BRIEFING

European Parliament

Harmonisation of insolvency laws: Economic perspectives

SUMMARY

Insolvency laws are the rules governing the legal proceedings applicable to companies unable to repay debts as they fall due. The convergence of non-financial companies' insolvency laws across the Member States is high on the EU's policy agenda: the two reports requested from former Italian prime ministers Enrico Letta and Mario Draghi both emphasised the importance of the convergence of insolvency laws for the defragmentation and proper functioning of EU capital markets. This would help unlock capital and support both the EU's green and digital transitions and its competitiveness in general.

In 2019, the EU adopted a directive to harmonise the preventive restructuring framework. The European Parliament and the Council are currently debating a European Commission proposal on the harmonisation of certain aspects of insolvency regimes.

Theoretical and empirical economic literature has provided substantial evidence suggesting that insolvency regimes impact the conduct of business, in particular access to equity and debt, and their respective costs. The insolvency regime is an implicit component of the contract between a company and its financiers, and determines the chance of recovery of credits in the event of company failure. Converging corporate insolvency rules would also increase the predictability of returns on cross-border financing, enhancing volumes while decreasing costs.

The European Parliament and the Council have expressed support for harmonising insolvency laws with a view to completing the savings and investment union and boosting the financing of the EU's economy.

IN THIS BRIEFING

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Introduction

The Letta Report and the Draghi Report both call for the harmonisation of business bankruptcy legislation – also referred to as insolvency laws – as a critical step towards the defragmentation of EU capital markets and progress towards capital markets union (**CMU**). Harmonisation is essential for the predictability of insolvency proceedings and outcomes, which in turn fosters cross-border business activities and completes the CMU. The European Commission has put forward a proposal to harmonise certain aspects of insolvency laws, which is currently debated in the European Parliament and the Council. Moreover, the reports and the mission letters to the Commissioners-designate, suggest the establishment of a '28th insolvency regime', an EU-level corporate legal framework, encompassing insolvency rules, to which companies – especially innovative ones – could opt in.

The harmonisation of insolvency proceedings is challenging, in particular because it touches on multiple technicalities that have real interrelated effects. The general objective determines both the priorities and the approach to be taken.

The Commission has set the general objectives to (i) maximising the share of debt recovered (recovery rate), (ii) at the highest speed and lowest cost possible, and (iii) with a predictable and fair distribution of recovered value among creditors.[1]

Box 1 – UNCITRAL Legislative Guide on Insolvency Law

The legislative guide of the United Nations Commission on International Trade Law (UNCITRAL) identifies nine key objectives and principles that national insolvency laws should encompass:

- provision of certainty in the market;
- maximisation of value of assets;
- balance between liquidation and reorganisation;
- equitable treatment of similarly situated creditors;
- provision for timely, efficient and impartial resolution of insolvency;
- preservation of the insolvency estate;
- transparent and predictable insolvency law that contains incentives for gathering and dispensing information;
- recognition of existing creditor rights and establishment of clear rules for ranking of priority claims;
- establishment of a framework for cross-border insolvency.

The guide is aimed at achieving a balance between quick and efficient proceedings and the interests of creditors and other stakeholders in the debtor's business.

These objectives are consistent with those identified by the United Nations Commission on International Trade Law (Box 1), as well as with scientific economic evidence.

EU insolvency laws: Latest developments

The Directive on preventive restructuring frameworks,[2] adopted in 2019, is the latest piece of legislation in the area of insolvency laws. The directive seeks to harmonise the legal framework before and after insolvency proceedings. Most notably, it offers debtors the possibility to restructure their debts in order to prevent insolvency and ensure their sustainability; the principle of 'debtor in possession' holds during the restructuring; and an appointed practitioner assists the debtor and creditors in designing the plan.[3]

Prior to this directive, the EU in 2015 adopted the Regulation on insolvency proceedings,[4] which provides the legal framework for determining the jurisdiction cross-border investments' insolvency proceedings, as well as their applicable law – without addressing the 'content of insolvency law'. In addition, the regulation enhances information sharing between jurisdictions and the application of insolvency proceedings decisions.[5]

Furthermore, in 2022, the Commission tabled a proposal for a directive harmonising certain aspects of insolvency law. The objective of the proposal is to enhance and support the 'convergence'[6] of insolvency proceedings for (i) the optimal recovery of assets, (ii) the efficiency of proceedings, and

(iii) the predictable and fair distribution of recovered value. The proposal is currently under review by Parliament and the Council.

