Chapter 2

Bankruptcy and second chance for SMEs (Dimension 2) in the Western Balkans and Turkey

Ensure that honest entrepreneurs who have faced bankruptcy quickly get a second chance (Small Business Act Principle 2)

Realistically, policy makers understand that many SMEs will not succeed, and thus need bankruptcy laws to help them exit the market in an orderly fashion. These laws need to protect the rights of both creditors (repayment of loans, legal recourse due to firm failures) and debtors (maximising the preservation of assets, providing options to reorganise or liquidate an enterprise, and potentially restarting). Just as importantly, governments should promote a positive attitude towards second chances, encouraging honest entrepreneurs to start a new business after failure.

Most economies in the Western Balkans and Turkey have established sound insolvency laws, with clearly defined procedures for distressed firms, with the exception of Kosovo which is drafting a new law. However, most economies still have procedural delays and lack some institutional support mechanisms such as early warning systems to identify distressed companies before they need to enter formal bankruptcy procedures. Discouragingly, not one economy has a programme in place to promote second chances after bankruptcy, thus exacerbating the stigma associated with failed entrepreneurs.

Introduction

Policy makers endeavour to provide the conditions SMEs need to grow, remain economically viable and generate long-term employment growth. However, it is just as imperative to ensure that the appropriate measures and legal provisions are in place when a business fails. Insolvency laws are crucial for both entrepreneurs and lenders, both of whom require legal recourses when an insolvent and indebted enterprise is no longer economically viable.

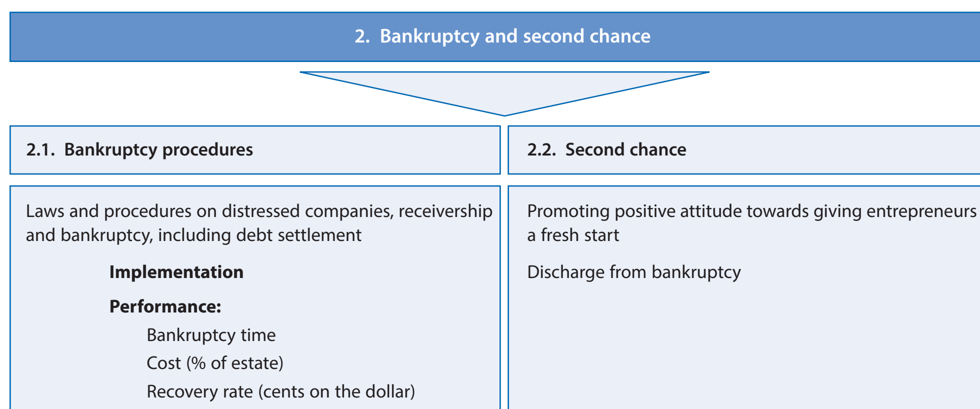
In order for a market economy to function efficiently, when new firms are created and unviable ones destroyed, there must be laws to help the latter exit from the market in an orderly fashion. Insolvency laws protect the interests of both the creditor and the debtor, as such laws work to maximise the preservation of a firm's assets. Efficient insolvency frameworks should promote the reorganisation of viable firms and the liquidation of unviable ones at the lowest possible cost, whilst preserving the principle of fair and equal treatment of all parties involved (Cirmizi et al., 2011). In the absence of such laws, or where they do not work well, lenders are reluctant to extend loans to enterprises as they would have no legal recourse if the borrower fails to repay a loan. Insolvency laws should also aim to limit burdensome and lengthy procedures, as protracted proceedings could further reduce the value of an insolvent business and threaten the successful reorganisation of a salvageable one.

Policy makers should work to strike the appropriate balance between the interest of debtors and creditors (IFC, 2011). They should work to ensure firms can reorganise and potentially restart, and to give creditors legal support to claim debt repayments and thus feel secure in future lending. In partnership with insolvency laws, policy makers should work to put supporting institutions/mechanisms in place such as early warning systems (to identify distressed companies), the option of out-of-court settlement, efficient court procedures and post-bankruptcy provisions such as discharge and the promotion of second chances.

