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Insolvency and Debt Recovery Procedures in Economic Development

An Overview of African Law

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Insolvency and debt recovery procedures are as crucial to a well-performing financial sector as credit provision itself. They are even more important in Africa, where attempts are underway to create fully-fledged financial markets. For the financial system to be credible, creditors must be ensured that lenders will meet their obligations and that cases against them will be brought to closure. A good legal framework for insolvency also ensures distressed firms a form of orderly exit, thereby enabling their owners to start afresh. However, institutions of this nature take time to take effect, and need to be supported politically and by reforms in other sectors of the economy.

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JEL classification: E6, G3, K0, K4

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1. Introduction

The view that the quality of institutions supporting economic activity is an important determinant of economic growth and welfare has become widespread in the development literature. Some economists argue that political institutions play a major role (North, 1990; Olson, 1993). Particular groups that gain power may be able to shape institutions and policies so as to enrich members of the groups, and if these groups represent narrow interests the enrichment may take place at the expense of the majority. Others argue that legal institutions defining and enforcing property rights and contracting are particularly important although the development of law is not independent of political institutions.

According to La Porta et al. (1997, 1998) legal institutions in countries with similar legal traditions have much in common across political systems. These authors focus in particular on the development of financial intermediation and markets in countries with different legal traditions and, therefore, different degrees of support for property rights and voluntary contracting in law. Beck, Demirguc-Kunt and Levine (2001) find empirical support for the view that legal institutions are particularly important for financial development. Well-functioning financial intermediation and markets would influence economic growth, because they enhance the supply of external financing, and the quality of corporate governance.

Other channels for legal institutions to affect economic growth are through technological deepening, and the productivity of investments. Clarke (2001) analyzes empirically whether institutional variables such as rule of law, and risk of expropriation contribute to explain expenditures on R&D relative to GDP. A number of economic control variables are used. The significant impact of the mentioned institutional variables on R&D expenditures seems robust even for low and middle-income countries. Devarajan, Easterly, and Pack (2001) ask whether low productivity of investment as opposed slow accumulation of capital affect explain the weak economic growth in Africa during the last decades. They find that the productivity of investment has been so low that one can talk about over-investment rather than under-investment in much of Africa in spite of the observed low investment rates. The results apply on both private and public investment, while Calamatsis et al. (1999) find that the low productivity is a particular problem for public investment. Devarajan et al. do not specifically refer to legal institutions to explain the low productivity of investment, but the observation above that R&D expenditures are partly explained by legal institutions is consistent with a relation between these institutions and the productivity of investments.

The legal institution emphasized in this paper is insolvency law. The procedures for dealing with insolvent firms are particularly important for the financial sector, and they reflect the prevailing social attitude to contracts and property rights. As Wood (1995) writes

> Insolvency law…..is the most piercing indicator of the doctrines that divide the world’s legal systems in the context of financial law. It is the destructive force of bankruptcy which has molded the central tenets of commercial law and it is bankruptcy which is the ultimate test of a jurisdiction’s ability to realize its own view of fairness, equity and legal civilization.

Insolvency procedures may be determined by formal law or informal rules and practices. The scope of informal procedures depends on properties of the law and its enforcement. In formal law it is common to distinguish between bankruptcy law referring to rules for liquidation of firms, and restructuring law referring to rules for reorganization, debt restructuring, and rehabilitation of firms without change in ownership. Sometimes insolvency and bankruptcy are used synonymously, however. In this paper, bankruptcy is used in its more narrow definition.

The objective of this paper is to evaluate economic effects of insolvency procedures in sub-Saharan African countries in particular, and to develop principles for economically efficient procedures. Unfortunately, quantitative data and information about insolvency law and its enforcement in Africa are limited. The focus is therefore on principles rather than actual procedures and their specific consequences. The discussion is limited to insolvency procedures for firms in the manufacturing and services sectors, except banks. Personal bankruptcy is a different body of law that is not discussed here although it may influence incentives in corporate insolvency as well.

The role of insolvency procedures in an economic growth process, and in economic crises is discussed in Section 2. A distinction is made between *ex ante* and *ex post* efficiency of law. The latter refers to the time of distress, while the former refers to the time of lending and investment decisions. The variation in formal insolvency law across countries is described in Section 3, where insolvency law is also classified in different ways. Most often laws are classified as more or less creditor-or debtor oriented but this classification says little about the law’s contribution to economic restructuring, and the fate of different stake-holders in a distressed firm. A more interesting classification from an economic point of view is the extent to which it recognizes and enforces voluntarily entered contracts. The practical implementation of insolvency law and its contribution to restructuring in different countries is discussed in Section 4. Enforcement of law is identified as a particular weakness of insolvency regimes in most developing countries. This aspect of insolvency procedures in Africa is discussed in Section 5. Indicators of the quality of the legal system in Africa are presented, and it is argued that continued financial repression and recurring financial crises are partly explained by the low quality of insolvency procedures. Important aspects of the design of insolvency law in emerging market economies are discussed in Section 6. Concluding comment follow in Section 7.

2. The role of insolvency law and procedures[1]

‘Bankruptcy is a collective procedure for the recovery of debts by creditors. It also protects individuals who have become overburdened by their debts’. (Wood, 1995, Preface) This quote summarizes well the role of bankruptcy law including separate laws for restructuring such as Chapter 11 in the USA. There is a potential benefit to both creditors and debtors in bankruptcy. Creditors wish to recover debts to the extent possible in a speedy manner from a borrower who is unable to pay all creditors fully. From the borrower’s point of view, bankruptcy should allow the speedy resolution of debts. Thereafter, the borrower can devote his or her human and other remaining resources to new ventures. The assets employed in the firm can similarly be reallocated to projects with positive values.

[1] This section is based on Wihlborg and Gangopadhyay (2001).

Insolvency procedures, including informal, voluntarily agreed upon procedures for settling the debts of an insolvent borrower, play an important role in the restructuring process of an economy. Without agreed upon procedures in contracts or in law specifying, for example, priority among creditors, conflicts of interest between the debtor and creditors, and among creditors could hinder any resolution of claims. Expecting such a situation, debtors could try to recover loans as soon as they suspect a borrower to be heading for distress. Thus, positive value projects may be prematurely abandoned, if one or more creditors would be able to recover a loan. An important efficiency aspect of insolvency procedures is, accordingly, that they provide a timely resolution of claims as emphasized by Posner (1992).

In the following subsection the role of insolvency procedures for firms in 'economic and financial distress' is discussed. Thereafter, the contribution of insolvency procedures to growth and crises is discussed. Finally in this section a distinction is made between ex ante and ex post efficiency of procedures.

2.1 Economic and financial distress

In Table 1, a distinction is made between 'economic distress' and 'financial distress'. In 'economic distress' the net present value of a firm's assets are negative and from a financial valuation point of view, the firm should be shut down in its present form. It is possible, however, that physical assets under different management would produce a positive net present value. If so, it would be efficient to auction or sell the firm as a 'going concern' to new owners that would be able to improve management. Under 'financial distress', the net present value of the assets is positive but the value of debts exceeds the present value of the cash flows generated by the assets. Thus, in financial distress a firm is insolvent but its assets produce a positive value from a social point of view. In this case, debt-reduction and rehabilitation, possibly in combination with more fundamental restructuring, such as change in control, would be efficient.

A firm may find itself in financial distress also because of liquidity constraints even if the present value of cash flows from assets exceeds the debts. This situation presumes that the financial system for one reason or another fails in its role of providing liquidity to solvent firms. The obvious remedy is rescheduling of debt, or liquidity infusion. Difficulties of designing efficient insolvency procedures are caused by information problems and asymmetries of information about the cause of distress. Procedures must be determined ex ante before distress occurs for lenders to be able to evaluate credit risk, and in order to reduce the risk of conflicts of interest. At the time of distress, shareholders and debtors may want to claim different reasons for distress without either party being able to clearly prove its claim. Only for firms with an extremely simple structure of stakeholders would it be possible to resolve conflicts in an efficient manner at the time of distress. Thus, without ex ante insolvency procedures firms will tend to remain simple in their stakeholder-structure or be organized with the objective of reducing the probability of bankruptcy in, for example, conglomerates.

