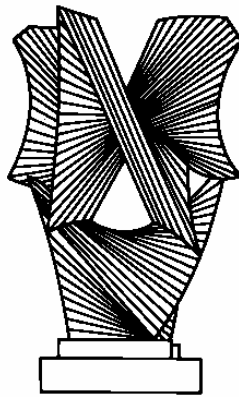


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## Credit Markets, Creditors' Rights and Economic Development

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## CREDIT MARKETS, CREDITORS RIGHTS AND ECONOMIC DEVELOPMENT

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Credit markets are just as important as equity markets to financial development. And in most countries far more finance is generated in credit markets than in public equity markets. Even in the United States, which is usually thought the country with the most pronounced equity culture, far more money is raised in credit markets than in equity markets.

### The Role of Banks

The central institution for large-scale lending, the bank, is therefore the point of departure for any analysis of financial development for developing countries. It is true that some developing countries have corporate debt markets, especially the more developed of those countries, but even the countries of Southeast Asia that have been successful in developing stock markets are still at the early stage of developing corporate debt markets.<sup>1</sup> Hence, the focus of the first part of this chapter will be on banks. The discussion will turn to special problems that creditors—not just banks but all creditors—face when the borrower cannot pay or fails to pay. The core of the legal issues turns on creditors rights law and bankruptcy law.

Because banks play such a central role in developing world economies, it is important to look at the special role of banks in those countries. The fundamental economic role of a bank is to be an intermediary between savers and the ultimate users of savings, who invest those savings in nonfinancial assets. (Of course, in some countries the public sector deficit is large and financial intermediaries use the flow of savings to

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<sup>1</sup> Dickie and Fan (205).

increase their holdings of government bonds, which from the standpoint of the real economy is not investment but rather a dissipation of savings.) The efficiency of the transmission of savings to those ultimate users is essential to economic development. To the extent that banks are the principal channel of that transmission, as is the case in most developing countries, banks play a crucial role in the development process.

For several reasons, however, banks may not play that role with efficiency. The banks may themselves be state-owned; over 42 percent of the equity in the ten largest banks in the average country was owned by the state as late as 1995.<sup>2</sup> For all kinds political and personal reasons, it is difficult for managers of state-owned banks to make purely business decisions. Perhaps not surprisingly (though the direction of causation may be an issue), Barth, Caprio and Levine found that greater government ownership of banks is associated with less well developed financial systems.<sup>3</sup> And La Porta, López-de-Silanes and Shleifer found that “higher government ownership of banks is associated with slower subsequent development of the financial system, lower economic growth, and, in particular, lower growth of productivity.”<sup>4</sup> For one reason, as Sapienza shows with respect to Italy, the “lending behavior of state-owned banks is affected by the electoral results of the party affiliated with the bank.” In particular, she found that “the stronger the political party in the area where the firm is borrowing, the lower the interest rates charged.”<sup>5</sup>

### Directed Lending, Crony Capitalism and Related Lending

Privately owned banks may not be in a position to operate solely on a commercial basis. On the one hand, the government itself may direct the flow of savings. This is particularly the case where much of the economy is in the hands of state-owned industries and therefore the government chooses to use the savings of citizens to provide financing (often to cover losses) of state-owned industries. A mechanism for doing so is *directed lending* where political influence is used to allocate bank loans to favored sectors and companies. Even where the government chooses to use directed lending to assist sectors of the private economy that it considers of strategic importance, as was a central tenet of South Korean development policy for several decades,<sup>6</sup> one can question whether directed lending does not interfere over the long run with the development process by undermining the vitality of the banking sector and by misallocating resources.

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<sup>2</sup> La Porta, Lopez-de-Silanes and Shleifer [hereafter LLS] (2002, p. 267).

<sup>3</sup> Barth et al. (2001, p. 47).

<sup>4</sup> LLS (2002, p. 267).

<sup>5</sup> Sapienza (2004, p. 357).

<sup>6</sup> Cole and Park (1983, p. 284).

Even where a developing country government does not consciously use directed lending as a development policy, it may not have available the normal tools of monetary policy and therefore may actively encourage or discourage certain types of lending in order to stabilize the macroeconomy. For example, in 2004 China tried to fight off overheating of the economy by directing banks to reduce certain kinds of lending. But since local governments were themselves directing lending to locally popular “prestige projects,” the discouragement of that lending by the central authorities can be viewed as a further illustration of the perils and complexities of a system based on directed lending.<sup>7</sup>

Governments, of course, find it difficult to avoid having some influence on bank lending. For example, prudential regulation, which one finds in both developed and developing countries and which is generally regarded as an essential responsibility of governmental banking regulators, may steer banks away from what are regarded by the regulators as overly risky loans. The intent of prudential regulation is to insure the safety and soundness of the banking system, but it may also affect development outcomes, especially where there are few other channels for savings to reach the ultimate users of those savings.

A further distortion of bank lending beyond directed lending lies in what has been termed “crony capitalism.” Since in many countries controlling shareholders of banks tend to have broad interests, including politics if only because political influence is good for their bank’s success, those controlling shareholders may be motivated to lend to friends of the government or of the party in power. Such crony capitalism lending played a considerable role in the Asian financial crisis of the late 1990s. A particularly egregious combination of directed lending and crony capitalism was experienced in Indonesia leading up to that crisis. Dwight Perkins of Harvard University pointed to the contrast between precrisis efforts to strengthen the Indonesia banking system and what actually happened in the crisis:

The Harvard Institute for International Development, among others, was involved in [a bank strengthening] effort in Indonesia over many years. The laws were rewritten, bankers were trained, private banks were authorized and proceeded to grow rapidly, and the commercial banks were given substantial autonomy from the central bank. And yet, as of 1999, all of Indonesia’s banks were technically bankrupt.... Indonesia’s banking problems ... were [in part] a result of a decade in which many of the banks had been the toys of the ruling elite and could not have withstood even a mild crisis without government support.... To prevent the recurrence of a similar crisis at some later date, the banks must stop being

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<sup>7</sup> Kynge (2004).

subject to the discretionary interventions of high officials in support of pet projects.<sup>8</sup>

Moving banks away from directed lending and crony capitalism is only partly a task for substantive law and the legal system. More competition in banking would help to drive bank management toward greater efficiency. And a hands-off policy by the government would equally help. But even if directed lending and crony capitalism were eliminated, corporate governance issues concerning self-dealing (reviewed in the previous chapter) take on a central importance in the banking sector because of banks' central role in the economy of most developing countries.

Banks are, of course, corporations and some of the problems in the banking industry parallel those of corporations generally. Problems related to controlling and minority shareholders are directly relevant to banks. A survey of 44 countries showed that only about 25 percent of banks are widely held (having no shareholder with more than a 10 percent interest) and among the remaining 75 percent, a family is in control of more than half.<sup>9</sup> Hence, the opportunities of controlling shareholders to engage in self-dealing are abundant. In addition to the ways in which controlling shareholders can gain financially at the expense of minority shareholders in nonfinancial corporations, they have even more options for doing so in banks. A common way of doing so is by lending to parties related to the controlling shareholders.

Because of the corporate structure of many developing countries, the opportunities for such self-dealing in the banking area are widespread. La Porta, Lopez-de-Silanes, and Zamarripa listed 24 developing countries where “prominent” banks were “controlled by persons or entities with substantial nonfinancial interests.”<sup>10</sup> To study the incidence and effect of such “related lending” by banks, the authors picked a random sample of loans from the top 300 loans of all banks in Mexico outstanding at the end of 1995 and followed the loans' performance through the end of 1999. Among their many findings were that loans to related parties were: (1) made at 4.15 percentage points lower interest rates than to unrelated parties; (2) 30 percent less likely to be made against collateral; (3) less likely to be backed by personal guarantees (such as by an officer of the borrower); and (4) made for longer maturities and with longer grace periods.<sup>11</sup> Their findings on outcomes were even more dramatic. The default rate was 66.4 percent for related borrowers versus 37 percent for unrelated borrowers. And the recovery rates for

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<sup>8</sup> Perkins (2000, p. 242).