Assessment framework

The assessment framework of Dimension 2 is composed of two sub-dimensions. The first analyses the strength, effectiveness and efficiency of the insolvency legal framework and the second the environment promoting a second chance for entrepreneurs (Figure 2.1). One minor change in the framework since the 2012 assessment has been to move debt settlement procedures into the sub-dimension assessing bankruptcy procedures. The

Figure 2.1. **Assessment framework for Dimension 2**



second chance sub-dimension therefore concentrates on the post-insolvency process and the frameworks for debt discharge and any measures to actively promote second chances for entrepreneurs.

Sub-dimension 1: Bankruptcy procedures

This sub-dimension considers bankruptcy procedures both on paper and in practice, and their alignment with international standards. It looks at the existence of alternatives to in-court bankruptcy processes, the establishment of an early warning systems (such as self-tests, call centres or training courses to identify financially distressed firms) and out-of-court settlement mechanisms such as mediation and arbitration (European Commission, 2014). The dimension also assesses whether court procedures are consistent with international standards, including the protection of creditors' rights, the strength of reorganisation procedures as an alternative to liquidation, the availability of incentives for post-petition finance and the existence of a temporary moratorium on other actions against firms undergoing bankruptcy.

Finally, this sub-dimension assesses the actual performance of insolvency frameworks by assessing the average time, cost and recovery rate of a typical bankruptcy case, as measured by the resolving insolvency indicators of the World Bank's *Doing Business* report (World Bank, 2015). These figures are particularly useful for identifying potential weaknesses in insolvency procedures and limitations in administrative capacity. These indicators have also been found to be highly correlated with the availability of credit and investment opportunities to enterprises (Succurro, 2012).

Sub-dimension 2: Second chance

The second sub-dimension looks at the measures in place to facilitate second chances for entrepreneurs and to reduce the stigma of business failure. The primary policy objective is to help entrepreneurs who have had failed businesses to start new ones and to view bankruptcy as a means to better understand how to start afresh. Achieving this should minimise the economic impact of lost entrepreneurial potential which may stem from discrimination against failed entrepreneurs and the stigma associated with undergoing bankruptcy (European Commission, 2011). This can be achieved through promotional campaigns advocating second chances as a reinvigorated fresh start, and by reducing the barriers for those restarting a business (Timmons and Spinelli, 2004). Economies that promote second chances often have higher levels of entrepreneurship, with businesses set up by "re-starters" often growing faster and contributing more to employment than first timers (Stam et al., 2008; Armour and Cumming, 2008).

Policy makers can use several mechanisms to promote such second chances, such as campaigns to promote a positive attitude towards giving entrepreneurs a fresh start and encouraging potential re-starters through training and information campaigns. An effective basket of policy measures should include discharges to release entrepreneurs from pre-bankruptcy debt within a period of time after a final court decision.

Analysis

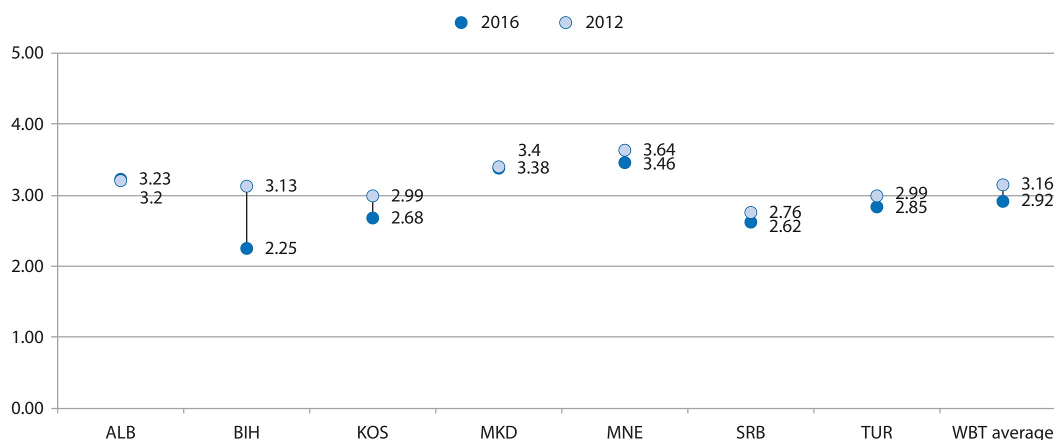
Most economies have made only minor developments concerning bankruptcy since the 2012 assessment, as they had the fundamental insolvency laws in place. Future progress will depend on reducing procedural delays and establishing the necessary institutional support mechanisms such as early warning systems and publicly available bankruptcy registers. The economies have also worked to develop institutions and support mechanisms