Insolvency procedures, should not only resolve a distress situation but the resolution should be accomplished at the lowest possible costs. Several studies show that direct and indirect bankruptcy costs in the USA are substantial. They vary across industries and depend on, for example, predictability and duration of procedures.[2]

Table 1
Types of distress and efficient action at the time of distress (ex post efficiency)

	Definition	Action
Economic distress	The net present value of assets is negative under any management team	Piecemeal liquidation of assets
	The net present value of assets is positive under a different management team	Sale of assets as a 'going concern' to enable a change of management
Financial distress	The present value of cash flows is positive but it is lower than the value of claims by non- shareholders	Debt reduction in combination with restructuring and/or ownership change, if value of assets thereby can be enhanced
	Liquidity-problem	Debt-rescheduling Liquidity-enhancement

Souce: author's compiliation

2.2 Insolvency procedures in growth and crisis

Insolvency procedures provide only one way to restructure an economy where assets need to be reallocated continuously in response to changes in preferences, technology and human skill. Mergers and acquisitions, internal restructuring within conglomerates, and voluntary closings of firms with associated asset sales offer alternatives in the restructuring process. Thus, insolvency procedures should be seen in the larger context of their contribution to restructuring. Insolvency procedures or the lack thereof can be the cause of recessions and economic crisis, they can deepen a crisis, and they may extend or shorten the duration of a crisis by influencing the speed of recovery. The procedures can be the cause of a crisis if disincentives for bankruptcy in combination with a politically influenced banking system, and state support of banks and firms contribute to an accumulation of surviving, economically distressed firms. The disincentives for bankruptcy may be that proceedings are costly, and long drawn out with little likelihood for creditors to be paid in any case.

An existing crisis may be deepened and prolonged if financially distressed firms are not rehabilitated but are forced to shut down. Similarly, a crisis is deepened, if liquidity problems cause the shut-down of operations in a credit crunch. Wide-spread financial distress in a country may be caused by a severe macro-economic shock, large exchange rate changes, or increases in interest rates. We certainly observed this type of deepening of a crisis in the hard hit Asian economies, Indonesia, Korea, Malaysia, and Thailand (Hussain and Wihlborg, 1999).

[2] Direct bankruptcy costs are, for example, lawyers' fees, while indirect costs may be caused by lost sales, or added costs of inputs in a distress situation. See, for example, Altman (1984), Altman and Vanderhoof (1994) and Weiss (1997).

There exists strong evidence that the lack of effective insolvency procedures can contribute to a banking-crisis, and the ability of banks to recover from a crisis. In a study by Caprio Jr and Klingebiel (1996) severe banking crises in 69 countries between 1980 and 1995 are recorded. Crises in 26 countries are studied in more detail with respect to their causes, and the resolution of crises. In a large share of the latter countries politically influenced lending practicies of banks were seen as a contributing cause of the crisis. An inefficient legal framework hindered the resolution of crises in many countries.[3] We return to evidence with respect to Africa in Section 6.

2.3 Ex ante versus ex post efficiency

It is easy to lay down the principle that if a firm's assets generate a positive net present value, then they should continue in operation even if the firm is in distress. The difficulty of implementing procedures leading to 'ex post efficiency' as defined above is substantial, because of differences in availability of information among managers, shareholders and various creditors, and because inherent conflicts of interest imply that all information is not voluntarily disclosed. As a result, an independent body with enforcement powers, such as a court, is required in order to come to a conclusion on the issues of restructuring vs. liquidation, and of control. The valuation of assets at the time of distress is extremely difficult to arrive at, however. To obtain any approximation of value it may be necessary to offer the assets for sale in different configurations. Offering the assets for sale as a 'going concern' or piecemeal implies that the alternative of rehabilitation including debt forgiveness with the present ownership is made possible. If the present owner can make the highest bid in spite of distress will there be restructuring without change of control. (Such informal restructuring is not uncommon as we note in Section 6). One reason why an incumbent owner may value a firm higher than others is that he or she may have 'invested' in or acquired firm-specific human capital (knowledge). Since this specific capital would be lost if the present owner would not be able to remain the owner after distress, he or she may value the firm as a going concern higher than others.

Not only the owner of a distressed firm may have invested in or acquired specific capital that would be lost if a firm were discontinued as a going concern. Many employees may have skills that would not provide any return if they want to work for other firms. Suppliers, customers, the surrounding community, the municipality and the state may also have strong interests in the continuation of the particular activity of a distressed firm. If these entities are owners of specific assets, they may have a strong interest in a firm's survival, and actually be willing to pay for its survival. If there were well-functioning markets for labor and the services provided by assets, then labor and the owners of the specific assets could reduce their charges for the distressed firm's use of their services. They would thereby contribute to the survival of productive activities in a voluntary and efficient manner. However, markets are lacking for many assets or the services they provide, and employees are often not able or willing to reduce their wage demands.

These considerations lead to the argument that there could be a social good in having a distressed firm continue under the old ownership without risking that the firm could be

[3] Debt recovery was hampered by the legal system in the following heterogeneous group of countries outside Africa with recent banking crises: Indonesia, Thailand, Brazil, and Hungary. These observations indicate that a large number of countries with different legal traditions on all continents have insolvency procedures that contribute to or prolong economic crises.

shut down if it is declared bankrupt and liquidated. Employment considerations in particular have led many countries to favor rehabilitation and restructuring over bankruptcy. Wood (1995) observes that legislation favoring rehabilitation has generally been implemented after severe economic downturns, when the consequences of bankruptcies have been felt. After World War II employment and 'job security' considerations have been a more explicit policy concern. As a result, a number of countries have legislated in favor of rehabilitation and restructuring of distressed firms to discourage bankruptcies during the last few decades. We return to specific examples of restructuring law below.

Insolvency procedures affect economic incentives not only at the time of distress but also at the time various stakeholders enter contracts with a still healthy firm. The expected resolution of distress will therefore affect the incentives of various stakeholders to invest in firm-specific assets. Furthermore, the procedures affect the willingness of different groups of creditors to supply financing. Insolvency procedures that increase the likelihood of firm survival increase the incentives of various stakeholders to invest in firm-specific capital. The same procedures would reduce the expected return on financing the firm, if survival is accomplished at the expense of the lenders. As a result the costs of financing a healthy firm would increase. Uncertainty about procedures increases these costs further.

An economic efficiency analysis of these considerations is sensitive to, for example, assumptions about the relation between asset specificity and return on projects, the substitutability between general and specific assets, and the supply of debt financing. Bebchuk and Picker (1993) ask how risky project choice requiring investment in specific skills is affected by the relative position of creditors and shareholders/managers in bankruptcy. They find that allowing managers/shareholders to retain a stake in the assets in case of bankruptcy (deviation from absolute priority) may enhance ex ante efficiency under limited liability. Frierman and Viswanath (1995) show that deviations from absolute priority can reduce the agency problem between shareholders and lenders. Accordingly, deviations from absolute priority could reduce excess risk-taking. Gangopadhyay and Wihlborg (2001), on the other hand, come to the conclusion that favoring of shareholders/managers with specific assets may lead to over-investment in specific and risky assets, and increased credit rationing. They show that the existence of credit rationing offsets or reverses the results obtained by other authors, and conclude that an absolute priority rule minimizes the cost of capital. The mentioned papers do not assign a role to monitoring of debtors with limited liability. Cornelli and Felli (1996) link the incentives to monitor to the position of senior and junior creditors in bankruptcy. Assuming that monitoring is a productive activity they find that neither absolute priority nor a more debtor friendly rule is efficient with respect to monitoring incentives of all creditors. The issue of the ex ante efficient priority rule in bankruptcy remains unresolved even when a rather narrow range of specific assets is considered. What can be said is that ex ante efficiency is enhanced if:

i) Insolvency procedures are flexible enough to allow different types of resolutions for firms with different types of stakeholders.

ii) Recontracting is possible at the time of distress for services provided with specific assets.

iii) Insolvency procedures are well defined ex ante. In other words, the rules for dealing with insolvency should not be subject to uncertainty.

iv) Insolvency procedures allow speedy resolution of distress.