<sup>9</sup> Caprio et al. (2004, p. 16).

<sup>10</sup> La Porta et al. (2003, p. 233).

<sup>11</sup> La Porta et al. (2003, p. 253–254).

bad loans were 27 percent for related borrowers versus 46 percent for unrelated borrowers.<sup>12</sup> These two findings on outcomes are mutually reinforcing; loans to related borrowers not only produced more defaults but also led, after default on a particular loan, to a lower recovery rate.<sup>13</sup>

The problem is by no means limited to Mexico or even Latin America. Faccio, Lang and Young reported that “effectively all (96.91%) Asian loosely-affiliated nonfinancial corporations are affiliated to a group that also controls a bank at the 10% level.”<sup>14</sup>

The conclusion is clear that banks present not just special corporate governance problems, but, in view of the centrality of banks in the economies of many developing countries, a special challenge to prudential regulation of banking activities. The corporate governance issues are essentially legal problems, but the prudential regulation issues are largely beyond the scope of this book.<sup>15</sup>

### The Relationship of Creditors Rights and Bankruptcy

Two fields of law heavily influence the strength of a financial sector in the credit arena. One is the law of creditors rights, and the other is bankruptcy law. They are related. And both legal fields are underdeveloped in the developing world. Sometimes the two fields, being closely related, are confused in the eyes of policymakers who focus on the inability of debtors to pay, and therefore on the rights of creditors in the event of bankruptcy.

Short of bankruptcy, there is a problem of creditors who are solvent but who simply find it more convenient not to pay interest and principal when they believe they can avoid doing so. Economic development will be compromised if debtors can get by with procrastination. The size and growth of credit, which is the lifeblood of business, will be inadequate. An adequate law on secured credit helps to deter procrastination by allowing creditors to foreclose on property provided by debtors to secure their repayment. The World Bank has estimated “annual welfare losses caused by barriers to secured transactions ... at 5 to 10 percent of GDP in Argentina and Bolivia.”<sup>16</sup>

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<sup>12</sup> La Porta et al. (2003, p. 256).

<sup>13</sup> In interpreting these outcomes, it is important to know that Mexico experienced a financial crisis in the wake of a December 1994 devaluation of the Mexican peso and so during the 1995–1999 period the overall incidence of nonperforming loans was quite high and indeed many banks became bankrupt or were rescued by the government.

<sup>14</sup> Faccio et al. (2003, p. 25).

<sup>15</sup> On prudential regulation see Barth et al. (2004) and related articles in Mishkin (2001).

<sup>16</sup> World Bank (2001b, p. 93).

The importance of bankruptcy law lies in part in making the resolution of multiple creditors' conflicting claims more orderly and thereby enhancing the amount of their joint recovery. Efficient bankruptcy procedures can thereby enhance the willingness of creditors to lend in the first place and hence strengthen financial markets.

Efficient bankruptcy procedures have an economic function as well in markets for goods and services. Just as entry, free of unnecessary governmentally imposed barriers to that entry, is important to competition and hence to economic growth, exit is also important to economic progress. Inefficient firms need to exit the economy to make room for more efficient firms. To be sure, failing firms may eventually close their doors when they run out of money, fail to pay existing creditors, and can obtain no further credits.<sup>17</sup> But a large firm may have many creditors, and a legal fight among creditors over the assets may delay the actual exit of the firm, especially if the firm still has some going concern value that could justify a sale to a more able entrepreneur. The continued presence of doomed firms is not just an unnecessary barrier to entry of more efficient firms but impedes economic development. An efficient bankruptcy system may make their exit faster and less damaging to third parties, particularly creditors. The World Bank found a correlation between creditors' recoveries and the level of private credit (measured as a percentage of GDP).<sup>18</sup> The industry from which the inefficient firm exits achieves higher productivity, and productivity in the economy as a whole correspondingly increases: "Exit of unviable businesses contributed 19% to productivity growth in Taiwan (China), 23% in Korea and 39% in Indonesia in the 1990s."<sup>19</sup>

The temptation of governments to intervene or to preempt the judicial machinery of bankruptcy, particularly for big companies with large numbers of employees, is well-known, even in developed countries. In earlier periods when state ownership of industry was more popular than today, nationalization of failing companies and industries was a favorite technique. Experience shows that much state ownership of industry arises from just such bail-outs. Italy created large state-owned conglomerate holding companies (such as IRI) in the 1930s, not out of ideology but rather to protect existing industrial and utility company against creditors' threats to dismember the companies by selling their assets in bankruptcy.<sup>20</sup> With nationalization having fallen from favor, governments still attempt to fend off bankruptcy with state credits or state credit guarantees, which simply assure that bankruptcy cannot carry out its economic function of facilitating exit.

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<sup>17</sup> World Bank (2005, p. 67).

<sup>18</sup> World Bank (2005, p. 73, Figure 9.7).

<sup>19</sup> World Bank (2005, p. 73).

<sup>20</sup> Rajan and Zingales (2003, p. 212–216).

Although bankruptcy may facilitate exit for a firm with many creditors, it is not necessary where there are few creditors. As we will see, secured credit can in that simpler situation substitute for bankruptcy; the secured creditor can foreclose, enforcing his secured interest, without any need for a bankruptcy court. Indeed, especially in a case where the debtor is solvent but simply unwilling to pay, even an unsecured creditor can bring an action in court, obtain a judgment, and then proceed to levy on the debtor's property in satisfaction of his judgment. Of course, insolvent firms often simply close down voluntarily. In 2003, there were some 57,000 bankruptcies in the United States, but the remainder of the 600,000 business closures in that year took place outside of bankruptcy.<sup>21</sup>

Quite aside from governmental influence and corporate governance issues, there is a further set of legal issues about the rights of creditors when borrowers face financial difficulties. Insofar as corporate bond markets and other forms of securitization of credit have not been developed, banks are likely to be the principal creditors. But at this more general level of analysis, it makes little difference whether creditors are banks or groups of bondholders or other kinds of lenders, or even trade creditors who supply goods and services on credit. The important contribution that law reform can make in this area of economic development is in the legal fields of secured credit and of bankruptcy law.

Much of the literature on economic development fails to make a distinction between creditors rights law and bankruptcy law. The result, for example in the Legal Origins literature, is considerable confusion. And the distinction is not an easy one because the two areas of law interact whenever bankruptcy is declared.

Two legal points are crucial. First, the rights of creditors are established by commercial law, not by bankruptcy law (though those rights can be affected once bankruptcy is declared). In particular, secured creditors have enforcement rights against a nonpaying debtor; the most important of those rights have to do with collateral. Secured creditors can enforce those rights even though the debtor is not in bankruptcy. And the priority among different classes of creditors is normally the same, at least in principle. These rights are of great importance in everyday life. To take a simple example, repossession of automobiles by lenders is an everyday occurrence on the streets of U.S. cities. This is an instance of a self-help creditor remedy. But court actions are also common.

Second, once bankruptcy is declared, a new legal situation is created. The rights of creditors, including secured creditors, and the priorities of different classes of creditors

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<sup>21</sup> World Bank (2005, p. 67).



normally carry over to the new bankruptcy context. The question of absolute priority, when raised in the bankruptcy context, refers to the enforcement of those prebankruptcy priorities in the bankruptcy context. However, bankruptcy law controls this issue.

Most economists believe that the best system for economic development is one that gives the strongest protection for creditors. The theory is that such protection maximizes the willingness to lend and hence leads to greater financial development. But there are different kinds of creditors whose rights potentially conflict: lenders who contract for security (e.g., a mortgage); unsecured creditors, including trade creditors (who sell under a contract calling for future payment); workers who normally are paid only after labor is performed; and governments that are owed taxes.