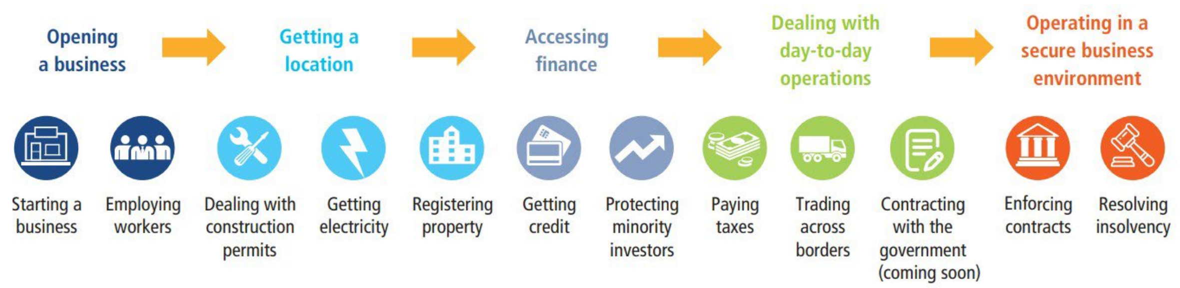
Economic effects

Insolvency laws and the interacting effects of their clauses are complex, and their respective economic effects difficult to disentangle. To analyse these effects, various empirical methods are applied, which each address specific objectives.

The first empirical testing method consisted in looking at the 'business environment' rather than specific insolvency clauses. This approach relied on a World Bank benchmark indicator – the Doing Business (2004-2020) indicator[7] – that provides measures of a country's 'business environment'. The indicator is made up of a set of items capturing different aspects of the business environment, two of which have been used to analyse the economic effects of insolvency laws:

- 'enforcing contracts': time and cost to resolve a commercial dispute and the quality of judicial processes for men and women;
- 'resolving insolvency': time, cost, outcome and recovery rate for a commercial insolvency and the strength of the legal framework for insolvency.

Figure 1 – World Bank's Doing Business indicator



Source: World Bank, 2020.

A recent World Bank study highlights that empirical studies converge on supporting that effective insolvency regimes can mitigate the level of distressed bank loans – also known as non-performing loans[8] (**NPL**). Furthermore, a World Bank review of empirical work shows that suitable insolvency regimes can maintain viable businesses and avoid their liquidation. The design of these regimes should discourage lenders from granting high-risk loans, and managers and shareholders from taking unconsidered loans and taking careless financial decisions. A company suffering from poor management choices or a temporary economic downturn can still turn viable again; creditors can recover a larger part of their investment; more employees keep their jobs; and the network of suppliers and customers is preserved.

Effects of shareholders' and creditors' rights on company financing

More specifically, the literature on law and finance has highlighted several real effects of the legal environment on the external financing of companies.[9] A milestone publication is the 1997 study by Lopez-de-Silanes, Shleifer and Vishny (**LLSV** for short).[10] Controlling for the type of legal origin environment – English, French, Scandinavian and German laws – the authors find that the countries with poorer investor protection, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets – both equity and debt markets. LLSV produced a series of studies on the topic showing that overall, investor protection benefits access to capital markets. Subsequent research looked in more detail into legal components regarding shareholder and financial creditor protection.

