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„Towards an optimal bankruptcy law: Is international bankruptcy code possible?“

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List of tables:

List of figures:

Table of contents:

Introduction

In a globalized world, where corporations spread their businesses across the border of one country searching for new opportunities, the competition is very strong. Due to this severe competition and different internal and external factors business failures are very common today. And it's not only small companies that end up in bankruptcy. As practice shows, some of the world's largest corporations are not safe from becoming bankrupt as well.

Having more than one country involved in such a case, bankruptcy becomes of a transnational and international nature. The complications of international bankruptcy come from the fact that different parties from various countries are involved, each with their own preferences and interests. The fare resolution of disputes becomes very difficult and requires a predictable and efficient bankruptcy system and a unified approach.

The concept of international bankruptcy regime has been attracting attention of scholars and international institutions for a very long time. Understanding the importance of this question they paid a lot of attention to the question of efficiency of bankruptcy law, identifying its main goals, principles and objectives, based on the world's best practices.

The purpose of this paper is to review empirical research on bankruptcy in order to identify the possibility of reaching an optimal and unified international bankruptcy law that could be used by countries around the world. This paper analyses the development of bankruptcy legislation of different countries, which reform their laws to make them more efficient. It examines such issues as cross-country differences and the challenges which arise on the way to a unified international bankruptcy code. The paper concentrates on the idea that country differences and approaches make global unification of bankruptcy legislation and procedures not achievable, at least in the nearest future.

This paper consists of three parts. The first part examines the main theoretical concepts of bankruptcy and summarizes briefly the origin and the evolution of bankruptcy legislation in some countries. Part 2 identifies the notion of efficiency of bankruptcy system considering different views on bankruptcy procedures and factors that influence its efficiency. Part 3 focuses on the issues related to international bankruptcy. It discusses the main approaches to a cross-border insolvency, considers international elements of bankruptcy law and focuses on the challenges to the international bankruptcy, which make its full unification and harmonization very difficult if possible at all.

1. Bankruptcy and bankruptcy law: theoretical framework.

"Every country needs effective procedures for closing a failed business or saving a viable one that is experiencing temporary problems."[1]

1.1. The concepts of bankruptcy and bankruptcy proceedings

The word bankruptcy originates from ancient Italy. It is derived from *banca rotta*, which means a "*broken bench*". As was pointed out by Sheppard (1995), if merchants in medieval Venice were unable to pay their debts they "*were closed by banca rotta - the breaking of the bench from which they did their business*". [2] In ancient Rome, additionally to breaking the bench, imprisonment was used as a punishment and even a loss of an ear for merchants who failed to pay their debts. Debtor's prisons were also used in medieval England and Europe.[3]

Nowadays **bankruptcy** can be defined as *"... a legal process whereby financial distressed firms, individuals, and occasionally governments resolve their debts."*[4]

There are two tests for bankruptcy. In most of the cases, to file for bankruptcy a company needs to be *illiquid* - unable to repay debts as they fall due. But in some cases the company also needs to be *insolvent* - the value of liabilities has to surpass the value of assets. For example in the UK bankruptcy law the company needs to be insolvent to file for bankruptcy.[5]

In the literature we can find a broader approach for defining insolvency. Gratzer (2008) states that, "***Insolvency** is (today) a legal term meaning that debtor is unable to pay his debts*". [6] Ross, Westfield and Jaffe (1999) define **insolvency** as inability to pay one's debts or lack of means of paying one's debts. [7] De Oliveira (2008) also mentions that "*any person or firm unable to pay their debts is **insolvent**. If their state of insolvency is legally recognized, they become **bankrupt***."[8]

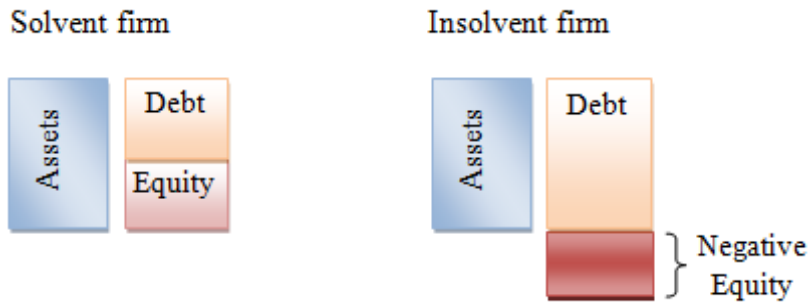
Ross, Westfield and Jaffe (1999) go further in distinguishing between stock-based insolvency and flow-based insolvency (figure 1). *Stock-based* (value-based) insolvency is defined as occurring when the value of the debts of a firm is more than the value of its assets (it implies