Viewing priority rules as one aspect of a firm's ex ante contracts with different stakeholders, these points 1-3 indicate that, from an economic efficiency point of view, rules should allow the different stakeholders to obtain the types of contract they find suitable. We return to implications of this view below.

3. Orientations of insolvency procedures across countries[4]

It is common to denote insolvency procedures as either creditor-oriented or debtor-oriented. These terms indicate whether the procedures tend to favor creditors or debtors in terms of claims on the distressed firm's assets, and in terms of control over these assets in and after legal proceedings for bankruptcy or restructuring. The existence of an easily accessible restructuring law generally favors debtors, since such a law—if it is mandatory—implies that there is a constraint on the range of contractual solutions in distress situations. If incumbent owners are permitted to retain a stake and/or control after insolvency, then informal workouts with a lesser stake to be retained by the incumbent owners are hindered. The degree to which restructuring law limits the range of informal contractual solutions depends on the ease of access to the restructuring procedures.

The degree of creditor or debtor orientation is not an unambiguos classification as we shall argue below. A more interesting classification of law from an ex ante efficiency point of view is the degree to which it recognizes terms of ex ante contracts in formal bankruptcy and restructuring proceedings. From an ex post economic efficiency point of view we also want to evaluate whether procedures are 'survival' or 'shut-down' oriented quite independent of whether control changes hands or not. Survival of a firm is possible even if liquidation is mandatory under formal procedures, because an insolvent firm's assets can be sold as a 'going concern'. The assets can even be sold back to the original owners. Furthermore, creditors can agree on an informal workout prior to bankruptcy with conditions for the owners. Thus, an evaluation of the survival-orientation of insolvency procedures requires that incentives for informal workouts, and incentives for the sale of assets as a 'going concern' are analyzed. These incentives are naturally strongly influenced by the design of formal insolvency law, its application and enforcement.

Table 2 with African countries highlighted is based on Wood's (1995) assessment of the degree of creditor or debtor orientation of formal procedures in different countries. Wood defines a creditor-oriented law as one that recognizes the claims of creditors to the greatest extent in insolvency. A debtor-oriented law allows debtors to retain a stake and/or control in insolvency although there is no equity left in the firm. The table rates traditional British law as the most creditor-oriented, and current French law as the most debtor-oriented. The implementation of formal procedures for restructuring (administration) in 1985 and 1986 has made British law less creditor-oriented but it is still rated as marginally more creditor oriented than German, Dutch and Swedish law. Japanese and US laws are rated in the middle as more creditor-oriented than Italian, Spanish, and French law. Most developing countries base their insolvency laws on the law of the former colonial power, while the

[4] An expanded version of this section can be found in Wihlborg and Gangopadhyay (2001).

former members of the communist bloc seem to have adopted an insolvency law akin to one of the Western European laws.

Table 2
Creditor/debtor orientation of corporate insolvency law

1	Former British colonies except S. Africa, Zimbabwe
2	England, Australia, Ireland
3	Germany, Netherlands, Indonesia, Sweden, Switzerland, Poland
4	Scotland, Japan, Korea, New Zealand, Norway
5	United States, Canada except Quebec
6	S. Africa, Botswana, Zimbabwe (all Dutch-based); Austria, Denmark, Czech and Slovak Republics
7	Italy
8	Greece, Portugal, Spain, most Latin American countries (except Paraguay that protects security interests strongly)
9	Former French colonies, Egypt, Zaire; (Belgium)
10	France
No insolvency law:	Liberia (many Arab countries)
Not classified:	Russia, Belarus, Ukraine, Khazakstan

Source: based on Wood (1995); the orientation refers to explicit law disregarding the practical implementation through the court system

Note: Scale: 1=extremely pro-creditor, 10= extremely pro-debtor. African countries underlined

The main determinants of the creditor-orientation are listed in Table 3. Increasing the scope and efficiency of security allows more financing against collateral with greater probability for the secured creditors to keep the claim intact. On the other hand, the stronger the position of secured creditors, the less likely it is that unsecured creditors, employees, and the state will be paid in insolvency. The existence of a rehabilitation statute or restructuring law reduces or weakens the position of creditors, because debtors are able to seek protection against some or all creditors, and it allows a search for a court-led solution with control and a remaining stake for the debtor. From creditors’ point of view restructuring law may have the advantage that debtors have a stronger incentive to maximize the value of the assets even when distress can be foreseen. These incentives depend on the prospects for an informal workout, however. It is argued below that a stronger position of creditors enhances the likelihood of a workout.

If the law allows set-offs in insolvency, then some unsecured creditors have a de facto security in the form of a debt to the insolvent firm. Recognition of ownership of assets in the possession of the debtor but not formally owned by the same is a controversial issue and ambiguous from the point of view of creditor-orientation. Clearly, if assets in a trust are deemed to belong to the estate of the insolvent firm it increases the funds available for creditors. On the other hand, recognition of ownership to assets in a trust can be seen as recognition of ex ante contractual relations, which is also the principle of recognition of security. Whether the veil of incorporation and therefore limited liability of shareholders, and protection of directors against personal liability actually protects creditors or not can be debated depending on circumstances, but upholding the protection offered by the veil in insolvency can also be seen as recognition of ex ante contractual relations.The upshot of this discussion is that the classification of creditor orientation as above amounts to the increased recognition of ex ante contractual relations after the filing for bankruptcy or restructuring rather than a clear-cut classification of the position of debtors and creditors.

Table 3
Determinants of high degree of credit orientation following Wood (1995)

1	Wide scope and efficiency on bankruptcy of security and title financing (retention of title, factoring, leasing)
2	Weak corporate rehabilitation statutes
3	Insolvency set-off enables reciprocal unsecured creditor to be paid ahead of other unsecured creditors
4	Ownership of assets in the possession of debtor is recognized (e.g. trusts)
5	Veil of incorporation and protection of directors against personal liability

Source: author's adaptation from Wood (1995)

Note: these determinants are ambiguous from creditors point of view, but creditor orientation by these determinants can be seen as the recognotion of explicit and implicit contracts between the firm and various stakeholders involving property (see text).