A large part of the literature has analysed the real effects of financial creditor rights.[11] Earlier studies[12] showed that higher judicial efficiency is associated with more frequent insolvency proceedings, and is a 'substitute' for creditors' rights. The literature has particularly focused on the conflict of interest between the manager of a company, its shareholders and its financial creditors. It has found that, under specific circumstances, creditors may gain (partial) control over the company even before insolvency proceedings, and that their decision is beneficial for the company's performance.

A 2017 World Bank study showed that effective reforms of creditor rights are associated with lower costs of credit, increased access to credit, improved creditor recovery and strengthened job preservation. If at the end of the insolvency proceedings, creditors can recover most of their investments, they can continue reinvesting in companies and improving their access to credit. Similarly, if a bankruptcy regime respects the absolute priority of claims, secured creditors can continue lending, and confidence in the bankruptcy system is maintained.

Overall, the World Bank highlights the combined positive effects of contract enforcement and the quality of judicial processes.[13] The World Bank argues that both relate to the rule of law and effective protection of creditors' rights. According to the World Bank, they improve the business environment, which promotes innovation, attracts foreign direct investment and secures tax revenues.[14]

General effects of insolvency procedures

In an early study conducted in Italy, Fabri and Padula showed that an increment in the backlog of pending trials has a statistically and economically significant positive effect on the credit request's probability of being turned down.[15] In a same country, where the law is identical across regions, the cost of enforcement captured by the expected judicial decision affects access to credit.

Thus, better enforcement of contracts results in better access to credit. A 2017 study conducted by the European Commission Joint Research Centre (JRC) jointly with the World Bank further explores the relationship between companies' performance, their regional business environment, and whether they are located in EU lagging regions.[16] The analysis shows that Italy and Spain, companies located in lagging regions perform worse than those in non-lagging regions, while this is not the case in Poland and Romania.[17] Moreover, companies located in regions with higher regional business environments display better performance, in terms of employment, sales growth and profitability.

As economy-specific research has shown, insolvency reforms that encourage debt restructuring and reorganisation reduce both failure rates among small and medium-sized enterprises (SMEs) and the liquidation of profitable businesses. After Belgium in 1997 introduced a new bankruptcy law that encouraged corporate rehabilitation rather than liquidation, bankruptcies among SMEs fell by 8.4 %. In Colombia, a reform of the bankruptcy legislation made reorganisation an attractive option for viable companies with financial problems by reducing its costs, although this mainly benefited larger companies. About 40 % of companies filing for reorganisation under the old bankruptcy law underwent liquidation, while only about 26 % did so under the new law. Research has also shown that bankruptcy reform can aid in the quick recovery of an economy during a recession, as in Chile during the early 1980s and Colombia in 1999.[7]

