unification (under the old system) but also after the insolvency reform of 1999 and is presently third behind Sweden and France. The degree of creditor friendliness of the US system is assessed quite differently by the authors. While Wood gives a medium score, the other authors' score is much more on the debtor friendly side. However, US business insolvency cases are on a long-term decline and presently lowest of the countries in our sample (Figure 3).

It is also plausible to assume that the degree of creditor friendliness influences the recovery rate (last line in Table 1; see also Box 1). Again we have two sources. For the UK, France and Germany both sources are unanimous: the average recovery rate is highest in the UK and lowest in France – which corresponds well to the countries' degree of creditor/debtor friendliness. However, the US falls out of line in this case because a high recovery rate (according to the World Bank) coexists with a regime of low to medium creditor friendliness.

That recovery rates under debtor friendly rules are lower is plausible – but only at first glance, because creditors are able to adjust their lending behaviour accordingly. They can be more prudent, can demand higher collateral and can focus on those types of collateral that are not subject to dilution by preferential creditors. The latter type of collateral is, in the case of France, the debtor's receivables. Other collateral is at

Table 1

Business bankruptcy procedures, creditor friendliness and recovery rates in France, Germany, UK, and the US

	France	Germany	UK	US	
Main procedure, in national language	*Redressment judicaire*	*Insolvenzordnung* (the new code since 1999)	Administrative receivership	Chapter 11	Chapter 7
Bankruptcy trigger	Cessation of payments (inability to meet current liabilities)	Cessation of payments or overborrowing	Default (covenant breach)	No objective test. Also solvent firm may enter chapter 11	No objective test
Control rights	Court-appointed administrator	Creditors under court supervision	Secured creditor	Debtor, creditors collectively, bankruptcy court supervision	Trustee
Automatic stay	Unlimited	3 months	None	Unlimited	None
Super-priority financing	Yes	Creditor's approval required	None	Yes	None
Dilution of secured claims	Significant	Limited	None	Limited	None
Scores for creditor friendliness*					
LLSV (1 – 4):	0	3	4	1	n.a.
Wood (1 – 10):	1	8	9	6	n.a.
Recovery rate					
D & F, mean:	54%	61%	74%	n.a.	n.a.
D & F, median:	56%	67%	92%	n.a.	n.a.
World Bank:	48%	53%	85%	76%	n.a.
* Higher score means higher creditor friendliness.					

Source for the verbal information: D & F: Davydenko and Franks (2005).
Source for the scores: LLSV: La Porta, Lopez-de-Silanes, Shleifer and Vishny (1998) and Wood (1995).
Source for the recovery rate: D & F: Davydenko and Franks (2005) and World Bank (2005).

the disposal of the insolvency courts and may be sold by them below the highest bid – in order to preserve employment. Davydenko and Franks (2005) show, first, that French banks, indeed, adjust to the debtor friendly environment. In comparison to the UK and to Germany, French banks demand more collateral per euro of debt and choose other types of collateral. Secondly, the authors point to the fact that the significantly different lending behaviour does, however, only mitigate, not eliminate, the differences in outcomes: recovery rates are lower and insolvencies more often in France than in the UK or Germany.

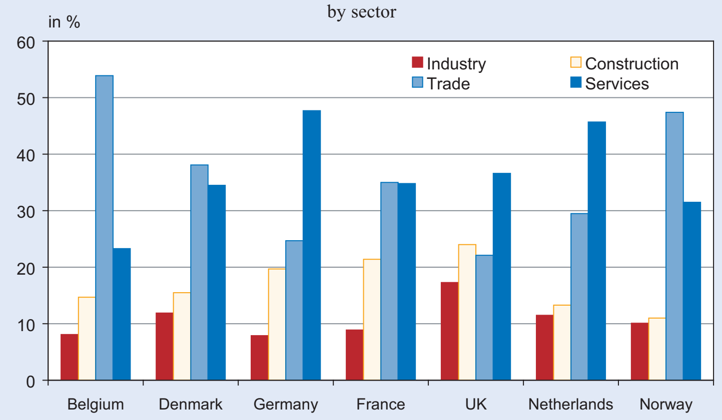
While Davydenko and Franks' analysis is based on a large number of insolvency cases studied in detail but occurred in three countries only, Claessens and Klapper (2005) study the insolvency rules and the number of bankruptcy filings of a large number of countries. The index of creditor rights they use has been developed by La Porta et al. (1998). It consists of 4 sub-indices: *restrictive reorganisation, mandatory management turnover, no automatic stay* and *secured creditors priority*. Claessens and Klapper come to the conclusion that the frequency of bankruptcy filings (1) does *not* clearly correlate with the level of creditor rights, (2) that there *is*, however, a positive correlation with an efficiently functioning general judicial system, and (3) with restrictions to reorganisation. They find (4) that bankruptcy filings are negatively correlated with no automatic stay – i.e., automatic stay of assets, as in the US under Chapter 11 (see Table 1), increases the frequency of filings.