A World Bank study finds a correlation between country per capita income levels and what kinds of claims have priority: “Lower-income countries are less likely to give priority to secured lenders” and are more likely to give priority either to claims of labor or to government claims.<sup>22</sup> The law in many countries, and not just developing countries, makes tax claims of governments and certain rights of workers, normally the right to unpaid wages, senior even to secured creditors. According to a World Bank survey, labor claims have top priority in France and in many French legal origin countries as well as in India (a common law country), while taxes have top priority in a number of countries of French, German, and common law legal origin.<sup>23</sup> (The United States also gives tax claims of the Federal government priority over private secured creditors, but the impact is limited by the rule that the government claim has to be manifested in the filing of a tax lien in the appropriate registry--which normally takes place a few years after the tax becomes due; even when filed the U.S. tax lien does not take priority over creditors acquiring their secured interest prior to the filing of the lien.<sup>24</sup>)

### Secured Credit

In view of this complex relationship between secured credit and bankruptcy, it is best to start with the prebankruptcy rights of creditors. And the most important of those rights have to do with secured credit. A secured loan involves collateral. Where the debt is secured by real estate, a mortgage is involved. When the debt is secured by movable property, a variety of terms is used (security interest, pledge, charge, lien, etc.), causing considerable confusion. But the terminology is less important than the existence of an effective mechanism to enable secured credit. It is in this area that legal reform is especially

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<sup>22</sup> World Bank (2004, p. 76).

<sup>23</sup> World Bank (2004, p. 76, Table 6.3).

<sup>24</sup> Picker et al. (2002, p. 429–433).

important in the developing world, as the European Bank for Reconstruction and Development (EBRD) learned in its work with the transition countries, where initially “none of the EBRD’s 26 countries of operations had any workable laws permitting nonpossessory security over movable assets.”<sup>25</sup>

The greatest barrier to greater use of credit in some developing countries has to do with the difficulties of making collateral legally available for secured lending. A World Bank task force found that where secured credit was limited to real estate, “the extension of credit and the development of the national economy have been seriously impeded. This has been found to be the case, for example, throughout most of Latin America and in Central and Eastern Europe.”<sup>26</sup> Some secured credit systems provide only for a “pawn shop” type of security arrangement where the debtor deposits the collateral with the lender, thereby defeating the value of secured credit to expansion of economic activity. For example, “Thai law does not recognize security interests in property that remains in the debtor’s possession.”<sup>27</sup>

Few large-scale loans of the type necessary to finance companies and projects are likely to be forthcoming in many developing countries without the borrower providing collateral. To some extent this is true in developed countries as well. According to an IMF paper:

About half the credit offered in the United States is secured by some kind of movable property: about two-thirds of bank loans are secured by either movable property or real estate, and nonbank institutions that lend against movable property—such as leasing and finance companies—do almost as much lending as banks.<sup>28</sup>

Indeed, collateral on movable property is also normally needed by small individual borrowers (who, in developing countries are often to obtain mortgages on their real property because of an inability to establish title to that property—an essential precondition for real estate to function as collateral for a loan).<sup>29</sup> In the commercial sector of the economy a healthy financial sector requires legal rules that allow businesses to pledge machinery, inventories, accounts receivable, and other nonrealty assets.<sup>30</sup>

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<sup>25</sup> Simpson and Menze (Autumn 2000, p. 21). See Dahan and Simpson (2004).

<sup>26</sup> World Bank, *Effective Insolvency Systems: Principles and Guidelines* (October 2000), pp. 63-64. World Bank (2001a, p. 19, ¶ 49).

<sup>27</sup> Walker (2000, p. 37).

<sup>28</sup> Fleisig (1996, p. 44).

<sup>29</sup> Kenneth W. Dam, *Land, Law and Economic Development* [available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=876659](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=876659)]

<sup>30</sup> World Bank (2004, p. 68–69).

The advantage of going beyond a reliance on mortgages for real estate to facilitating pledges of movable property is illustrated in a World Bank document:

Uruguay and Kansas have similar typographies and well-educated populations interested in advanced technologies and able to apply them, and both are world-class exporters of beef cattle. In Kansas, private banks view cattle as one of the best forms of loan collateral; this is also the view of the bank examiners at the Federal Reserve Bank of Kansas City. Banks with ‘cattle paper’ are seen as solid whereas banks with ‘exposure to farm real estate’ are seen as risky. By contrast, in Uruguay, because of flaws in the legal framework governing secured transactions, private banks and bank examiners prefer real estate as collateral for loans; they consider a pledge on cattle as worthless as collateral. The unacceptability of cattle as collateral applies to all types of transactions, including sales of cattle on credit, sales of cattle finance by third-party lenders like banks or finance companies, or working capital loans for other purposes that might be secured by cattle.<sup>31</sup>

Facilitating greater use of secured credit is not just a question of establishing substantive law supporting such pledges of movable property (including not just cattle but also vehicles, inventories, and intangibles, such as accounts receivable). It is also a question of establishing collateral registries. Without such a registry system, so that lenders do not have to worry that the assets have already been pledged to earlier lenders, credit is less likely to be forthcoming.<sup>32</sup> The essence of a registry is that pledges registered earlier in time have priority over subsequently registered pledges and all unregistered pledges. Many countries do not yet have such registries for movables, even if they have them for land.<sup>33</sup> The creation of registries was a special problem in the transition countries of Central Europe and the former Soviet Union after the collapse of communism. The EBRD reported that, even after a number of years and despite secured credit legislation in most countries where the EBRD operated, “the issue of the existence of an effective system for publicising nonpossessory charges gave rise to very mixed results across the region.”<sup>34</sup>

Some countries maintain registries but put formidable obstacles in the way of their use. In many countries it takes more than a month to complete registration.<sup>35</sup> To take an extreme example, in Poland a requisite to registration of a security interest is a

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<sup>31</sup> Fleisig (1996, p. 45).

<sup>32</sup> World Bank (2004, p. 68).

<sup>33</sup> World Bank (2004, p. 68).

<sup>34</sup> Fairgrieve and Andenas (Autumn 2000, p. 35).

<sup>35</sup> World Bank (2005, p. 44).

court certification of the legality of the underlying credit agreement, which can take as long as six months.<sup>36</sup>

Sometimes small borrowers have no property to serve as collateral. Then the doors of the financial community are usually closed to them, at least in much of the developing world (unlike developed countries such as the United States where credit cards and other forms of unsecured credit are more freely available). The popularity of microfinance arises in large measure because very small firms, especially individual entrepreneurs (such as women engaged in home production), are unable to borrow from the formal banking sector because they have no collateral to pledge. Hence, by relying on their personal reputation among individuals or nongovernmental organizations who know them, they are able to borrow small amounts. Within this context, reputation can serve as a substitute for collateral.<sup>37</sup> But as its name implies microfinance is not designed to meet the borrowing needs of large firms and therefore cannot suffice to power an economy as a whole, even in a poor country. And it is precisely in the case of large loans that reputation alone is unlikely to be a substitute for collateral.

Where the collateral is movable property, the rights of creditors to seize collateral as a “self-help” measure in the event of nonpayment is an important issue. Only one-quarter of the 130 countries surveyed in a study for the World Bank permit the sale of collateral without court involvement.<sup>38</sup> The extent to which creditors must first establish in court their right to seize movable collateral is one issue. In some countries “self-help” seizure of collateral by the creditor is permitted where expressly agreed in writing. Where court action is required, enforcement is often illusory:

In Chile, the creditor files a claim with the court, and the court must declare default and order a bailiff to seize assets, before there is a public auction. The debtor may appeal the process at every stage. In Argentina, enforcing collateral in the hypothetical good-case scenario takes 148 days and costs [an amount equal to 42 percent of the country’s average per capita income].<sup>39</sup>

In some countries the delays are even more startling: While it “takes a week for a creditor to seize and sell collateral in Germany, Ireland, Tunisia, and the United States ... it can take five years in Bosnia and Herzegovina, Brazil, and Chile.”<sup>40</sup> In fact, in some 40

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<sup>36</sup> World Bank (2005, p. 44).

<sup>37</sup> World Bank (2001b, p. 92). See also Barr (2001).

<sup>38</sup> World Bank (2004, p. 62).

<sup>39</sup> World Bank (2004, p. 62).