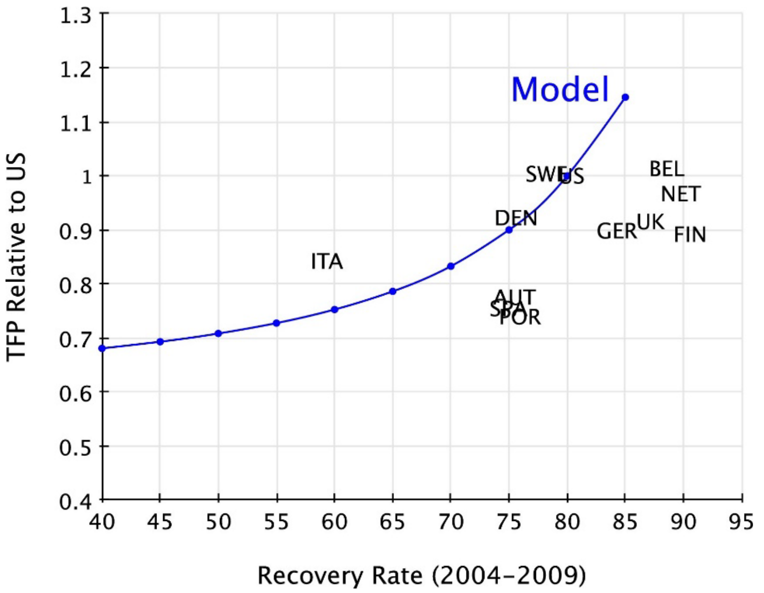
Insolvency regimes and productivity

The EU's productivity lag, in particular as compared with the United States (US), has been highlighted in several recent policy reports, including that requested from former Italian prime minister Mario Draghi. The legal environment, including insolvency laws, explains this lag at least partially. Less efficient and unfavourable insolvency proceedings may create an incentive for banks to renew loans to companies with low profitability and productivity, instead of leading them to file for insolvency; these companies – known as 'zombie companies' – would not be 'alive' in an environment with stronger creditor rights.[18] Zombie companies retain a share of capital allocation and labour resources in a country, thereby diminishing overall productivity.[19]

A 2017 study by the Organisation for Economic Co-operation and Development (OECD) explored cross-country differences in the design of insolvency regimes and their potential links with two inter-related sources of labour productivity weakness: the survival of zombie companies and capital misallocation. Company-level analysis shows that reforms of insolvency regimes that reduce barriers to corporate restructuring and the personal cost associated with entrepreneurial failure may reduce the share of capital sunk in zombie companies. These gains are partly realised by restructuring weak companies, which in turn promotes the reallocation of capital to more productive companies.

A study conducted by the European Commission JRC jointly with the OECD in 2018 also finds that the growth of zombie companies in terms of employment crowds out the growth of other, non-zombie companies, especially young ones.[20]

Figure 2 – Recovery rate and total factor productivity (TFP)



Source: J. Neira, 'Bankruptcy and cross-country differences in productivity', *Journal of Economic Behaviour & Organization*, Vol. 157, 2019.

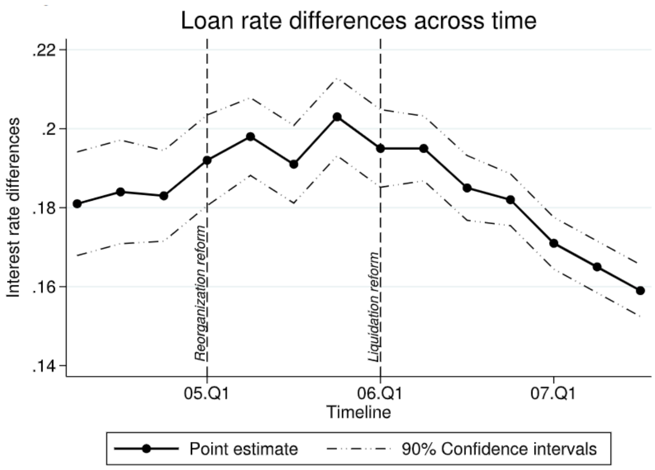
A scientific study from 2019 documents a systematic positive relationship between (i) aggregate (total factor) productivity; (ii) the employment share by large companies; and (iii) the proportion of large companies in the economy. The theoretical model suggests that as the expected recovery rate decreases, lenders grant more loans to smaller (less productive) companies, and do so at lower volumes. Based on the model, the author finds that moving the level of recovery rate from the US level to that of the lowest recovery rate country in the OECD sample reduces total factor productivity by about 30 % (Figure 2).

Country-level analysis of insolvency law changes

A relative recent branch of the financial economics literature has shifted from cross-country analysis of insolvency regimes and laws to the study of the impact of specific changes of laws – preferably comparing them with other jurisdictions where no changes occurred.

A 2016 study analyses the effects of two significant changes in insolvency laws that took place in Italy. First, the rules on reorganisation procedures were modified in 2005 to facilitate loan renegotiation; then, in 2006, a reform strengthened creditors' rights in liquidation.[21] The first reform on reorganisation procedures gave rise to higher interest rates and lower investment volumes, whereas the second reform on creditors' rights resulted in lower interest rates and larger investment volumes (Figure 3 below).