to facilitate effective bankruptcy procedures such as clearly defined discharge rules and out-of-court settlement procedures. As Figure 2.2 shows, the average regional score for this dimension stands at 2.92 for 2016, slightly down from the 2012 regional average of 3.16, with most economies having scored slightly worse. Montenegro is the regional leader, with a score of 3.46 (a decrease from 3.64 in 2012), followed by the Former Yugoslav Republic of Macedonia with a score of 3.38 and Albania with a score of 3.23. Turkey (score of 2.85), Kosovo (2.68) and Serbia (2.62) ranked in the middle. The worst performer is Bosnia and Herzegovina, with a score of 2.25. Most economies' scores fell slightly, primarily due to methodological changes. However, for the most part these declines are marginal and the overall picture is one of policy stagnation.

The outstanding challenges in this dimension are:

- Procedural bankruptcy processes need to be improved as the time taken to undergo bankruptcy procedures has not changed since the 2012 assessment. Costs are high in some economies, and the recovery rate is well below the OECD average.
- Most economies have not worked to develop an early warning system in order to identify distressed enterprises before they need to enter bankruptcy.
- None of the economies have established promotion and training programmes to entrepreneurs on the concept of a second chance.

Figure 2.2. **Weighted scores for Dimension 2 compared to 2012**



Note: See Annex A for further information on the assessment methodology.

Economies in the region could strengthen their existing insolvency laws

Almost all the economies in South East Europe have functioning insolvency laws in place to govern the formal procedures of distressed companies. The exception is Kosovo, which is currently drafting a new law on insolvency, as its former law under UN supervision has been revoked. Bosnia and Herzegovina has no national-level bankruptcy law; bankruptcy is governed by the insolvency laws of the two major entities, the Federation of Bosnia and Herzegovina (FBIH) and the Republika Srpska (RS).

Most economies have worked to ensure that their insolvency laws follow the UNCITRAL *Guide on Insolvency Law* (UNCITRAL, 2004), which is the international standard. In most cases, the legislation is in line with international standards on court proceedings against the debtor and the necessary protection of creditors' rights, but the level of compliance with

international standards varies. Montenegro and Serbia exhibit high levels of compliance; other economies, such as the Former Yugoslav Republic of Macedonia, recognise that they need further improvement with provisions to strengthen judicial intervention and rules on reorganisation at earlier stages of bankruptcy procedures. In all economies the respective laws' procedures are considered to be applied in a transparent and systematic manner. Insolvency laws apply equally to state-owned enterprises, except in Albania and Kosovo.

Some economies have made minor amendments to their laws to address procedural delays. For instance in Serbia, which performs relatively weakly in this area, the government implemented new changes to the bankruptcy law in July 2014, which will reduce the deadline for bankruptcy procedures, reduce the associated costs of restructuring and sale of assets, establish an electronic registry, and reduce administrative procedures for bankruptcy proceedings. Turkey is attempting to address its relatively lengthy and expensive bankruptcy procedures by restructuring the enforcement of the bankruptcy system, establishing a single enforcement office (currently being piloted in some courts) and abolishing the historical practice of multiple enforcement offices in the same location. As mentioned above, Kosovo has revoked the insolvency law that existed during the UN administration and is currently drafting a new insolvency law.