The extraordinarily high level of business insolvencies in Sweden is explained by Buttwill (2004) partly with the high share of insolvencies of "zero employee enterprises". Such "enterprises" when failed are most probably counted as "individual insolvency" in the statistics of other countries. This also fits well with the fact that the official records of cases of individual insolvency are extremely low in Sweden (see below).

A further possible factor influencing the frequency of business insolvency is payment behaviour. As Creditreform (2006) reports, there are indeed considerable differences in payment behaviour across European countries (Table 2). Terms of credit plus delays of payment add up to an average of 89 days in Italy and to 37 days in Sweden. But again, the table

Figure 4

BUSINESS INSOLVENCIES, 2005
by sector



Source: Creditreform (2006).

Table 2

Payment behaviour in Europe

Country	Terms of credit plus factual delays of payment, in days
Italy	89
France	58
UK	54
Belgium	50
Switzerland	43
Austria	41
Netherlands	40
Germany	40
Sweden	37

Source: Creditreform (2006, p. 12).

is only partly able to explain the different insolvency levels. Sweden and Switzerland (the latter not shown in the figures of this article), both with very high insolvency levels, rank low or middle in the number of credit and delay days.

The frequency of bankruptcy cases may also be influenced by the average size of enterprises, their size distribution, the available legal forms for enterprises and the sector structure of the economy. We only provide information about the sector structure of business insolvencies (Figure 4). This sector structure (for 2005) is remarkably similar between countries. In all countries considered *industry* insolvencies account for the lowest share of all insolvencies, while the highest frequency of insolvencies occurs either in the *service* or the *trade* sector. The *construction* sector, however, contrary to the anecdotal evidence, is not a leading insolvency sector but is on the second lowest rank in all countries (except UK).

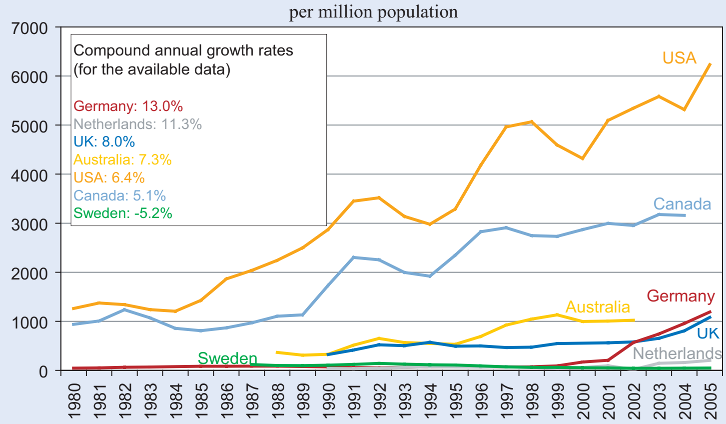
Personal insolvencies

As we have seen, the driving factor behind the general growth dynamics of total insolvencies, depicted in Figure 1, cannot be business insolvency, because this type of insolvency does not exhibit a significantly increasing trend in most countries (see Figure 2). Figure 5 shows that the decisive factor for the overall growth trends as well as for the differences of insolvency levels across countries is individual insolvency. Compound annual growth rates of individual insolvencies are considerably higher than those of total insolvencies. Germany and the Netherlands lead the list with 2-digit growth rates, while the US and Canada are on lower ranks.

The levels of individual insolvencies per million population reached in 2005 are very different. The highest figure by far occurs in the US, while Canada follows at quite a distance. Germany, UK and Australia, being next in ranking, have individual insolvency cases of only about 15 percent of the US level. The contrast between levels of business and of individual insolvencies is most striking in the US and Sweden. While the US in 2005 exhibits the lowest level of business insolvencies (Figure 3), its level of individual insolvencies is highest. In Sweden it is just the other way round: the Swedish level of business insolvencies is highest, but the level of individual insol-

Figure 5

INDIVIDUAL INSOLVENCIES, 1980–2005
per million population



Source: see Table1.

vencies is lowest – and even declining (annual compound growth of –5.5 percent).

Figure 6, without the US and Canada, allows a closer look at the interesting case of Germany, where the insolvency figures have been exploding since 2001. The reform of the insolvency procedure in 1999 had also introduced the possibility of debt cancellation for insolvent non-business individuals. Immediately, the insolvency figures reacted and doubled within two years. A virtual explosion started after the new law was reformed in 2001. The annual compound growth rate for 1999–2005 is more than 40 percent in the case of Germany.