Insolvency laws vary across countries in terms of scope and efficiency of security. Table 3 includes a rating of the attitude to security expressed in some countries' laws. Countries are rated on a scale from very sympathetic to very hostile to security. Of particular interest here is the protection offered 'floating charges', i.e. security against all existing and potential assets, and the position of employees and the state. Floating charges can be viewed as extending the scope of assets that can be offered as security to intangibles. Countries listed as very sympathetic to security allow floating charges as security. Countries listed as sympathetic rank employees and the state below all senior creditors, while at least some senior creditors are ranked below employees and the state in 'hostile' countries.[5]

Wihlborg and Gangopadhyay (2001) show in more detail how different industrialized countries are ranked in the different dimensions of insolvency law listed in Table 3. Countries are ranked differently with respect to creditor orientation in different important dimensions. While the traditional English procedures and the French procedures are on either extreme in all dimensions, the German system is actually more creditor oriented than the English in two dimensions. In particular, the prospects for formal rehabilitation in favor of the debtor are low in Germany, while the implementation of restructuring law in England in 1986 has made the system more debtor-friendly in this respect. Both German and Japanese laws protect title finance strongly but contracts are not recognized as strongly 'across the board' as in British law. For example, set-offs and trusts are recognized in British law. The scope of security is also wider in British law with the strong recognition of floating charges. These differences affect incentives of different creditors in informal workouts. Since one objective of insolvency law is to keep viable entities alive the role of rehabilitation statutes is particularly interesting. The US legal system is very debtor friendly in terms of prospects for rehabilitation under Chapter 11, but relatively creditor friendly in other dimensions, and, therefore, in bankruptcy proceedings for distressed firms

[5] In some 'sympathetic' countries employees are protected by other means. For example, in Sweden there is a state supported wage guarantee for employees of bankrupt firms.

not seeking protection under Chapter 11. Even countries that are considered hostile to formal rehabilitation have some legal procedure for restructuring. Most common are 'compositions' implying a moratorium on the payment of debts and the possibility of a negotiated restructuring of creditors'claims. These composition procedures are very rarely used, however, because of requirements for immediate payments of a share of non-secured creditors' claims (Austria, Brazil, Denmark, Italy, Norway, Sweden and others), or because the debtor must show that insolvency resulted from misfortune rather than mismanagement (Belgium, Luxembourg).

More debtor-friendly restructuring law has been implemented in recent decades in a number of countries. The French law of 1967 changed the orientation of French law strongly. Chapter 11 of the US bankruptcy code was enacted in 1978. British 'administration proceedings' have been possible since 1986. Australia allowed formal restructuring in 1992, while Germany and Sweden have enacted restructuring laws in 1994 and 1996 but the latter two laws are not much different from already existing composition laws. Modern French law (redressement judiciaire and reglement amiable), and American law (Chapter 11) provide relatively easy access to restructuring procedures. The courts will accept a debtor's application if there is some likelihood that the firm is a viable entity.

Restructuring laws differ in terms of their protection of various claims on the debtor. These differences reflect the objectives of the law. While British law is oriented towards upholding contracts, French law in particular explicitly gives the courts the role of keeping firms in operation, and preserving employment. The control over the firm in restructuring shifts to the courts or to a person assigned by the court to different degrees. In countries with mild restructuring laws, management certainly loses control. Under Chapter 11 in the US, the management retains control, under court supervision. In other countries the influence of management is up to the courts and depends on the court's objectives. In France in particular the courts' powers are used to protect employees and the role of the old management is subordinated to this objective.

The differences among restructuring laws reflect not only their objectives but, most likely, the different organizations of financial systems and the rules for banking. Kaiser (1994) observes that American banks are reluctant to get much involved in corporate decisions, because they may be held liable for bad advice (lender's liability). There are many alternative sources of financing in the American marketplace in particular, with the result that a corporation's financial structure is often complex with a large number of creditor groups with conflicting interests. A negotiated informal workout involving debt-rescheduling or reduction can therefore be difficult to achieve (Baird 1997a, b). There is always a risk that one creditor demands full, immediate repayment, thus preventing a negotiated settlement. Accordingly, the courts are able to bind dissenters in Chapter 11 proceedings.

Most continental European and Japanese financial markets are bank-oriented, and banks are deeply involved in corporate decision making. One bank tends to serve as the 'house-bank' and main senior creditor of each corporation. The house-bank is well-informed about the economic situation of the firm, and it can initiate informal workout negotiations. Therefore the banks determine the treatment of insolvent firms in the vast majority of insolvencies. Also in the UK banks tend to lead informal workouts although the position of banks in corporate control is weaker than on the continent (see Franks and Sussman, 2000). British banks do not risk liability as American banks do, however.

Rehabilitation proceedings or restructurings have a low success rate in most countries, including France and the US where the proceedings are relatively accessible. Kaiser (1994) presents date for the USA, Germany, France and the UK In both the USA and France most firms filing for Chapter 11 or applying for restructuring end up being liquidated but the time it takes to get there is longer. The experience in France is that many of the firms being restructured—often for reasons of preserving employment—return to insolvency after some time. In the US, the firms exiting from Chapter 11 seem to survive more often. However, Chapter 11 allows many insolvent firms to live for a year or two, only to end up being liquidated. In order to evaluate whether restructuring law actually contributes to the survival of viable entities, or only allows economically distressed firms an extended life under legal protection, we have to compare effects of restructuring law with incentives of creditors to contribute to informal workouts with or without the incumbent management.

4. The practical application of insolvency law

To what extent are financially distressed firms rehabilitated in informal workouts, and to what extent are economically distressed firms allowed to survive under different insolvency regimes? In this section we look at the empirical evidence that may have a bearing on the efficiency of different insolvency law regimes. Both industrialized and emerging market countries are discussed. Thorburn (2000) analyzes the results of 300 liquidation cases in Sweden between 1987 and 1991. She finds that in 75 percent of the cases the bankrupt firms survived as 'going concerns'. Sweden has a strongly creditor oriented law and allows floating charges like the UK. Restructuring law was and remains inaccessible. On the other hand the incidence of bankruptcy is very high in an international comparison. The procedure employed by the courts in bankruptcy is 'cash auction' of the firms, meaning that the courts take over the insolvent firm and try to sell the whole entity to the highest bidder.

Stromberg (2000) argues that the Swedish cash auction system tends to lead to a sale of assets back to the original owner in cases when the bank benefits from this solution. The probability of such a sale-back increases with the specificity of a firm's assets. Thus, it seems that the auction system under creditor-oriented law to a large extent accomplishes what restructuring laws are designed to accomplish. The high survival rate of the bankrupt firms in Sweden seems quite surprising taking into consideration that the data do not cover informal workouts. No doubt the role of the bank in pre-packaging deals before auctions is crucial in explaining the survival rate. The figures indicate that criticism of highly creditor-oriented insolvency procedures on the grounds that they cause too many shut-downs of firms should be questioned.

Franks and Sussman (2000) present complementary evidence for Britain. They show in a study of three banks' handling of distressed firms that the banks have implemented elaborate informal rescue processes. The majority of distressed firms remain outside formal procedures, and the rate of liquidation does not seem particularly high, when banks remain in control of the insolvency procedure.

Wood (1995) notes that the greatest disincentive for informal workouts of distress situations is the existence of relatively debtor friendly restructuring law. The evidence for Sweden and the UK seem to confirm this observation. Furthermore, there is no evidence that the existence of strong restructuring law (France, US) allows a greater survival rate for financially distressed but viable firms as compared to countries with no or ineffective restructuring laws (UK, Germany, Sweden). The caveat to be noted here is that the evidence presented refers to periods with normal economic conditions.

The conclusion that may be drawn from the evidence presented is that the absence of restructuring law has not hindered the survival of viable firms in financial distress during normal times, and probably speeded up the shut-down of economically distressed firms. The anecdotal evidence from Sweden during a period of severe macroeconomic crisis 1991-93 including a banking crisis indicates that the Swedish informal system for restructuring did not function as well as during normal times, however. The willingness of banks to supply credit for survival was reduced, and there were few potential buyers with the means to buy distressed firms as a 'going concern'. An important question is whether a system with easier access to formal restructuring procedures could function better during macroeconomic crisis. Formal reorganization procedures may have the advantage of providing more time for alternative bidders to appear. The cost would be that the life of economically distressed firms could be prolonged as well. It is possible that the only effective remedy is to resolve a threatening banking crisis quickly.[6]

The evidence presented so far refers to Europe and the USA. We turn now to emerging market economies where explicit insolvency law plays a lesser role. InsolvencyAsia (1999) reports that prior to the Asian crisis in 1997 bankruptcies were almost non-existent in Indonesia, Korea, Thailand, Taiwan and the Philippines. Only Malaysia, Singapore and Japan among the East Asian economies had and have insolvency law that is actually applied with any frequency. There are three possible reasons why the actual insolvency procedures in a country can look very different from the system described in formal law. First, the credit allocation process of banks may be influenced by political factors, and specific groups with strong relations to a bank. Second, the legal process for dealing with insolvency according to the law may be ineffective, time consuming, and/or corrupt. Third, creditors and debtors may prefer informal procedures, perhaps because their value system differs from the one expressed in law.