Most economies lack institutional support for effective and efficient bankruptcy procedures

The bankruptcy process remains an issue throughout the region. The time it takes to undergo bankruptcy procedures – typically two years in most economies – has not changed since the 2012 assessment (see Box 2.1 for more details). In Serbia, Turkey and Kosovo the average cost of bankruptcy proceedings remains high, at 20%, 15%, and 14.5% of the value of the estate respectively. The other regional economies are more in line with OECD average level of 9%; the average for the region stands at 12.4%. Recovery rates also remain relatively low in most economies; the average recovery rate in the region is 36.9%, well below the OECD average of 72.3%.

Most economies maintain registers of insolvency cases (typically handled by commercial courts, central banks or a central register), but they are not open to the public except in Montenegro and Turkey. Encouragingly, every economy has established provisions in their laws to ensure that out-of-court settlements are available, and often these are considered a cheaper alternative to formal bankruptcy filings.

Finally, most economies have not established formal early-warning system to identify distressed companies although, in some cases, banks and private credit assign a risk "rating" (to different types of loans, based on calculated risk of default.

Table 2.1 gives the scores for the sub-dimension on laws and procedures for bankruptcy.

Table 2.1. **Scores for Sub-dimension 2.1: Laws and procedures**

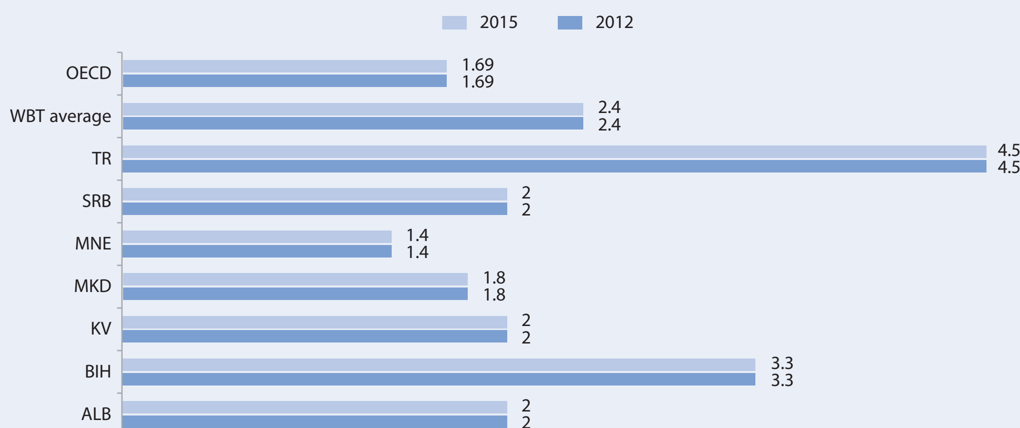
	ALB	BIH	KOS	MKD	MNE	SRB	TUR
Implementation	2.33	1.47	1.47	3.25	3.58	2.92	3.83
Performance	3.67	2.67	3.33	3.67	3.67	2.67	2.67
Weighted average	**3.33**	**2.37**	**2.87**	**3.56**	**3.65**	**2.73**	**2.96**

Note: See the Policy Framework and Assessment Process chapter for information on the methodology.

Box 2.1. **Key findings from the World Bank Doing Business 2016 indicators on resolving insolvency**