<sup>40</sup> World Bank (2004, p. 63).

countries “enforcing collateral requires the same long court trial as for unsecured debt.”<sup>41</sup> Brazil illustrates the difficulties of requiring court proceedings:

Long proceedings ensue before the judge decides to enforce and orders bailiffs to seize the assets. After appraisal, a public auction is scheduled and advertised. The court determines a minimum price. If met, sale proceeds are deposited in a public agency and distributed through settlement procedures. Debtors have unlimited opportunities to drag the process by appeal. Enforcement takes more than 7 years.<sup>42</sup>

A related and possibly offsetting consideration to speed (and its benefit in making credit more easily available) is, of course, the extent to which borrowers can protect themselves against wrongful seizure where prior judicial determination is not required. The U.S. rule, which attempts to balance the interests of the creditor, debtor, and the economy, is that out-of-court seizure (often called “repossession”) of collateral is permissible if it can be done without breaching the peace, which *de facto* means that things that are kept behind locked doors cannot be taken.<sup>43</sup> When one considers, of course, the overall interests of debtors as a class, debtors have the same interests as creditors insofar as expanded credit markets favor debtors. Nevertheless, the occasional scandal created by unscrupulous creditors may sometimes make it difficult politically to introduce out-of-court enforcement of collateral.

The case of India illustrates the difficulties in finding a politically sustainable balance:

Ten years ago it was almost impossible to enforce collateral in India. The process could easily take 25 years. In 1998 the government established Debt Recovery Tribunals, with expedited enforcement proceedings. Expected time to enforce was cut to around 10 years. More reforms were introduced in May 2004. State-owned banks, which account for 90% of lending, were permitted to enforce out of court. On default the bank must notify the debtor. After a 60 day grace period the bank can seize the assets directly and sell by public auction. Introducing the reform was difficult—it had to survive a Supreme Court challenge. But the new procedure is widely used. Creditors can expect to enforce within 9 months.<sup>44</sup>

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<sup>41</sup> World Bank (2005, p. 44).

<sup>42</sup> World Bank (2005, p. 44).

<sup>43</sup> Picker et al. (2002, p. 309–328).

<sup>44</sup> World Bank (2005, p. 47).

The fact that only state-owned banks can enforce out of court discriminates against private sector banks and nonbank lenders and hence limits the long-term strength of India's financial system.

Even if out-of-court enforcement by seizure of collateral is not permitted, court reform can be a partial substitute by making delay by the debtor difficult. Estonia, for example, has introduced summary procedures that limit the grounds on which debtors defend and appeal.<sup>45</sup>

However, where out-of-court enforcement is not possible, weaknesses in the judiciary translate to weak credit markets. The finance minister of Mexico made the point clearly and in detail:

Judicial processes [in Latin America] are unpredictable, riddled with corruption, long, and expensive. Their costs are reflected, among other effects, in high bank intermediation margins. Excessively high credit rates discourage demand for credit, and poor credit demand is, in turn, reflected in a scant supply of deposits and of other banking services. Intermediation margins are, after all, the "price" or cost of the financial sector which, when expensive, result in a flabby banking sector. Such immature and insufficient financial sectors often mean insuperable entry barriers for small firms and a dearth of housing mortgages.<sup>46</sup>

Court delays are costly not just to creditors but also to the development of credit markets. Jappelli, Pagano and Bianco put the key point succinctly:

The key function of courts in credit relationships is to force solvent borrowers to repay when they fail to do so spontaneously. Hence poor judicial enforcement will increase opportunistic behavior on the part of borrowers: anticipating that creditors will be unable to recover their loans easily and cheaply via the courts, borrowers will be tempted to default. Lenders respond by reducing the availability of credit.<sup>47</sup>

Using Italian data on mortgage markets, they found that "in Italian provinces with longer trials or large backlogs of pending trials, credit is less widely available."<sup>48</sup> They also found that "judicial performance is important to the performance of credit markets [as

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<sup>45</sup> World Bank (2005, p. 47).

<sup>46</sup> Gil Diaz (2003, p. 8). On the impact of judicial inefficiency on credit spreads, see also Luc Laeven and Giovanni Majoni, Does Judicial Efficiency Lower the Cost of Credit, World Bank Policy Research Working Paper 3159 (Oct. 2003).

<sup>47</sup> Jappelli et al. (2005, p. 225).

<sup>48</sup> Jappelli et al. (2005, p. 223).

evidenced by their] findings ... that judicial efficiency correlates positively with the volume of lending and negatively with proxies for credit constraints.”<sup>49</sup>

Delays and costs are relevant even where secured credit is available. Where enforcement is weak, creditors often demand “overcollateralization”: “banks in Malawi, Moldova, and Mozambique typically secure more than 150 percent of a loan’s value” because the “prospects of recovering [the collateral] are dim.”<sup>50</sup>

An important issue for the creation of a strong financial sector involves the kinds of property in which a creditor can obtain a security interest. Although virtually every country has some provision for security interests in movables, the kind of movables and particularly the kind of intangibles that are available makes an enormous difference. Only 40 countries, counting both developed and developing countries, allow the debtor to pledge “a changing pool of assets (such as inventory or receivables), future assets (such as crops) and the entire business as collateral.”<sup>51</sup> Many countries require the specific property to be listed, which effectively eliminates pledges of many kinds of movable property, both tangible and intangible. For example, a manufacturer of products cannot as a practical matter pledge inventory if every time a new item comes off an assembly line the credit agreement must be amended (and the credit registry updated). A similar problem confronts any firm selling a product in using receivables financing.

### The Relevance of Legal Origin

The entire notion behind the Legal Origins approach—namely, systematic differences between common law and civil law, and in particular between common law and French law—is seriously misleading as applied to secured credit, according to the EBRD research undertaken in connection with bringing secured transactions law to the transition countries of Central Europe and the former Soviet Union.<sup>52</sup> The reason is that “there are very few common rules or standards in western legal systems [and] the full extent of this lack of commonality is rarely recognised.”<sup>53</sup> U.S. and U.K. law differ not just in terminology but also in the principles of secured transactions law; for example, a “floating charge” over present and future assets of a debtor is possible under English law

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<sup>49</sup> Jappelli et al. (2005, p. 224). But see Padilla and Requejo (2000, p. 6), which states that they found “no conclusive evidence on the sign and magnitude of the effect of creditor rights on credit market efficiency, [but found evidence of] the great importance of macroeconomic stability for credit market performance.”

<sup>50</sup> World Bank (2004, p. 61).

<sup>51</sup> World Bank (2005, p. 43).

<sup>52</sup> Dahan (Autumn 2000).

<sup>53</sup> Dahan (Autumn 2000, p. 38).

but not U.S. law.<sup>54</sup> U.S. law, on the other hand, was revolutionized by the adoption in the mid-twentieth century of the Uniform Commercial Code, which created the “concept of a unitary security device, which takes the place of the former variety of devices (for example, pledge, chattel mortgage and conditional sale), each of which had been governed by its own law.”<sup>55</sup> While the unitary security device concept has been adopted in a few common law countries, no uniform approach, even as to basic concepts, exists in the common law world.<sup>56</sup> Civil law systems equally show great diversity, according to the EBRD research. Even within the French law family, countries as close in legal history and approach as Belgium and France—the commercial law of both being rooted in the Napoleonic Commercial Code—reflect “differences ... that have major practical effects on the validity and availability of secured transactions.”<sup>57</sup>

The relationship of creditors rights to bankruptcy was approached in the seminal LLSV Law and Finance study discussed in connection with shareholder rights in an earlier chapter.<sup>58</sup> Let us look more deeply therefore at the substantive rules they chose in the credit field. Their study is somewhat confusing from a legal point of view because it does not clearly distinguish between creditors rights when the debtor is in bankruptcy and when bankruptcy has not been declared and perhaps is not even in prospect because the debtor is just procrastinating. For example, it does not consider the right of a secured creditor to self-help seizure.