[1] Doing business in 2006: Creating jobs, 2006: p.67
[2] Sheppard, J.P., 1995: p. 99
[3] Salerno, T.J., Kroop, J., Hansen, C., 2010: p.2
[4] White, M.J., 2008: p.1
[5] Marinč, M., Vlahu ,R., 2011: p.7
[6] Gratzer, K., 2008: p.16
[7] Ross, S.A., Westerfield, R.W., Jaffe, J., 1999: p.795
[8] De Oliveira, M.T., 2008: p. 242

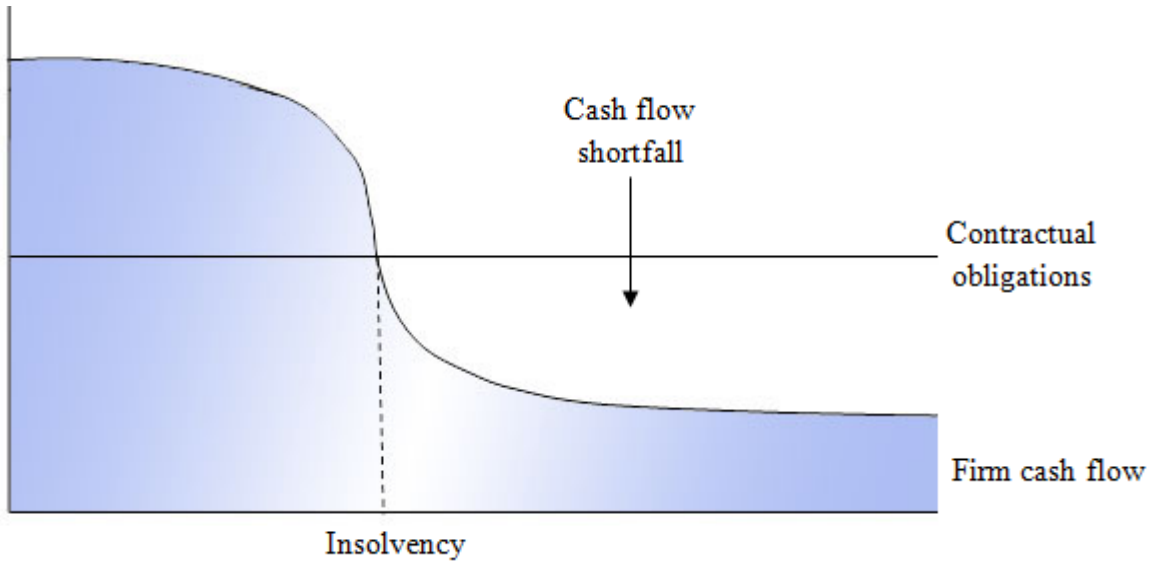
the negative equity). *Flow-based* insolvency, on the other hand, occurs when contractual obligations and required payments of a firm cannot be covered by its own cash flows.[9]

Figure 1 Insolvency

A. Stock-based Insolvency



B. Flow-based insolvency



Source: Ross, Westfield and Jaffe, 1999: p.795

Thus, insolvency can be determined as debtor's inability to pay his debts. Bankruptcy, on the other hand, is connected with the court's determination of insolvency.

But what are the main characteristics of bankruptcy and when is it used? Is bankruptcy the only way out for firms in distress? It is important to look into these questions, as well as the issue of bankruptcy procedures and regimes, which exist around the world today. The following three sections of the paper will be devoted to the discussion of these questions.