Figure 3 – Insolvency law and interest rates



Source: G. Rodano, N. Serrano-Velarde and E. Tarantino, 'Bankruptcy law and bank financing', *Journal of Financial Economics*, Vol. 120(2), 2016.

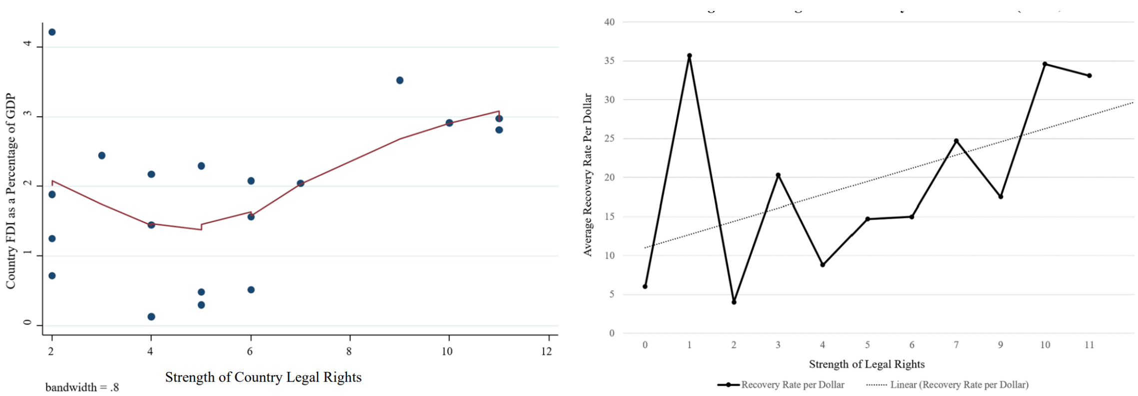
Another study, published in the *Review of Financial Studies* in 2009, investigates the effect of legal change on the lending behaviour of banks in 12 transition economies. The authors find that banks increase the supply of credit subsequent to legal change, and that changes in collateral law[22] matter more for bank lending than do changes in insolvency laws. The authors argue that while collateral works as a guarantee and increases creditors' expected recovery rate, insolvency law ensures an orderly process for resolving multiple, and often conflicting, claims after a debtor has become insolvent. According to the study, the result shows that the expected recovery rate seems more relevant to creditors than the insolvency procedure as such.

However, too strong creditors' rights may thus be detrimental to financial debt itself. For instance, a recent study looking at a 2011 reform of the German Insolvency Law found that the reform led larger companies to reduce their financial debt and pay relatively higher interest rates. The reform gave financial creditors of larger companies more influence over the appointment of the insolvency administrator.

Effects on cross-border investment

Part of the effects expected by the harmonisation of the insolvency laws in the EU is the promotion of cross-border investments within the EU, but also likely making the EU more appealing to international investors. A note published in the *Minnesota Journal of International Law* in 2018 concludes that improvement and modernisation of insolvency laws usually has an immediate and direct impact on foreign direct investment. Figure 4 shows the link between the strength of legal rights with recovery rates on the one hand, and foreign direct investment on the other.

Figure 4 – Foreign direct investment (FDI), recovery rate and legal rights



Source: J. Jack, 'A Missing Variable: The Impact of Cross-Border Insolvency Laws on Foreign Direct Investment', *Minnesota Journal of International Law*, 2018.

An empirical study published in the *International Review of Law and Economics* in 2008 shows a negative relationship between expected insolvency costs and investment levels. Furthermore, it finds that the magnitude of this effect is greater concerning those of reorganisation without creditors' consent and creditors' lack of control, as compared with those of automatic stay and the violation of absolute priority. All the characteristics of the analysed insolvency codes that are expected to give rise to under-investment processes are found to increase the sensitivity of a company's investment to its cash flow. However, the negative consequences for investment efficiency of the possibility of reorganisation without creditors' consent, and of creditors' lack of control when the company files for reorganisation, are greater than those of the imposition of the automatic stay on secured creditors and the violation of the absolute priority rule.[23]

In their study published in 2018,[24] Kliatskova and Savatier find that investors prefer to invest more in countries with more efficient insolvency frameworks, although the effect varies across sectors, with households and institutional investors being particularly sensitive. In addition, equity providers are mostly responsive to prevention and streamlining tools, while creditors respond more to availability of restructuring tools.[25]

Finally, according to the above-mentioned study from 2009, foreign-owned banks respond more strongly to legal change than domestic banks, thus showing that changes are likely to encourage cross-border investment.