The difference in the two situations is important. First, secured credit law can be thought of as a substitute for bankruptcy law. Collection of an unpaid debt may be much faster and cheaper if bankruptcy proceedings are not necessary. This is particularly the case where self-help is permitted. Second, many countries have totally inadequate bankruptcy laws. Often it is not the law itself that is necessarily inadequate, but the bankruptcy system does not function properly due to the shortage of bankruptcy judges or their lack of training. The inadequacy of the bankruptcy system in Southeast Asia became painfully clear in the Asian financial crisis of the late 1990s, especially for situations where financial distress was systemic.<sup>59</sup>

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<sup>54</sup> While the blanket security interest is a movement in U.S. law in the direction of the British floating charge, the latter—once it crystallizes—extends to all assets of the debtor. In addition, the floating charge mechanism gives creditors procedural rights not available under U.S. law. For a description of the floating charge, see Davydenko and Franks (2004, p. 23)..

<sup>55</sup> Dahan (Autumn 2000, p. 41).

<sup>56</sup> Dahan (Autumn 2000, p. 41).

<sup>57</sup> Dahan (Autumn 2000, p. 40).

<sup>58</sup> LLSV (1998). LLSV refers to LaPorta, Lopez-de-Silanes, Shleifer and Vishny, the authors of LaPorta et al. (1998).

<sup>59</sup> Three important developments reflecting this lesson of the Asian financial crisis were the publication of Claessens et al. (2001) by the World Bank; the development by the World Bank of Principles and



Although bankruptcy proceedings can be brought with respect to all kinds of debtors, including individuals and even nonprofit institutions, LLSV focused on corporate enterprises. Such corporate enterprise bankruptcies actually fall into two major classes, “bankruptcy” in the narrow sense of leading to liquidation of the corporation and “reorganization,” referring to a proceeding in which the corporation survives in a new form, usually with new shareholders (in the typical reorganization the old creditors becoming the new shareholders) and with new management. The LLSV analysis does not crisply distinguish between bankruptcy in the narrow sense and reorganization. To be sure, in view of their disposition toward maximizing the rights of creditors, ignoring the boundary between the two types of proceedings is perhaps understandable. (However, in the United States, the two types are statutorily separate, bankruptcy in the sense of liquidation being in Chapter 7 and reorganization being in Chapter 11 of the Bankruptcy Code, and the LLSV analysis pertains only to Chapter 11.)

Four substantive law rules characterized by LLSV as “creditor rights” were: (1) “no automatic stay on assets,” meaning that secured creditors could seize collateral even though bankruptcy proceedings had commenced; (2) “secured creditors first paid,” which established the rule of absolute priority among creditors, assuring that secured creditors would be paid in bankruptcy proceedings before unsecured creditors; (3) “restrictions on going into reorganization,” which referred to statutory provisions assuring that management could not start reorganization proceedings without the consent of creditors; and (4) “management does not stay in reorganization,” which refers to a rule automatically ousting management from their positions up on the commencement of the proceedings.<sup>60</sup>

The methodology for creditors rights was that each country was given a binary one or zero score for each rule and so each country would, by simple addition, end up with a score from zero to 4. The English-origin (common law) countries won the competition with an average score of 3.11, with the French-law countries achieving the lowest average score, 1.58, and with German-law and Scandinavian-law countries coming in between, with 2.33 and 2.00, respectively.<sup>61</sup> The relative relationship between the common law score and the average of the three civil law scores was significant at the one percent level, as was the relationship between the English-origin and French-origin score, thus strongly supporting the view that the common law countries accord stronger rights to creditors than do civil law countries in general and French law countries in

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Guidelines for Effective Insolvency and Creditor Rights Systems in 2001; and the widespread enactment and updating of bankruptcy codes throughout the developing world. World Bank (2004, p. 71).

<sup>60</sup> LLSV (1998, p. 1136 (Table 4).

<sup>61</sup> (LLSV (1998, p. 1136-1138 (Table 4).

particular.

Yet when one penetrates into the details, one finds a number of anomalies that may give pause as to what to make of the results if one is concerned with policy implications, particularly for developing countries. And indeed one should be cautious, even if prepared to go down the line with the proposition that the stronger the rights of creditors, particularly secured creditors, the better for the financial development of a country's economy and thereby the better for economic growth. The first and most startling result is that the United States, the economy that has grown the most rapidly in the developed world in recent years, came up with the low score among English-origin countries—a mere 1 out of a possible 4 (though admittedly higher than the zero scored by such diverse countries as France on the one hand and Peru on the other).

Moreover, there was wide dispersion within each of the four legal families. Just to take the common law family: Australia, Canada, and Ireland shared the same low ranking as the United States, falling short of a number of weak economies within the common law family that nevertheless achieved the maximum score of 4, such as Zimbabwe, Pakistan, and Kenya (none of which is renowned, to say the least, for its credit markets). To be sure, quite a number of countries, many of them strong successful economies also achieved a 4—notably the United Kingdom itself. Nonetheless, English-origin countries certainly showed wide dispersion in their willingness to follow the mother country, which again raises the question of the value of the concept of legal origin for policymakers.

The French-law countries showed equally startling divergences. France led, if that is the right word, with a zero score, but such countries as Ecuador, Egypt, and Indonesia—despite being in the French law family—achieved the same four as the United Kingdom.

One final discrepancy, though of a somewhat different kind, is found in the German law countries. Since the rights of creditors are of the greatest interest to the main credit providers, namely the banks, it is interesting that the lowest ranking among German-law countries went to Switzerland, where banks historically have played a leading role in the economy.

#### Economic Development, “Law and Finance,” and Legal Origin

The LLSV results in their “Law and Finance” article highlight three major issues about the usefulness of cross-country regression results, one that LLSV address, but two that they ignore. The issue that they address is that enforcement may be more important than substantive law in protecting shareholders and creditors. But the two issues that they

do not address are, first, that their cross-country regressions may not provide results that are relevant to economic development in developing countries and, second, that the need imposed by the use of cross-country regression techniques may lead to an oversimplification of key rules, even a misassessment of the extent to which their selected substantive rules accurately describes legal rights of creditors in practice.

With regard to the results for developing countries, it is interesting that LLSV in their Law and Finance article were not particularly focused on the issue of economic development and therefore dealt only in passing with whether the results were as strong for developing countries as for developed countries. Nonetheless, they did note that “creditor rights are, if anything, stronger in poorer than in richer countries.”<sup>62</sup> In fact, their own analysis reveals an inverse relationship between stronger creditors rights (as they select and measure them) and income levels, with the bottom 25 percent of countries (sorted by GNP per capita) ranking stronger than the mid-50 percent, which in turn rank stronger than the highest 25 percent.<sup>63</sup> The authors speculate that this surprising relationship may exist because “poor countries adapt their laws to facilitate secured lending for lack of other financing opportunities.”<sup>64</sup> But if secured lending is important to a stronger financial sector and hence to economic development, then one would expect countries well along in the development process to have stronger laws, not weaker laws, in the secured transaction area. The discussion in their Law and Finance article of the relation of legal origin to economic development is so sparse that one should be cautious as to the legal implications for developing countries.

Furthermore, when Djankov, McLiesh, and Shleifer later did a regression study based on newer data that included 129 countries (not 49 countries as in the LLSV Law and Finance paper), they found that legal origin by itself apart from other variables was “unimportant.”<sup>65</sup> This result suggests that what is important lies in the level of development of national legal systems, not legal origin nor the substantive law of creditors rights. Hence, the fundamental driver for economic development purposes in the creditor rights area is likely to be the quality and effectiveness of enforcement.

In the course of an interesting study that proposed that the real difference between legal systems was not the actual substantive law rules but rather the philosophies of the respective legal families with regard to the role of the state, Mahoney ran regressions to look at the relation between legal origin and per capita income growth. Since Latin American and African countries performed poorly during the period he was investigating,

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<sup>62</sup> LLSV (1998, p. 1139).

<sup>63</sup> LLSV (1998, p. 1133, Table 3).

<sup>64</sup> LLSV (1998, p. 1139).