Among the East Asian countries, Korea, Thailand, Indonesia and the Philippines had banking systems before the crisis that did not impose a hard budget constraint on firms, and political influences on credit allocation were strong as shown in Hussain and Wihlborg (1999). No doubt, many firms in economic distress were able to survive and accumulate losses over time in these countries, contributing to the crisis when the costs of the procedures became too high. As shown in Hussain and Wihlborg (1999) the judicial procedures were ineffective or unpredictable in terms of judicial handling in these four countries, as well as in Taiwan (China). Insolvency procedures thereby became de facto relatively debtor oriented. In Hong Kong (China) informal procedures seem to be have been preferred in spite of the existence of an effective legal system. Also Taiwan (China) seems to have had effective informal procedures although the legal system was unpredictable. In contrast to the other countries with ineffective legal procedures banks in Taiwan (China) imposed hard budget constraints on firms avoiding the accumulation of economically distressed firms. Malaysia is the anomaly in Asia. The country was hit hard

[6] The role of capital requirements play in supplying liquidity in a macroeconomic crisis is another factor deserving research.

by the crisis in spite of effective formal procedures for dealing with firms in economic distress, and a reasonably sound credit allocation process. The effective formal procedures seem to have contributed to a relatively fast recovery from the crisis in Malaysia, however.

Japan has relatively creditor-oriented and effective procedures for insolvency. Formal restructuring procedures are inaccessible much like in Sweden. However, the recent and ongoing banking crisis in Japan indicates that banks have been too generous in providing credits to related firms, and there is a reluctance to cut off credits even when firms are in economic distress. The legal infrastructure for handling bankruptcies and restructuring or workouts certainly exists, if only banks have incentives to try to recover their claims.

Indian insolvency procedures are discussed in Wihlborg and Gangopadhyay (2001). In spite of its British inspired creditor oriented law the debt recovery and restructuring systems are extremely ineffective. Large firms in distress enter administrative restructuring proceedings that effectively protect debtors for years. Small firms on the other hand are subject to legal proceedings but these are very time-consuming. There is also a draconian law threatening debtors with imprisonment for certain arrears of payment. Such draconian consequences of distress do not contribute to the process of rehabilitation of a firm, however. The incidence of bank-led informal workouts of viable firms seems to be low in India.

Insolvency procedures in Latin America are discussed in Rowat and Astigarraga (1999). They describe insolvency procedures as ‘woefully inadequate’ in most countries of the region. The procedures are rigid and formalistic, they give judges too much arbitrary power to serve what they consider the ‘general interest’, there is widespread cynicism about political influences overriding judgements, there is a powerful bias in favor of labor claimants, and corruption is rampant. Although the procedures are seemingly debtor oriented they do not provide debtors with effective means to preserve going concern-value. Nevertheless, any reform that is considered simply pro-creditor is likely to receive strong resistance according to the mentioned writers.

Turning to the former socialist countries in Eastern Europe many have implemented modern insolvency law but few have managed to enforce the laws successfully. Poland and Estonia are the countries that have progressed the most in terms developing a functioning insolvency system based on law.[7] However, lack of capacity in the legal system is a problem in all the countries. Lack of expertise and tradition affect the time of proceedings take, as well as the ability of creditors to recover assets from the insolvent estate. Uncertain and ill-defined property rights have naturally been a hindrance for secured lending in Eastern Europe. Djankov (1998) reports about Romania that ‘isolation programmes’ for large loss-making state enterprises have been implemented but the soft budget constraint imposed by banks have undermined these administrative restructuring procedures. Banking reform has not progressed far. Djankov questions the effectiveness of administrative restructuring procedures outside the court system on the grounds that such systems are more vulnerable to interferences by special interest groups.

Insolvency procedures in Russia are discussed in, for example, Gaddy and Ickes (1999a, b) and Freinkman and Starodubrovskaya (1995). There is a modern insolvency law but the

[7] See, for example, Coates and Mirsky (1995), Gray (1996) and (1997), and Montes-Negret and Papi (1996).

procedures seem to be used for asset diversion of enormous magnitudes through the activities of an 'arbitration managers' appointed by a court to lead the insolvent entity after bankruptcy filing. Large resources of industrial groups are spent on influencing the choice of arbitration manager.[8]

Turning, finally, to the evidence for Africa hard data is lacking. The evidence is impressionistic but consistent. In a senior policy seminar organized by the African Development Bank (1997) legal institutions in most of Africa are described as inappropriate and lacking qualified personnel. The credit allocation process is strongly influenced by political factors and 'relations'. As a result, there is a large overhang of non-performing loans in most countries and there is no effective legal system for recovery of loans and security. For Kenya specifically, the World Bank (1992) reports that the judiciary and the court system is characterized by lengthy delays, judges lacking autonomy from the political sphere, and unpredictability. There is an extremely high level of administrative discretion on all levels in commercial matters leading to political influences substituting for commercial predictability, and providing a fertile ground for corruption. Thus, in spite a heritage of formal laws from the previous colonial powers in sub-Saharan Africa, these laws seem to have little effect on insolvency procedures in practice. South Africa is an exception, however. In the next section we review some evidence on enforcement of insolvency law and indicators of the quality of legal institutions in Africa.

5. Enforcement, and the quality of legal institutions and the financial sector in sub-Saharan Africa

The evidence presented in the previous section show that in large parts of the world lack of enforcement renders the letter of insolvency law nearly meaningless. Creditor oriented law in many countries becomes de facto debtor oriented in practice. Without court enforcement of insolvency law, the actual rights of creditors at the time of a borrower's insolvency are uncertain and the stakeholders that are able to influence court proceedings or banks' credit allocation stand to gain the most. In this section enforcement of insolvency law in Africa is studied. First, evidence with respect to the financial sector is considered. Thereafter indicators of the quality of the legal systems are presented.

5.1 Financial crises and financial repression

Financial sector reform has been on the development agenda in Africa since McKinnon and Shaw in the 1970s coined the term 'financial repression' to characterize a financial system lacking the ability to supply credit to a great number of viable projects, and misallocating the scarce existing resources. By lifting interest rate ceilings for the banking system, financial resources were expected to be mobilized and channeled by banks. By privatizing or, at least, commercializing the banking system, the credit-allocation mechanism would be improved. Financial sector reform initiated in a large number of countries during the 1980s followed these principles. 'It is now broadly confirmed that the response of investment to the variety of reform measures being widely pursued in the region has been quite poor' writes Ndulu (1997) summarizing the results of research for the Second Senior Policy Seminar organized by the African Economic Research Consortium (AERC) in November, 1996. 'The banking sector has retained its character of

[8] See Wihlborg and Gangopadhyay for an elaboration on this description.

providing short-term finance and capital markets remain either weak or absent in the majority of cases' according to the same source.