Outlook

In a 2023 review of the 2019 Directive on preventive restructuring frameworks, Reinhark Bork (University of Hamburg) draws the lesson learned from the adoption and implementation of the directive. The author highlights both the difficulties of the legislative procedure and the directive's implementation by the Member States. According to the directive, Member States were to adopt and publish the laws, regulations and administrative provisions to comply with the directive by 17 July 2021, i.e. 2 years after its entry into force. Most Member States made use of the option of extending the implementation period by 1 year. When the deadline expired, only three Member States – Germany, Greece and Lithuania – had entirely transposed the directive into national law. The author provides examples of cases where a directive does not necessarily lead to effective harmonisation of law – namely the termination of contracts that were not fully performed,[26] and the involvement of insolvency practitioners. According to the author, the experience inferred from the directive may have interesting implications in the context of the ongoing legislation for the harmonisation of insolvency laws. He therefore suggests that harmonisation needs thorough preparation, careful EU legislation, and sufficient time for the implementation in Member State legislation.

In his analysis published in 2021, Jan H. Dalhuisen expresses his belief that insolvency law is probably one of 'the last vestiges of a nationalistic, codified approach to private law' in the EU. The author argues that there are several reasons for this: the main reason is that bankruptcy entails an 'enforcement mechanism that depends on local strong arm support which cannot easily be harmonised or internationalised'. Another reason is that bankruptcy regimes denote a public policy intervention in private relationships. A more fundamental reason for opposing harmonisation is that insolvency law is both imperative for, and dependent on, other areas of law that are equally difficult to harmonise internationally, e.g. the law of secured transactions, labour law and tax law.[27] However, looking back into historical experience, such as that of Germany and the US, the author argues that, in Germany, bankruptcy laws could be adopted at the federal level soon after unification because they were adopted before private law. In the US, private law can still vary across states, and the US model proves that harmonisation of bankruptcy law does not require harmonisation of private law.

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Kliatskova, T. and Savatier, L. B., Insolvency Regimes and Economic Outcomes, DIW Roundup 133, 2019.

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ENDNOTES

1 See for instance the objectives of the latest proposal on insolvency proceedings.

2 Directive (EU) 2019/1023 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt.

3 The directive also sets the creditors' voting rights adopting the restructuring plan, and addresses the discharge of debts. Insolvent entrepreneurs should have access to at least one procedure that can lead to a full discharge of debts.

4 Regulation (EU) 2015/848 on insolvency proceedings repeals Council Regulation (EC) No 1346/2000 on insolvency proceedings.

5 The regulation also provides for the establishment of a 'system for the interconnection of insolvency registers', designed subsequently by Implementing Regulation (EU) 2019/917 and named 'bankruptcy and insolvency registers'.

6 The proposal being a directive, it will lead to further convergence of Member States' insolvency laws rather than a unified legal framework. In practice, the 'harmonisation' brought about by the directive is meant to be an instrument of convergence of Member State insolvency proceedings, rather than a fully-fledged establishment of 'identical' rules. Indeed, should it be adopted by the co-legislators, the directive would be transposed by the Member States into their national laws, taking into account the respective idiosyncrasies. Therefore, rules would 'converge' as regards, e.g., objectives, scope and practice, but not be 'identical' as such.