<sup>65</sup> Djankov et al. (2005, p. 15).

he used dummy variables for those two continents in an attempt to test whether unidentified omitted variables rather than legal origin might account for that poor performance. He found that common law origin pointed to higher growth but at a lower level than without the dummy variables and at a lower statistical significance level (5 percent rather than one percent).<sup>66</sup>

Even more striking, Kaufmann and the World Bank Institute found, in a large-scale study of various dimensions of governance that included a legal origin component, that while there was “evidence of a small but significant correlation between legal origins and governance performance” for common law countries over countries with civil law origins, nevertheless when “we focus on the set of 75 lower-income countries, the differences between common and civil law essentially disappear.”<sup>67</sup> These last three studies suggest that cross-country legal origin regressions do not necessarily carry strong policy implications for financial markets in developing countries even though legal origin may be important in the developed world, at least as between English-origin and French-origin countries.

### Culture and Religion

In assessing the policy implications of the LLSV “Law and Finance” results with regard to credit markets, it is useful to consider what the root causes are for differences in the size and strength of credit markets and the posture of legal institutions toward those markets. A fundamental characteristic of all credit markets is the charging of interest, explicitly or implicitly. Two broad societal attitudes are therefore in question in considering credit markets. Is the charging of interest looked down on, or even prohibited? And what is the attitude toward rates of interest so high that they are considered to constitute usury? Perhaps these attitudes influence a country’s legal rules on creditors rights and bankruptcy.

The leading cultural factor involved is probably religion, though social attitudes toward the poor within a society may lead to usury laws designed to protect them from exploitation by money lenders. Muslim law—that is, the Sharia—forbids the charging of interest, though in modern times so-called Islamic finance involves finding ways to structure transactions in order to obviate the explicit charging of interest.<sup>68</sup> Nevertheless, financial development in most Middle Eastern countries remains weak.

Catholic doctrine has traditionally condemned usury. Since every French law

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<sup>66</sup> Mahoney (2001, p. 517).

<sup>67</sup> Kaufmann (2004, p. 147).

<sup>68</sup> Kuran (2004, p. 7–19).

country in the LLSV data is a Catholic or Muslim country, one has to ask whether the LLSV results concerning French law countries are not a consequence of the reflection in law of attitudes toward money lending rather than something inherent in the legal system as a whole. English common law countries, on the other hand, are both Protestant and Catholic and therefore present an interesting focus for further research. Nordic countries, it should be noted, are Protestant.

Stultz and Williamson found that “Catholic countries have ... significantly fewer long-term debt issues than Protestant countries [and] significantly less bank credit than non-Catholic countries.”<sup>69</sup> In other words, financial development is weaker in Catholic countries. They also found that “Catholic countries have significantly weaker creditor rights than other countries [even] when [they] control for the origin of the country’s legal system as well as for GNP per capita.”<sup>70</sup> This conclusion and the Sharia example suggest that reforming legal institutions in the creditors rights arena faces substantial cultural headwinds, not—or not just—a lack of legal understanding or interest group opposition.

#### What Does it Mean to Speak of a Common Law Legal Origin in Creditors Rights?

The legal origin approach depends on the premise that legal families exist with respect to the legal field under discussion. With respect to creditors rights and bankruptcy, the notion of legal families is none too solidly based. Several reasons for caution are, first, at least within the “common law family” the commonality of law is debatable. And second, the law on creditors rights and especially bankruptcy in most common law countries is relatively new and is almost entirely statutory, not judge-made.

An easy way to assess the assumption of commonality within legal families in this substantive legal field is to compare the United States and the United Kingdom. One would expect U.S. corporate bankruptcy law to resemble U.K. bankruptcy law. However, the United States is accorded a particularly low score of 1 and the United Kingdom the top score of 4, based on the four criteria that LLSV consider crucial in determining the nature of a bankruptcy system. But it is not just that the rules differ. Though U.K. bankruptcy law and even its procedure were indeed created in a common law case-by-case manner (with statutes enacted on particular points only), U.S. bankruptcy law is laid down in a comprehensive Bankruptcy Code. Even the U.S. Constitution has provided, since its inception in 1787, for Congress to legislate on bankruptcy, and the first U.S. statute was passed in 1800 with bankruptcy legislation being continuously in effect since

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<sup>69</sup> Stulz and Williamson (2003, p. 343).

<sup>70</sup> Stulz and Williamson (2003, p. 346).

1898.<sup>71</sup> (It is true that the U.S. concept of corporate reorganization evolved in the nineteenth century to meet widespread railroad insolvency by courts applying equitable principles and was not fully captured in legislation until 1978.<sup>72</sup>)

Today the principal lender to a U.K. corporation, having a “floating charge” representing a secured interest in corporate property (including property acquired after the secured interest agreement was entered into), is entitled upon the debtor’s default to appoint a receiver (normally outside any court action). The receiver then proceeds to liquidate the debtor company or its assets, including sale of the enterprise as a going concern. The management of the now defaulting company normally leaves office immediately.<sup>73</sup>

In the United States, on the other hand, once the debtor corporation files for bankruptcy (or is put into bankruptcy involuntarily by a creditor), the management of the defaulting corporation normally becomes the “debtor in possession,” continuing to manage the company, while creditors organize themselves in a creditor committee (often more than one committee if there are different classes of creditors). Although the rule of absolute priority constitutes the “black letter law” of bankruptcy, it is also true that junior creditors are entitled to procedural protections so that the system in practice involves negotiations among all classes of creditors of the bankrupt corporation. The normal right of secured creditors to seize collateral is subject to an “automatic stay” once bankruptcy is declared, and all creditors, including unsecured (“general”) creditors, have a procedural right to participate and be heard in the formulation of the “bankruptcy plan,” which determine who gets what. The creditors therefore bargain “in the shadow” of the rule of absolute priority.<sup>74</sup> The outcome of the bargaining need not be entirely in the interest of the secured creditors. Unsecured creditors may receive something as a “price” for resolution of the dispute, even though the secured creditors receive less than payment in full. And it happens sometimes that the equity holders receive something as part of side deals or other arrangements to finalize the agreement. At the end of the day, if the reorganization is successful, the corporation emerges from bankruptcy and goes on to live as a legal person another day.

Because of these differences in the way bankruptcy proceedings work (with the U.K. system in which the principal creditor takes over immediately differing from the

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<sup>71</sup> Kathleen A. Bussart, *Authority of Congress under Bankruptcy Clause of Federal Constitution...to Legislate on the Subject of Bankruptcy*, 71 L.Ed. 2d 905 (LEXIS 2004).

<sup>72</sup> Franks and Sussman (1999).

<sup>73</sup> Westbrook (2004, p. 818–820). As Westbrook points out, the floating charge does not necessarily entitle its holder to absolute priority over all assets. Westbrook (2004, p. 819–820).

<sup>74</sup> Baird (2001, p. 77–78).

U.S. pattern of the debtor remaining in possession), one can observe that in the United States the existing equity holders may occasionally emerge from last-minute bargaining with some equity even if all creditors are not paid in full and indeed the old management may sometimes remain in office at the end of the day. Because of these differences, it is often said that the British system is “creditor friendly” and the U.S. system is “debtor friendly” or “management friendly.” Yet absolute priority is the substantive rule in both countries. Because of these differences, some economists believe that the U.K. system is obviously superior because it grants creditors, especially secured creditors, the strongest possible tactical position. On the other hand, Stiglitz argues that, especially in developing countries facing the prospect of systemic bankruptcy (as in the Asian financial crisis), a rule that compromises absolute priority by giving existing management and shareholders some prospect of a surviving interest would be desirable because it would discourage them from delaying the commencement of bankruptcy and engaging in value-destroying actions such as asset stripping.<sup>75</sup>

#### U.S. Corporate Reorganization Practices

In the case of the United States, the facts appear to be rather different, especially in recent years, from what might be casually inferred from the LLSV analysis. In their scoring, the United States has only one of the four creditor rights in the LLSV study, the rule that secured creditors get paid first (that is, the rule is absolute priority). But according to the LLSV reading of the U.S. law, which is accurate so far as it goes, U.S. law does not prohibit management from remaining in place during reorganization; moreover, U.S. law does impose an automatic stay on enforcement action by creditors, and it allows management to take the corporation into bankruptcy (or reorganization) without the consent of creditors. So far so good for a cross-country regression study, but the facts as to what happens in the United States on the first point are actually quite different from what one might infer from LLSV’s understanding of the substantive rules. In a later section, the question will be addressed whether the other two criteria are actually desirable for developing countries in drafting a new statute.