Table 4
Banking crises in Africa

Country with episode in 1980-95	Causes include politically motivated lending	Regulatory shortcomings	Debt recovery hampered by legal environment	Recurrent Problems
Benin	x	x	x	no
Cameroon	—-	n/a	—-	yes
Congo	—-	n/a	—-	yes
Central African Republic	—-	n/a	—-	yes
Chad	—-	n/a	—-	yes
Cote d'Ivoire	x	x	x	no
Eritrea	—-	n/a	—-	no
Ghana	x	x	n/a	yes
Guinea			x	yes
Muritania	—-	n/a	—-	yes
Kenya	x	x		yes
Madagascar	x		x	yes
Mozambique	—	n/a	—-	yes
Nigeria	x	x	n/a	yes
Senegal	x	x	x	no
S. Africa	—-	n/a	—-	n/a
Tanzania	—-	n/a	—-	yes
Togo	—-	n/a		yes
Uganda	—-	n/a	—-	yes
Zaire	—-	n/a	—-	n/a
N. Africa				
Egypt	—-	n/a	—-	yes
Morocco	—-	n/a	—-	yes

Source: Caprio Jr. and Klingebiel (1996)

One explanation for the poor performance of the financial sector in African countries is that it has remained burdened by an overhang of non-performing loans originally given to publicly owned firms and parastatals. The banks have continued to finance these big often money-losing firms partly because the public sector, or well-connected interests with access to the 'public purse', have retained control over the domestic commercial banking sector in many countries. A sustained increase in the activities of foreign-owned banks has not solved the problem since these banks have not provided financing on a large scale to domestic manufacturing firms.

The accumulation of bad loans in commercial banks has led to banking crises in many African countries when the burden on the public sector of supporting banks with large credit losses has become overwhelming. Table 4 from Caprio Jr and Klingebiel (1996) shows the cases when banking crises have reached systemic proportions in 23 African countries between 1980 and 1995. The table shows that in a majority of countries ‘politically motivated lending’ and regulatory shortcomings were considered major causes of the crises. With few exceptions the crises were not resolved but considered as ‘recurrent problems’. One reason the crises tend to be recurring is that the legal environments in the sub-Saharan countires do not seem to support debt recovery as noted in Table 4. Efficient procedures for closing or rehabilitating insolvent have been lacking and recovery of assets pledged as security for loans have been time-consuming and uncertain. Popiel (1994) states that the recovery of non-performing assets have been ‘disappointing’ in all countries except Ghana, and that banking crises must be resolved jointly with the restructuring of the borrowing firms. Ghana along with Uganda have established ‘Non-performing assets trusts’ separating the bad loans from the healthy parts of the banks. These trusts focus entirely on debt-recovery, which includes contributing to the restructuring of distressed firms.repression.

Another perspective on the financial sector in Africa is offered by surveys conducted in the mid 90s within the framework of a World Bank project. The so-called RPED surveys (Regional Programme on Enterprise Development) focused on (i) enterprise finance, (ii) technical efficiency, (iii) structure of wages, and (iv) impact of regulation. Three rounds of surveys were conducted with more than 200 firms of varying sizes in each of seven countries: Burundi, Cameroon, Ghana, Kenya, Tanzania, Zambia and Zimbabwe. Biggs and Srivastava (1995) report that in all countries ‘lack of credit’ was considered the most severe obstacle to firm expansion among twenty possible obstacles including ‘lack of demand’, ‘lack of infrastructure’, and ‘labor regulation’. It is of course to be expected that an interviewed manager would say that lack of credit is a problem when the firm has been denied credit, whether the credit was to be used productively or not. Nevertheless, the prominence of ‘lack of credit’ as a problem in comparison with many alternatives (the manager could select only the three most severe problems) among twenty is an indication that something is amiss in the markets for finance.

Data on sources of financing confirm that the supply of credit is seriously constrained. Table 5 from Biggs and Srivastava (1996) shows the percent of firms in different size classes receiving a bank loan during the last five years, and bank loans as percent of sales. Among small firms with 10-20 employees the share of firms having received a bank loan lies between 20 percent (in Tanzania) and 49 percent (in Cameroon). The corresponding figures for large firms with more than 100 employees are 47 and 85 percent. Even in large firms the ratio of loans to total assets is low. For example, in Kenya the ratio of loans to total assets in large firms in 1993 was around 30 percent according to an RPED country-study (Isaksson and Wihlborg, 1994). The pattern for bank overdrafts used primarily as working capital is similar although the figures for ‘share of firms’ is slightly larger for overdrafts, while the total amounts are smaller. The same studies reveal that informal borrowing does not compensate for lack of bank credit. The amounts for informal borrowing are 5-10 percent of the amounts for bank loans and the country that relies most on bank credit—Cameroon, with formal loans amounting to 22 percent of sales—also has the largest market for informal loans with an amount of two percent of sales. The informal loans are to a large extent ‘business angels’ including family and friends for micro and small firms. Another observation is that the firms obtaining bank loans are mainly the ones also receiving trade credit, although in Zimbabwe and Tanzania the shares of small firms receiving trade credits is substantially higher than the shares receiving bank loans. Trade credits received are most important for large firms, however.

Table 5
Firms with access to bank loans and value of loans relative to sales in African manufacturing

Country	Micro	Small	Medium	Large	Average for all firms
Cameroon % of firms	31	49	48	85	
Loan as % of sales	17	27	25	15	22
Kenya % of firms	16	46	68	66	
Loan as % of sales	14	14	10	18	14
Tanzania % of firms	12	20	25	47	
Loan as % of sales	4	7	2	19	10
Zimbabwe % of firms	20	32	53	62	
Loan as % of sales	4	27	18	8	11
Zambia % of firms	12	27	37	63	
Loan as % of sales	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Briggs and Srivastava (1996)

For Kenya, Isaksson and Wihlborg (1996) show that a large share of micro and small firms rely entirely on cash transactions, although around 30 percent of micro and small firms are able to obtain advance payments as a source of financing. About half of the small firms owned by ethnic Asians are also able to obtain trade-credits. Except for the latter group of firms the results indicate that different forms of credit are not substitutes for relaxing the financial constraint. However, they may be substitutes for firms that have access to several kinds of credit. Additional light on the financial constraint firms is shed by figures for the value of collateral assets relative to the size of loans. Biggs and Srivastava mention that firms in Zimbabwe must offer collateral to a value of four times the loans while in Kenya, the figure is six. Isaksson and Wihlborg (1994) report similar figures for Kenya, and that the explanation given for the high collateral to loan value is uncertainty about banks' ability to claim the collateral in case of default. One example of uncertainty associated with collateral in Kenya is that so called Land Control Boards can invalidate the collateral by simply deciding that a bank's claim on a collateral asset must not be enforced allowing the borrower and owner of the asset to keep it.

Kenya and Zimbabwe are neither special nor extreme in the sub-Saharan region. Biggs and Srivastava (1996) provide similar information for Ghana, and Cameroon. The above statements from the African Development Bank and Popiel's (1994) observations indicate that political intervention in court proceedings and the overruling of court decisions are common in many African countries. Furthermore, proceedings may take several years to complete. The slow pace of court proceedings add costs to the process of debt recovery for the creditors, and provide debtors with opportunities to evade debt obligations. These stylized facts support the view that there are important institutional hindrances to an effective financial sector in most African countries. The African Development Report, 1997, calls for a more 'enabling' business environment including a 'credible legal and judicial framework that supports private economic rights and which is enforced equitably and transparently'. 'Laws relating to business contracts, property rights, collateral and debt recovery, commercial dispute resolution and arbitration will need to be enacted and effectively enforced' (ADR 1997:8). Bankruptcy law and, more broadly, institutions supporting debt recovery is clearly one of the legal areas singled out for attention as a potential source of continued financial repression. We turn next to the legal systems.

5.2 Indicators of legal system quality

The causes of lacking enforcement by the legal system may be low capacity of the legal system, lack of expertise and tradition, uncertain or ill-defined property rights, asset diversion/stripping by borrowers, arbitrary powers of courts, and corruption. These factors may also contribute to a soft budget constraint imposed by banks, because if a bank faces little likelihood of being repaid it may extend existing credit-lines in the hope of a turn-around of a borrower or the expectation of future state support. Weak property registration, accounting, and reporting standards contribute to the ability of debtors to divert assets from an insolvent estate. Corruption is, as noted, a widespread problem favoring particular groups. Naturally, the prospect of political intervention breeds corruption as does the great arbitrary powers of judges reported for Latin American countries above. In Africa, on the other hand, arbitrary powers of judges does not seem to be the main source of corruption. Instead the ability of politicians and administrative bodies like Land Control Boards to influence or overrule court decisions may breed corruption.