To explain the general trend of steep increases in individual (or: consumer) insolvency, two main factors have been identified. First, consumer debt, mostly unsecured, developed dramatically in industrial countries. This is mainly due to technical developments as well as legal deregulation in the capital markets (Tabb 2005). Second, an important aspect of any (modern, in contrast to medieval or nineteenth century) insolvency law is debt discharge. If a law exists that permits such a discharge, it will be used by the debtors.

Box 3 provides information on the introduction of individual insolvency laws and their reforms across industrial countries. Since 1984, as Tabb (2005) observes, a virtual wave of individual insolvency laws has occurred. In nearly all cases, a debtor friendly legislation has been introduced or the existing laws have been made more debtor friendly. The exceptions seem to be only the US and Canada. Already for more than a hundred years (since 1898) the US had a generous (i.e., debtor friendly) individual insolvency law. It had been modified several times in order to limit abuse, but provided, until recently, "… broad access to an immediate and unconditional discharge of debts, unhampered even by a corresponding requirement of future income contribution" (Tabb 2005, p. 2). It is only the 2005 reform in the US and the 1997 reform in Canada that has taken significant steps in the direction of reduced debtor friendliness. Thus, two opposing trends are observable: generous laws are made less generous (more restrictive), restrictive laws (as until recently in most countries) are made more generous for the debtor.

Box 3

Individual insolvency legislation since 1984

1984	Denmark, United States
1985	Scotland
1986	England and Wales
1989	France
1992	Canada, Norway
1993	Finland
1994	Austria, Germany, Sweden, United States
1996	Hong Kong, Israel
1997	Canada, Netherlands
1998	Belgium
1999	Germany
2000	Luxembourg
2001	Germany
2002	Australia, England and Wales
2005	United States

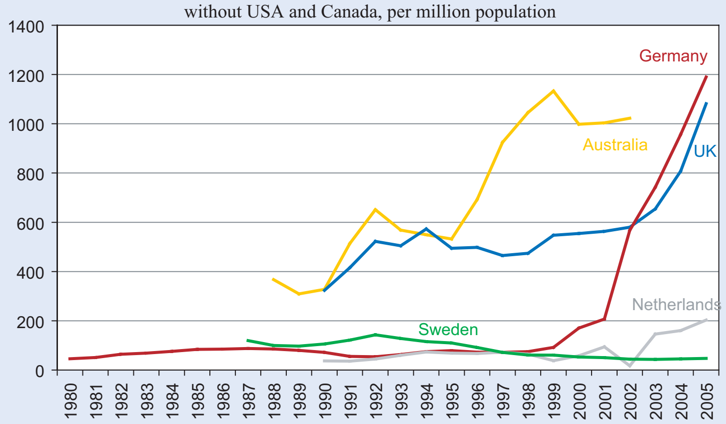
Source: Tabb, 2005.

Opportunistic behaviour, social welfare

It is plausible to assume that the possibility of debt discharge leads to opportunistic behaviour – by enterprises and by individuals. The unprecedented steep increase in individual insolvencies immediately after the introduction of a debt discharge legislation, as is the case for instance in Germany, cannot sufficiently be explained by rising unemployment (in Germany: stagnating, albeit at a high level), rising interest rates (stagnating at a low level) or rising consumer debt (much less increase). Tabb (2005), however, refers to such considerations as an "'abuse' mantra" (p. 7), pointing to a number of studies which have tried to call into question a significant occurrence of opportunistic behaviour of consumers seeking easy debt dis-

Figure 6

INDIVIDUAL INSOLVENCIES, 1980–2005
without USA and Canada, per million population



Source: see Table1.

charge. Zywicki (2005), by contrast, regards the view that household overindebtedness is caused by overlending of banks and adverse income shocks due to unemployment or health problems as the "traditional model" that can no longer satisfactorily explain the consumer bankruptcy trends. He concludes: "Individuals increasingly appear to be *choosing* (italics in the original, R.O.) to file for bankruptcy as a response to financial distress, rather than reducing spending or tapping savings to avoid bankruptcy" (p. 2).

The possibility of an individual debt discharge can be regarded as consumer insurance because it smooths consumption paths over time. Grant and Koeniger (2005) set this in relation to redistributive taxation and to public welfare programmes, both of which also smooth consumption paths. (The relation between redistributive taxation and social insurance was explored already in 1980 by Varian.) For the US, with state level data, the authors try to show that redistributive taxation and debt discharge legislation are substitutes, not complements. They even identify a "policy trade-off in that bankruptcy exemption (i.e., debtor's assets exempted from payment obligations, R.O.) is less effective in increasing welfare if redistributive taxation is already pronounced" (p. 29). They go on to set the recent wave of individual insolvency laws in Europe in perspective to the already existing substantial public assistance programmes in Europe and conclude that, from a social welfare point of view, "the additional insurance provided by these reforms is unlikely to be important … in these European countries" (p. 30).

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