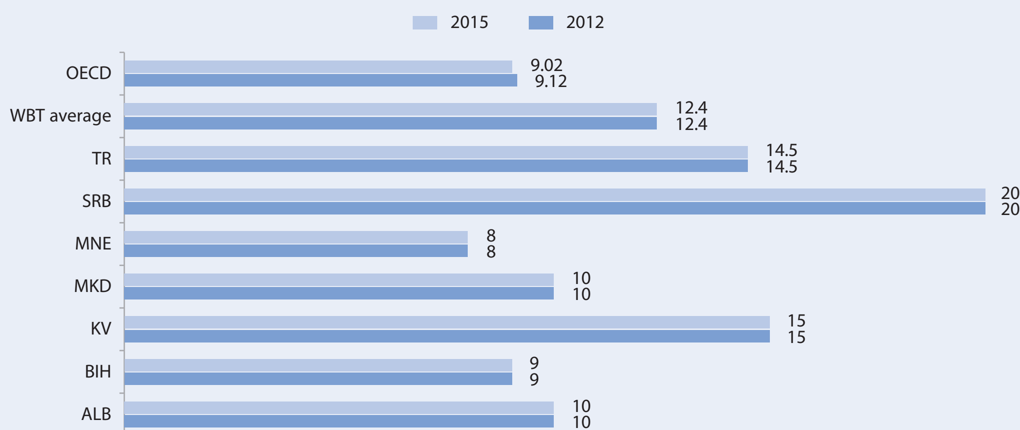
For the most part economies in the Western Balkans and Turkey have not made significant improvements on key metrics measuring the ease of undertaking insolvency laws. In part this is the result of many economies already having converged on OECD levels. For instance the regional average time to complete insolvency procedures stands at 2.4 years compared with the OECD average of 1.69 years, but this average is distorted by outliers such as Turkey (4.5 years) and Bosnia and Herzegovina (3.3 years). Many economies have already reached or surpassed the OECD average (Figure 2.3). A similar story emerges regarding the average cost of insolvency proceedings, with Serbia, Turkey, and Bosnia and Herzegovina distorting the results upwards (Figure 2.4). Most economies have bankruptcy proceeding costs which are near or below the OECD average. However, the Western Balkans and Turkey do lag behind in the recovery rate from the bankruptcy procedures. Here the regional average is 36.9%, which is virtually the same as it was in 2012, and well below the OECD average of 72.3% (which has increased from 68.4% since the 2012 assessment). Although most economies in the region are seeing improvements, albeit marginal ones, in this measure Turkey is sliding backwards – and its recovery rate stands at 18.7%, down from 23.6% (Figure 2.5).

Figure 2.3. **Time taken to complete insolvency proceedings (2012 and 2015)**



Source: World Bank (2015), *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, World Bank, Washington, DC, www.doingbusiness.org/reports/global-reports/doing-business-2016.

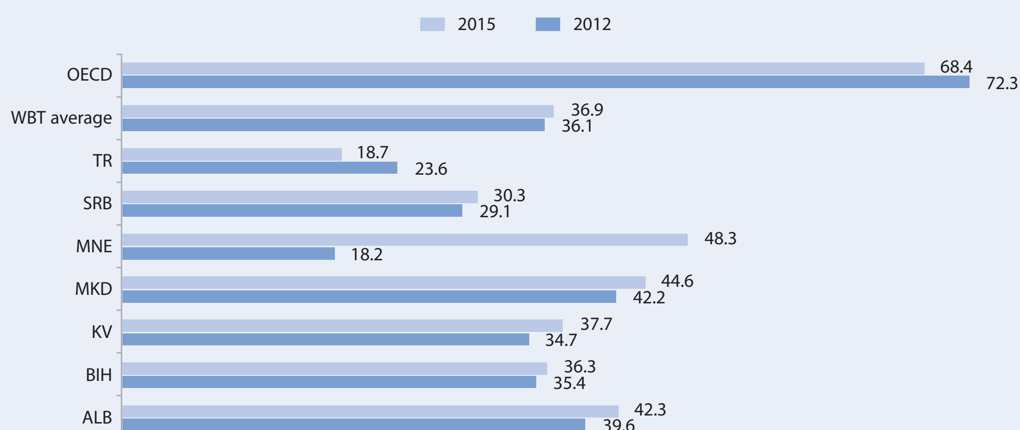
Figure 2.4. **Cost of insolvency proceedings (2012 and 2015)**



Source: World Bank (2015), *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, World Bank, Washington, DC, www.doingbusiness.org/reports/global-reports/doing-business-2016.