La Porta et al. (1997a, b) analyze the relationship between the supply of external finance and indicators of the quality of the judicial system based on data for a large number of countries world-wide. They show that legal institutional factors are important for variation across countries in the supply of external financing.[9] In Table 6 columns 2-6 show scores published in La Porta et al. (1997b) for the 'efficiency of judicial system', 'rule of law', 'corruption', risk of expropriation', and 'risk of contract repudiation' in four sub-Saharan countries and Egypt. The figures are averages for the period 1980-95. A high score indicates high quality (high efficiency and rule of law, low corruption and risk). The highest possible score is 10. With the possible exception of risk of expropriation, the different measures of quality of the legal system in columns 2-6 would seem to capture different aspects of enforcement. South Africa scores relatively well on corruption, and risk of contract repudiation indicating that banks' lending and debt recovery decisions would be relatively free from political influences, and that contracts are upheld in court. On efficiency of the judicial system south Africa's score is mediocre, while the rule of law

9 Demirguc-Kunt and Huizinga (1998) show that interest spreads on corporate debt issued by firms in different countries are influenced by an index of contract enforcement.

Table 6
Indicators of legal system quality in Africa

	Index of Economic Freedom w.r.t.					
	Property Rights (1)	Efficiency of judical systems (2)	Rule of law (3)	Corruption (4)	Risk of expropriation (5)	Risk of contract repudiation (6)
Botswana	2,00					
Cape Verde	2,00					
Mauritius	2,00					
Namibia	2,00					
Swaziland	2,00					
Djibouti	3,00					
Egypt	3,00	6,50	4,17	3,87	6,30	6,05
Gabon	3,00					
The Gambia	3,00					
Ghana	3,00					
Kenya	3,00	5,75	5,42	4,82	5,98	5,66
Lesotho	3,00					
Madagascar	3,00					
Malawi	3,00					
Mali	3,00					
Senegal	3,00					
South Africa	3,00	6,00	4,42	8,92	6,88	7,27
Uganda	3,00					
Zambia	3,00					
Benin	4,00					
Burkina Faso	4,00					
Cameroon	4,00					
Chad	4,00					
Congo, Rep.	4,00					

Ethiopia	4,00					
Guinea	4,00					
Ivory Coast	4,00					
Mauritania	4,00					
Mozambique	4,00					
Niger	4,00					
Nigeria	4,00	7,25	2,73	3,03	5,33	4,36
Tanzania	4,00					
Togo	4,00					
Equatorial Guinea	5,00					
Guinea-Bissau	5,00					
Rwanda	5,00					
Zimbabwe	5,00	7,50	3,68	5,42	5,61	5,04
Angola	N/R					
Burundi	N/R					
Congo, Dem.Rep.(form. Zaire)	N/R					
Sierra Leone	N/R					
Somalia	N/R					
Sudan	N/R					

Source: La Porta et al. (1997b)

Notes: assessment by ICR; average (1982-95); scale from 0-10 with high score indicating low risk.

(1) Property Right Grading Scale (Source: The Heritage Foundation, 2001) 1 very high: Private property guaranteed by the government, and efficient court system enforces contracts: expropriation unlikely. 2. High: private property guaranteed by the government, but enforcement lax; court system is inefficient or subject to delays; expropriation unlikely. 3. Moderate: government recognizes some private property rights, but property can be nationalized; expropriation possible; judiciary subject to influence. 4. Low: property ownership limited with little legal protection; expropriation likely, and government does not protect private property adequately; judiciary subject to influence, possible corruption within judicial process. 5. Very low: almost all property belongs to the state; expropriation certain, <u>or</u> country so corrupt and chaotic that property protection is nonexistent.

(2) Efficiency of judicial system: is efficiency and integrity of the legal environment as it affects business, particular foreign firms produced by Business International Corporation. Average 1980-93, scale from 0-10 with 10 for high efficiency.

(3) Rule of law: an assessment of the law and order tradition in the country produced by International Country Risk (ICR). Average 1982-95; scale from 0-10 with 10 for strong tradition.

(4) Corruption: ICR's assessment of the (lack of) corruption in government. For example, 'bribe connected with import and export licenses, exchange controls, tax assessment, policy protection and loans' indicate corruption. Average 1982-95, scale from 0-10 with high score indicating low corruption.

score is very low. The latter score reflects the apartheid past. The other scores reflect that South Africa has had an at least functioning legal system supporting contractual arrangements including insolvency procedures based on Dutch law. Nigeria and Zimbabwe score relatively high on efficiency of judicial system but very low in other dimensions. These scores could indicate that courts work relatively fast but with unpredictable and arbitrary results relative to original contracts.

Column 1 in Table 1 shows the 2001 scores for the scope, and the enforcement of property rights for most sub-Saharan countries and Egypt. These scores represent one aspect of the Heritage Foundation's 'Index of Economic Freedom'. The scores are on a scale from 1 to 5 with a low score indicating high quality, i.e. wide scope of property rights that are well enforced. The table's footnotes describe the meaning of the scores. The description of the scores show that only the best score (1.00) is consistent with strict enforcement of insolvency and other laws pertaining to contracts with respect to property. All Western market economies obtain the highest score. The score 2 means that enforcement is lax, while a 3 indicates uncertain rights, insecure contracts, weak enforcement, and possible corruption. As seen in the table only five countries—of which two are islands—score better than 3 (Botswana, Cape Verde, Mauritius, Namibia, and Swaziland). South Africa receives a score in 2001 that is as weak many other sub-Saharan countries. In comparison with the older data in the other columns the low score for South Africa seems to indicate that contracts and property rights are now considered more insecure than during the old regime. These data constitute a harsh judgement of the legal systems in sub-Saharan Africa. They go a long way in explaining the financial repression, and financial crises discussed above, and in explaining a wide difference beween the letter and the implementation of insolvency law.

6. Issues of design of insolvency law as a contract

Insolvency law is a relatively complex body of law. There are many dimensions both to formal law, and to enforcement. A number of issues that countries must face when reforming insolvency procedures are discussed in Wihlborg and Gangopadhyay (2001):

i) Is insolvency law necessary and if so must it be mandatory?

ii) Which contractual obligations of a distressed firm should be recognized in insolvency?

iii) What priority shall be given to liabilities to employees, tax authorities, and to other social objectives?

iv) Is there a need for a formal process for restructuring? If so, should access be restrictive, and incentives to use the process weak or strong?

v) How will legislation deal with foreign claims on the firm and by the firm?

vi) How can enforcement of the law be assured?

vii) Do market oriented solutions provide an alternative?

The discussion here is limited to the relatively controversial issues (i), (iv), and (vi).

6.1 Is insolvency law necessary and, if so, must it be mandatory?

Insolvency law is one aspect of a category of laws called ‘law of contract’. This category represents contract law, and laws that can be interpreted as ‘standard form contracts’ specified in law. Company law and insolvency laws are examples of such ‘standard form contracts’.[10] A fundamental principle of a market economy is that contracts voluntarily entered into should be respected. Insolvency law determines how involuntary breach of certain contractual obligations shall be dealt with.. Clearly, the procedures for dealing with such a failure can be regulated in ex ante contracts between the firm and various stakeholders. The complexity of financial obligations is so high, however, that transactions costs (negotiation, information and enforcement costs) could be very high if there were no ‘standard form contract’ provided by the legislature in the form of insolvency law.