The actual results in the United States on the issue of management remaining in place can be derived from a study by Baird and Rasmussen of every reorganization completed in the United States in 2002.<sup>76</sup> From the Baird and Rasmussen analysis of those cases, it becomes clear that the creditors call the tune for the management in reorganizations under Chapter 11. Creditors have regularly changed management when

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<sup>75</sup> Stiglitz (2001, p. 19).

<sup>76</sup> Baird and Rasmussen (2005).

they have felt it to their advantage to do so. Management rarely if ever remains in place at the end of the reorganization. Of course, when Chapter 7 liquidation is chosen, then there is no longer a business to manage. Perhaps the largest point to be drawn from the Baird and Rasmussen research is that competent and specialized bankruptcy judges and a strong bankruptcy bar are of great importance. Indeed, when those factors are present, the formal substantive rules of bankruptcy law are less important.

Perhaps the principal shortcoming of the LLSV legal origin literature insofar as credit markets are concerned is its focus on bankruptcy rules, as opposed to secured credit law. Of the four rules LLSV chose, all assume bankruptcy and at least two are specifically applicable only in reorganization proceedings. LLSV do not look at secured credit outside of bankruptcy, even though in many developing countries the bankruptcy system is rarely used, except for “state-owned enterprises or subsidiaries of foreign firms.”<sup>77</sup> To take a specific example, a World Bank study found that “the five largest banks in Mozambique, which account for about 90 percent of bank loans to enterprises, ... never use formal bankruptcy.”<sup>78</sup> And even where the bankruptcy system is used, reorganization procedures may not be used.<sup>79</sup>

### A Survey of Developing Countries

Though the experience in large developed country economies, such as England and the United States, remain relevant, a more typical case was one studied by the World Bank and the International Bar Association. In this study a hypothetical set of facts was prepared, and a survey was taken of bankruptcy lawyers and judges in developing countries to determine how the assumed bankruptcy would be handled.<sup>80</sup>

The essence of the detailed factual hypothetical concerned a hotel company with revenues equal to 1000 times the per capita income of the developing country in question (which would for comparison have been, if the country were the United States, \$34,000,000). This medium-sized hotel had 201 employees and 50 creditors. The principal creditor was a bank with a mortgage on the hotel property; the amount of the mortgage principal still payable was equal to the market value of the hotel, with 10 years remaining in the payment schedule. The bank had one majority shareholder, and its shares were not publicly listed. Of the total claims against the hotel, unsecured creditors held 26 percent in value, and the bank’s secured claim constituted the remaining 74

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<sup>77</sup> World Bank (2004, p. 74–75).

<sup>78</sup> World Bank (2004, p. 78).

<sup>79</sup> World Bank (2004, p. 80).

<sup>80</sup> World Bank (2004, p. 72–74). The questionnaire is available on the World Bank’s Doing Business website at <http://www.doingbusiness.org/Default.aspx>.



percent. The bank preferred liquidation in the fastest and cheapest way, while the management and the majority shareholder preferred to keep the company in operation. On the legal side, it was assumed that there were three options: reorganization; liquidation by sale of the hotel, either as a going concern or piecemeal; and reorganization involving continuation of the company and management. It was postulated in the facts that the hotel would be worth more as a going concern than in piecemeal liquidation.

Against this stipulated factual background, the questionnaire contained questions about how the case would be handled in the particular country in question. The questions of greatest significance concerned the speed and cost of the proceedings and whether the case would lead to an “efficient outcome,” which was defined as the realization of the going concern value, either by sale as a going concern or through “successful rehabilitation with management dismissed.”<sup>81</sup> With regard to this definition of the “efficient outcome,” it was stipulated that the financial distress was the fault of the management. The results supported the legal origins research in the sense that English common law origin countries did better on average than French law origin countries on the speed dimension, 2.7 years to 3.7 years. But the costs were roughly the same, indeed slightly higher in the common law countries.<sup>82</sup> With regard to achievement of the efficient outcome—realization of the going concern value—the common law origin countries again bested the French origin countries, 48 percent to 23 percent of the time.<sup>83</sup>

The policy relevance of the Legal Origins literature is thrown into some doubt by the wide variance in outcomes within particular legal families. India, an English common law country, was the slowest, followed by Chad (French), Brazil (French), and the Czech Republic (German). The most expensive were Macedonia (German), Israel (English), Venezuela (French), the United Arab Emirates (English) and Uganda (English), a considerable mixture of legal traditions. Moreover, there are pronounced regional differences. On the time dimension South Asia, which has both common law and civil law countries, averaged 5 years, more than the developing country average of 3 to 4 years and well below the OECD high income area where bankruptcies were resolved in less than two years on average.<sup>84</sup> Moreover, these regional differences persist despite the LLSV finding that countries ranking in the bottom 25 percent of GNP per capita had better creditor rights scores than the middle 50 percent, which in turn were still better

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<sup>81</sup> World Bank (2004, p. 75).

<sup>82</sup> World Bank (2004, p. 74, and Figure 6.2).

<sup>83</sup> World Bank (2004, p. 76, Figure 6.3).

<sup>84</sup> World Bank (2004, p. 74, Figure 6.2).

than the top 25 percent—roughly the OECD countries.<sup>85</sup>

As for cost, the OECD high income countries had the best record with the average cost of the process consuming well under 10 percent of the value of the assets. South Asia, in contrast to its record on time, had nearly as good performance as the OECD high income countries with an average cost of about 10 percent. The Latin American, African, Middle Eastern, and Eastern European averages all clustered near 15 percent. And in East Asia, the average cost was about 20 percent.<sup>86</sup>

The third dimension (in addition to time and cost) was the ability to achieve the “efficient outcome.” While it is true that the English origin countries achieved the efficient outcome 48 percent of the time and the French origin countries only 23 percent of the time, it is also true that the regional variation was pronounced. Though OECD high income countries achieved the efficient outcome in 77 percent of the countries, no South Asian country achieved the efficient outcome (though South Asia contains both common law and French law countries). East Asian countries (which are mostly civil law countries), in contrast, achieved the efficient outcome in 42 percent of the countries.

### Policy Implications

What are the policy implications of a legal origins approach in view of the difference in outcomes in the World Bank study? A preliminary point is that the transplanting of “best practice” (“state of the art”) legislation should be easier and more successful in corporate bankruptcy than in many other legal fields. Two primary reasons are: First, the direct effects of corporate bankruptcy are focused on a relatively small number of people and hence social norms and other informal constraints are less likely to be a constraint (the possibility of corruption aside). And second, corporate bankruptcy is a highly specialized field with relatively few (albeit knowledgeable) legal practitioners involved and therefore the general level of the legal profession as a whole is not likely to be a concern. In any event, corporate bankruptcy, even in common law countries, has progressively become a subject of legislation and hence any postulated advantages of a common law case-by-case approach have become attenuated.

Still, at the time of the Asian financial crisis, bankruptcy laws in the crisis region were antiquated and often unused.<sup>87</sup> Indonesia had never translated the 1905 Dutch law into the local language and as a result judges and lawyers had little or no bankruptcy

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<sup>85</sup> LLSV (1998, p. 1133, Table 3).

<sup>86</sup> World Bank (2004, p. 74, Figure 6.2).