7 The indicator has been discontinued, following an internal probe determining that scores given to Azerbaijan, China, Saudi Arabia and the United Arab Emirates had been manipulated improperly. The results provided herein rely on periods prior to thedata irregularities on Doing Business 2018 and 2020 reported in four participating countries. In the meantime, the World Bank has set up a new Business Ready indicator.

8 Non-performing loans, also known as 'bad loans', are loans that a contracting company or individual will not – or is unlikely to – be able to repay within the agreed schedule.

9 External financing of companies occurs either in the form of debt or of equity. See EPRS briefing on the capital markets union for further details on their characteristics.

10 R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R. W. Vishny, 'Legal determinants of external finance', *The Journal of Finance*, 2012. The authors analysed the legal rules in 49 countries and their enforcement effectiveness, and inferred their respective impact on the 'external financing' of companies.

11 Financial creditors are mainly loan providers, i.e. banks and bondholders.

12 See for instance S. Claessens and L. F. Klapper, 'Bankruptcy around of the world', *American Law and Economics Review*, Volume 7(1), 2003.

13 Contract enforcement is measured by the time and cost for resolving a commercial dispute through a local first-instance court. The quality of judicial processes index evaluates whether each economy had adopted a series of good practices that promote quality and efficiency in the court system.

14 For instance, in India, a 2016 study found that companies in contract-intensive industries tend to locate in regions with good contract enforcement. A 2003 study of the transitioning economies of Eastern Europe and the former Soviet Union between 1992 and 1998 found that reforms in corporate and bankruptcy laws had effect on the development of their financial institutions only once their legal institutions became more efficient.

15 The empirical evidence builds on household data but can be generalised to businesses.

16 The study is based on an innovative World Bank's Subnational Doing Business indicator. It considers company-level data of four Member States: Spain, Italy, Poland and Romania. Detailed data allow for a comparison of sales, employment, productivity and profitability of companies according to their location.

17 The results thus highlight that it should be distinguished between regions that are 'low-income' (relatively poor) and those that are 'low-growth' (stagnating but not necessarily poor).

18 Zombie companies are companies that are apparently unable to repay their debt yet continue operating, likely because of their bank relationship and the renewal of loans. The reasons for such support vary; however, in the study identifying zombie companies in Japan, regulation was highlighted as the first motivation. This also relates to the discussion around banks' decision to renew loans if they hold additional private information showing that the recovery rate is higher if the company undergoing temporary shocks remains viable.

[19] These resources could be reallocated to viable and more productive companies in a legal environment where insolvency laws are deemed more 'efficient'.

[20] The study also suggests that larger and older companies are more likely to be zombie companies than relatively smaller and younger companies.

[21] The article explains that the Italian reform consisted of two distinct and consecutive laws. The first law, which entered into force in 2005, introduced legal outlets that made the renegotiation of credit contracts easier. The second law, which entered into force in 2006, significantly accelerated companies' liquidation procedures.

[22] Collateral is the amount of asset tied as a guarantee to the loan. It provides an indicator of the recovery rate.

[23] An experiment using the implementation of the insolvency and bankruptcy code in India, and based on 32 920 company-year observations from 2004 to 2023, showed that indebtedness adjustment is higher in distressed companies relative to non-distressed companies following the implementation. The new bankruptcy code is seen as a device streamlining distressed companies' debt access and reducing adjustment expenses.

[24] The empirical analysis combines the Securities Holdings Statistics by Sector data published by the European Central Bank with the OECD indicators on the efficiency of insolvency regulations.

[25] See also their review of the literature.

[26] Contracts that were not fully performed are known as executory contracts. The directive leaves the decision as to whether to enable insolvency practitioners to terminate these contracts in pre-insolvency proceedings to the Member States.

[27] For instance, harmonisation of insolvency laws is often mentioned as a pre-requisite for the expansion of other financial markets such as the securitisation market. Securitisation is a financing technique by which homogeneous assets – which on their own may be difficult to trade – are pooled and sold to a specially created third party, which uses them as backing asset to issue securities and sell them in financial markets.

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