To go one step further it is useful to distinguish between ‘enabling’ and ‘mandatory’ law. *Enabling law is* either a standard form contract that can be amended and changed as desired in mutual agreement by the contracting parties, or there is no explicit law but only recognition and enforcement of voluntarily entered contracts. For example, enabling standard form corporate charters permit shareholders to change their rules of governance to adapt to changing circumstances. The purpose of having a prespecified, enabling standard form contract is that the standard form provides information about what aspects of a contract parties need to think of, and it provides a ‘default contract’ for those who do not want to enter negotiations on many details. *Mandatory law* not only pre-specifies a standard form contract but it provides the only legal contract. Parties cannot deviate from the standard form even if they would be in agreement. Macey (1992) and Wihlborg (2000) argue that mandatory law tends be less efficient than enabling law, but that mandatory law is necessary for lawmaker to achieve objectives other than economic efficiency (in a dynamic sense). The political interests of the state and employees, in particular, are often given special weight, and these interests may not be served in accordance with the political interests if insolvency law is made enabling in every respect.[11]

Even if insolvency law is made mandatory with respect to particular social objectives, it can be designed in such a way that it provides strong incentives for, and enables efficient workouts outside court. In particular, the degree of creditor- and debtor orientation or more appropriately, the degree to which ex ante contracts are recognized in insolvency, affects the incentives for informal workouts as noted in Section 3. If debtors are given a strong position and contracts cancelled, debtors have an incentive to delay resolution of insolvency. During a delay, they will not have to repay, assets can be diverted in their favor, or they may hope for a turn-around of fortunes. On the other hand, if creditors are given strong rights, and their claims are largely preserved, they have an incentive to resolve the insolvency in a way that maximizes the value of the estate and their claims. Thus, if they can contribute to a solution with the firm continuing as a ‘going concern’ they would do so when such a solution increases the expected value of their claims. If the current management is the best suited to continue in control, then the creditors would want to contribute to a solution that allows such a resolution. Evidence was presented in

[10] Posner (1992) distinguishes between contract law, property law, and tort law in the area of civil law. Insolvency law belongs to the first group.

[11] The arguments for mandatory law and against enabling law have primarily been made by legal scholars such as Eisenberg (1989), McCheney (1989), Gordon (1989), and Romano (1989).

Section 4, that senior creditors in Sweden and the UK generally contribute to the preservation of going concern values either by contributing to court-led resolutions, or through informal reorganizations of distressed firms.

6.2 Is there a need for a formal process for restructuring? If so, should access be restrictive, and incentives to use the process weak or strong?

As noted informal restructuring is likely to occur in a creditor-oriented insolvency system recognizing ex ante contracts. Thus, there are great advantages to a creditor-oriented regime with very limited opportunities for court-led restructuring, since the existence of formal restructuring law acts as a disincentive for informal solutions. It was noted in Section 3 that the role of restructuring law should be determined in coordination with other rules for financial markets in general and banks in particular. For example, reliance on effective informal arrangements require that banks' incentives are consistent with the maximization of the value of assets. It is therefore most important that state guarantees of the banking system are abandoned, and that banking crises are resolved in a speedy manner in order to maintain banks' incentives to maximize asset.

6.3 How can enforcement of law be assured?

Enforcement is perhaps the most intractable problem in the area of insolvency law. Lack of enforcement is a world-wide problem but it cannot be solved by simply writing law. In a legal vacuum with no legally enforceable property rights and/or no rules regulating allowed transactions, mafia type regulation and enforcement will develop to make socially necessary commercial transactions possible. Physical force or the threat of violence will define property rights or become the primary means for contract enforcement. This is, however, a very inefficient system with high transaction costs. A viable market economy requires that parties to a voluntary transaction must feel secure that traded property changes hands securely, with a minimum of transaction costs, and each party must have some recourse to corrective action, other than threat of violence, in case of non-performance by the other party to the transaction. One requirement for this security is that the buyer knows that the seller has the right to sell. For many kinds of property simple possession satisfactorily defines ownership, but real estate transactions require more formal proof of ownership in the form of registration and title of ownership. This area is still unsettled in many of the formerly socialist countries.

Enforcement of financial contracts requires that property of a delinquent borrower can be identified. Similarly, contractual arrangements with and among firms require that property of the firm, and individuals signing are identifiable. Thus, firms as legal persons must be registered with the names of individuals acting as their agents. Apart from these registration requirements for some property, security of contractual relations in the absence of detailed law requires that the state enforce voluntary and 'reasonable' contracts, i.e., contracts that are not entered under duress. Some kind of arbitration and dispute settlement mechanism is necessary, although such a mechanism can be agreed upon in contract. Thus, even in this case can 'enforcer of last resort' be required.

In the absence of state-supported enforcement contract fulfillment must rely on self-enforcement. The most important mechanism of this kind is reputation. The threat of lost reputation is sufficient for many transactions involving etablished firms with repeated transactions within a well-defined group. Other types of self-enforcement are more costly.

Requirements for advance payments, a bond, or the internalization of transactions within a firm are examples. Reputation as an enforcement mechanism is not likely to work well unless repeated transactions are expected. It is a mechanism that cannot be relied upon in insolvency negotiations except possibly in countries where a strong social stigma would be associated with opportunistic behavior. Without court enforcement of insolvency law, the actual rights of creditors at the time of a borrower's insolvency become uncertain and the creditors who are able to apply influence of some kind will be the ones that have the strongest security. If the influence of the debtor in political or physical terms is substantial, then even a strictly creditor-oriented insolvency law becomes de fact debtor oriented. Enforcement touches on the very fundamentals of the political and economic system of each country. Powerful groups in various countries must find it necessary for their political survival to create an effective legal system, and old networks of influence must be destroyed.

Some first steps towards enhancement of the efficiency of the legal insolvency procedures are proposed for Latin America in Rowat and Astugarraga (1999). These steps have the objectives of increasing transparency, legal competence, and the capacity of the legal system. Enforcement problems in the area of insolvency law have also been recognized in recent initiatives from the World Bank, the Asian Development Bank, and the African Development Bank.[12]

7. Concluding remarks

Pistor et al. (200) state that 'The effectiveness of legal institutions has a much stronger impact on external finance than does the law on the books'. This statement is supported by the review of insolvency procedures across the world in this paper. Emerging market economies, with few exceptions, do not support the letter of the law with effective application and enforcement. Either the banking system allocates credit such that insolvency procedures are made irrelevant, or the legal system is so slow, unpredictable or corruptible that written law and its intent lack force. Most sub-Saharan countries perform very poorly both in terms of the banking system's ability to allocate credit and in terms of the effectiveness of the legal system. The letter of the insolvency law is essentially meaningless, although there are examples of countries where there are ongoing efforts to improve enforcement of debt contracts. Ghana and Uganda are such examples.

We have noted that changes in the legal system and its enforcement mechanisms take time. Experiences from Indonesia and Latin America indicate that strong enforcement of existing law lacks support among powerful groups. Effective enforcement requires public support for the intent of the law, as well as respect for legal institutions. In some countries like Taiwan and Hong Kong effective informal procedures seem to have developed without much use of the legal system. These experiences can probably not be generalized, however. Informal procedures also depend on the legal procedures as the ultimate threat.

The economic role of insolvency procedures and the design of effective procedures have also been discussed. One conclusion refers to the controversial issue of design of

[12] The main World Bank initiative is called GILD, Global Insolvency Law Database. A database covering insolvency law across the world is developed and made accessible through the World bank webs-site'.Best practices' principles for insolvency law are also developed.

restructuring law. The tendency to implement more easily accessible restructuring law may not increase the survival rate of viable but insolvent firms, nor decrease the rate of survival of firms producing negative value. Instead such formal procedures act as a disincentive for informal workouts based on ex ante contractual agreements. Weak enforcement of bankruptcy law has the same effect, since in general weak enforcement makes it possible for debtors to evade contractual obligations.

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