<sup>87</sup> See generally Walker (2000).

knowledge or experience.<sup>88</sup> Korea, in contrast, had a modern bankruptcy law, but until the 1990's it was seldom used.<sup>89</sup> In the rest of the world bankruptcy systems may have existed for some time, but they often are so inefficient that they do not serve the needs of creditors or of the economy for swift exit of inefficient firms. This is particularly the case where the statute provides for reorganization of ailing firms; these procedures often simply provide a mechanism for delay, allowing debtors to be protected from creditors:

Reorganization lasts nearly 6 years in the Philippines and about 4 years in Costa Rica and Romania. Brazil takes the longest: creditors can start foreclosure but there are many opportunities for appeal, each time suspending the process. It typically takes 10 years.<sup>90</sup>

The Russian experience illustrates the difficulty of transplanting “world class” bankruptcy law in a developing country with a weak judiciary. Black and Tarassova outline the problems:

[The Russian bankruptcy statute] was drafted with extensive assistance from Manfred Balz, a top German scholar and the principal drafter of the highly regarded German bankruptcy law. Quibbles aside, the Russian bankruptcy law is internally consistent, has no major inconsistencies with other laws, and mostly makes sensible policy tradeoffs. But it assumes that judges and bankruptcy administrators are honest; the procedure for creditors to choose trustees will not be rigged by false claims; judges can distinguish valid from invalid claims; and insiders will not collude with sham creditors to put solvent firms into bankruptcy. These assumptions are fine in Germany, but fatally flawed for Russia.<sup>91</sup>

On the other hand, as the World Bank Consultation Draft on Effective Insolvency Systems suggests, a bankruptcy procedure is not absolutely necessary if an effective informal private sector workout process can be established. If so, as is the case in some developed countries under the “London rules,” a workout would at least avoid problems involving weak judiciaries and corruption.<sup>92</sup> Nonetheless, the facts are that bankruptcy laws are being introduced or updated throughout the world.<sup>93</sup> A World Bank study found that Latvia, which (against a nonmarket socialist background) adopted its first bankruptcy law in 1996 and updated it in 2001, ranked among the top ten countries in

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<sup>88</sup> Walker (2000, p. 39).

<sup>89</sup> Walker (2000, p. 42); Lim (2002).

<sup>90</sup> World Bank (2005, p. 70).

<sup>91</sup> Black and Tarassova (2002, p. 257).

<sup>92</sup> World Bank (2001a, p. 78).

<sup>93</sup> World Bank (2005, p. 67).

achieving the “efficient outcome.”<sup>94</sup>

In such new legislation and updates, choices must be made. If judicial corruption is a problem, then the adoption of a system that maximizes the role of creditors and minimizes the role of courts is to be preferred. As we have seen, the British system allows the principal creditor to administer essentially the entire process. In an intermediate solution, the U.S. system is such that a specialized bankruptcy judge supervises what amounts to a private negotiation among creditors. In light of the British and U.S. practice, the World Bank study assessing the relationship between the powers of the court and the likelihood of achieving the efficient outcome is worth keeping in mind. Constructing a “court powers index,” the researchers found a direct correlation: the greater the power of the court, the less likely bankruptcy was to secure the efficient outcome.<sup>95</sup> In short, if a principal objective of bankruptcy is to assure an efficient outcome, too great a role for courts may in many countries be counterproductive.

Another conclusion is that the less financially developed an economy, the more important is the improvement in secured transaction law, as opposed to bankruptcy law, if for no other reason than that bankruptcy procedures are unlikely to be often used. In particular, reorganization procedures are unlikely to be used to the advantage of the economy as opposed to protecting incumbent managers. The focus on secured transaction law is particularly called for where large-scale lenders predominate and they are able to use informal workouts.<sup>96</sup> The researchers in the World Bank study came to the conclusion not only that bankruptcy is not necessary to the enforcement of secured creditors rights but also:

Bankruptcy is one example where the establishment of a sophisticated bankruptcy regime in a developing country generally results in inefficiency and even corruption.... In the poorest countries, it is better not to develop a sophisticated bankruptcy system and to rely instead on existing contract-enforcement mechanisms or negotiations between private parties....<sup>97</sup>

Countries with ill-functioning judiciaries are better off without sophisticated bankruptcy systems [because such] laws usually exacerbate legal uncertainty and delays in developing countries.<sup>98</sup>

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<sup>94</sup> World Bank (2004, p. 77).

<sup>95</sup> World Bank (2004, p. 78 and Figure 6.5). For the “court powers indices” of sample countries, see World Bank (2004, p. 130, Closing-a-Business Indicators).

<sup>96</sup> World Bank (2004, p. 79–81).

<sup>97</sup> World Bank (2004, p. xvi).

<sup>98</sup> World Bank (2004, p. 72).

Assuming, however, that a bankruptcy law is to be adopted or updated, then the choices made are important. For example, it is not at all clear that the LLSV four criteria are either the most important provisions or even necessarily point in the right direction for a developing country. To examine the latter point, consider LLSV's view that an automatic stay against creditor actions upon the commencement of bankruptcy proceedings is undesirable because it prevents creditors from pursuing other remedies and therefore infringes on creditors rights. Three points can be made. First, it is hard to see how a multi-creditor reorganization can proceed efficiently without a stay. The World Bank task force on Effective Insolvency Systems saw a stay as necessary in reorganization proceedings because a "business cannot be reorganized if it has no assets left to reorganize."<sup>99</sup> More generally, a business cannot continue in operation if key assets are awarded to creditors and hence the going concern value (assuming it is higher than the piecemeal liquidation value) will not be realized in the reorganization, even through sale of the enterprise if it has already been dismembered. Second, the reason that U.K. bankruptcy law needs no stay on creditor actions is that the bankruptcy proceedings are, as previously explained, normally in the control of the principal creditor with a floating charge on corporate assets. And third, it is always possible to provide for a lifting of the stay by court order, as is the case in U.S. law, when a creditor's action will not interfere with the reorganization.<sup>100</sup> This solution is what the World Bank task force recommended.<sup>101</sup>

### Credit Registries

An important issue in credit markets involves the role of credit registries (sometimes called credit bureaus) that facilitate the sharing among creditors of information concerning borrowers with regard to repayment and related information. It is essentially an organized way to build on reputation, which normally would work only among people who know each other or who live in a small community. Through credit registries, information with regard to the borrower's reputation can be shared on a nationwide or even larger scale.

The credit registry question is only peripherally a legal issue. Some discussion in the economic literature suggests, however, that credit registries may be a substitute for

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<sup>99</sup> World Bank (2001a, p. 42).

<sup>100</sup> Baird (2001, p. 169).

<sup>101</sup> World Bank (2001a, p. 31). Effective Insolvency Systems: Principles and Guidelines 19 (October 2000).

stronger rights for creditors.<sup>102</sup> Such private institutions sprang up to fill a business need in Paris and Amsterdam in the 17<sup>th</sup> century and in the United States in the 18<sup>th</sup> century.<sup>103</sup> Public credit registries are found in even more countries than private registries, particularly in the developing world.<sup>104</sup> The World Bank found that private registries generally contribute more to promoting credit markets than do public registries.<sup>105</sup> However, one study suggests an association between legal origin and the decision whether to permit private registries, with “common law emphasizing ex post private dispute resolution, and civil law (particularly of the French variety) emphasizing public ownership and ex ante regulation.”<sup>106</sup> Still, every developed country (except France) has at least one private sector registry.<sup>107</sup>

The principal legal issue that arises in some countries is whether private credit registries should be prohibited. Some countries do so.<sup>108</sup> Certainly from the standpoint of economic development, there is every reason for governments to permit, even promote, private registries. They have been found to be associated with larger credit markets in cross-country regressions.<sup>109</sup> Hence, it may make sense for a poor country to support a public registry so long as it does not prohibit private registries.

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<sup>102</sup> See Djankov et al. (2005).

<sup>103</sup> World Bank (2004, p. 56).

<sup>104</sup> World Bank (2004, p. 56).

<sup>105</sup> World Bank (2004, p. 59).

<sup>106</sup> Djankov et al. (2005, p. 22).

<sup>107</sup> World Bank (2004, p. 57).

<sup>108</sup> World Bank (2004, p. 60).

<sup>109</sup> Djankov et al. (2005, p. 17–18).

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