Box 2.1. Key findings from the World Bank Doing Business 2016 indicators on resolving insolvency *(continued)*

Figure 2.5. **Recovery rate for insolvency proceedings (2012 and 2015)**



Source: World Bank (2015), *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, World Bank, Washington, DC, www.doingbusiness.org/reports/global-reports/doing-business-2016.

Across the region there is a lack of programmes to promote second chances among entrepreneurs

There is a region-wide lack of provision of government-supported programmes to promote second chances among entrepreneurs who have had a failed business. Not one economy has included provisions in any national strategy to establish an information campaign to raise awareness about second-chance opportunities, although Turkey is in the process of developing a second-chance strategy. Nor is there any evidence that support or training programmes are being targeted towards honest entrepreneurs who have undergone non-fraudulent bankruptcy. Governments in the region may consider examining the initiatives introduced in a number of EU Member States (see Box 2.2), and how they can be applied in the context of their own economies. Table 2.2 gives the scores for this sub-dimension.

Table 2.2. **Scores for Sub-dimension 2.2: Promoting second chance**

	ALB	BIH	KOS	MKD	MNE	SRB	TUR
Second chance	2.29	1.23	1.00	1.79	1.79	1.64	1.83
Weighted average	**2.29**	**1.23**	**1.00**	**1.79**	**1.79**	**1.64**	**1.83**

Note: See the Policy Framework and Assessment Process chapter for information on the methodology.

The way forward

Most economies in the region have relatively well-developed insolvency laws in place that largely meet international standards. However, the remaining issues could be addressed:

- **Strengthen current insolvency laws by establishing prevention systems and public insolvency registers.** Putting early warning systems in place could help to identify distressed companies and thus potentially prevent bankruptcy altogether – minimising both costs to the enterprises, creditors, and the government. Insolvency and bankruptcy registers should be made available to the public.

- **Promote second chances among entrepreneurs.** The region faces a severe shortfall of programmes that promote second chance for honest entrepreneurs. Such programmes should support a fresh start and minimise stigma against those who have had a failed businesses. In this regard, public policy and legislation should progressively introduce a distinction between honest and dishonest entrepreneurs to ensure that the former are able to re-enter the market as soon as possible (see Box 2.2).

Box 2.2. **Support for second chance in the EU**

Beyond the limitation of maximum discharge periods to three years and a number of other legislative measures to facilitate quick business re-entry by honest entrepreneurs, a number of EU Member States have introduced programmes and initiatives to actively promote business re-entry and support those entrepreneurs in their new ventures.

A recent survey of 33 European countries has tried to assess the ease of second chance and identify some of the practices in use (European Commission, 2014). While the study concluded that more needs to be done to promote second chance in EU Member States, the survey identified at least one support measure in over half of the countries covered, including:

- assistance with access to finance (Ireland)
- preparation of guidelines for re-starters (Germany)
- awareness-raising activities (Croatia, France, Germany, Lithuania)
- second chance coaching and education (Germany, Belgium, Luxembourg).

Many of these initiatives are delivered by associations or other non-governmental entities. For instance, in Belgium, free coaching for re-starters is provided by associations while in Luxembourg the Chamber of Commerce organises regular seminars on business administration specifically targeting those entrepreneurs. In France, an association ("Initiative France") provides mixed financial services and mentoring for new ventures and re-starters.

Source: European Commission (2014), *Commission Recommendation of 12.3.2014 on a New Approach to Business Failure and Insolvency,* COM(2014) 1500 final, European Commission, Brussels.

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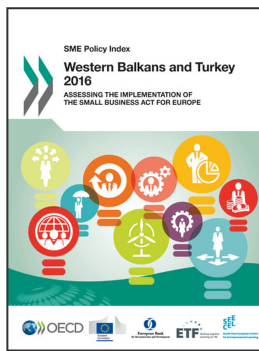

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