[9] Ross, S.A., Westerfield, R.W., Jaffe, J., 1999: p.795

1.1.1. Out-of-court restructuring vs. formal bankruptcy

A firm that has financial problems and faces financial distress has two possibilities to restructure its debt in order to avoid a default. It can renegotiate the debt contracts with its creditors in an out-of-court procedure or file for a formal bankruptcy. There is a widespread belief that a company should try to renegotiate its debt contracts before turning to bankruptcy.

One of the reasons for this is that "… *court-supervised bankruptcy process diverts managements' time and attention away from managing the enterprise*", as was correctly mentioned by Jensen (1989).[10]

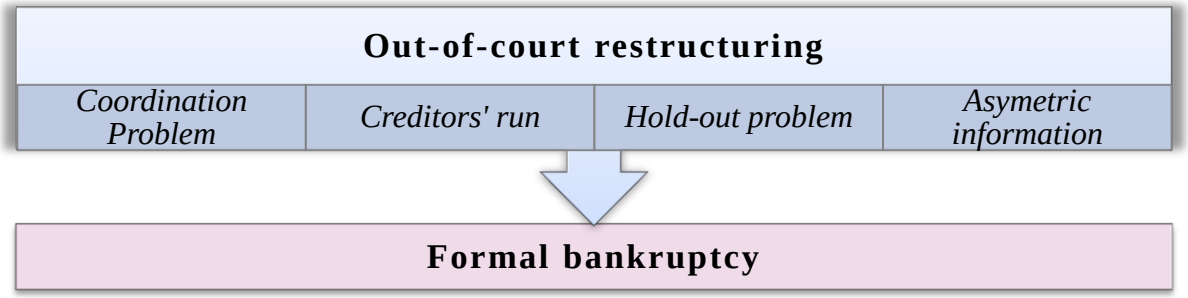
Another reason for choosing a private workout is bankruptcy costs, which are involved in a formal bankruptcy procedure. Debtors and creditors might prefer an out-of-court restructuring in case of lower costs compared to the formal bankruptcy.

On the other hand, debt restructuring can be beneficial for both sides: debtors and creditors. Marinč and Razvan (2011) indicated that this is particularly the case, if we have a viable corporation which faces some financial difficulties at the moment but will be profitable in the long run. [11]

Very often it is difficult to renegotiate debt contracts in an out-of-court procedure due to the conflicts between debtor and creditors. Those conflicts can also arise between the creditors themselves. One of the important factors when one considers debt renegotiation and restructuring is the dispersion of company's debt and its structure.

Debt dispersion is closely linked to coordination problem, hold-out problem, creditor's run situation, and asymmetric information issue (figure 2). Such conflicts between the debtor and its creditors may cause them to fail to come to an agreement in a private workout.

Figure 2 Major conflicts connected with out-of-court restructuring



For this reason Jostarndt (2007) pointed out that in case where the affected parties "…*cannot agree on how to share the alleged benefits associated with settling out-of-court, then*

[10] Franks, J., Sussman, O., 2005: pp.1-2
[11] Marinč, M., Vlahu ,R., 2011: p.6

formal bankruptcy may be the dominant option even though the combined wealth of all parties is ultimately lower".[12]

Before turning to the formal bankruptcy, it is important to look at the abovementioned conflicts in more detail.

One of the problems in debt dispersion is the **coordination problem**. It is difficult for a company to renegotiate its debt in a private workout, especially if the debt is widely held and heterogeneous in terms of term-structure, amount and some other features. Thus, the more creditors a company has, the mode difficult it is to restructure its debt.

Creditors' run situation occurs *"…when lenders exercise their first mover advantage, each trying to grab assets before other lenders, thereby precipitating the liquidation of a viable company"*.[13]

In some literature creditor's run is also referred to as a "run on the bank" and explained in the following way: *"when a debtor becomes insolvent, creditors have incentives to engage in a **"run on the bank"** enforcing their individual claims as quickly as possible, even if the result is a reduction in the overall value obtained."*[14]

Although, the first mover advantage is not always caused by debt dispersion, it can also take place if debt is structured in such a way that in the liquidation process the rights are not ordered by seniority.[15] That is why the systematic mechanism for asset reallocation became a very important instrument in terms of bankruptcy law and procedures.

Another problem associated with debt dispersion is the so called **hold-out problem**.

As was pointed out by Jostarndt (2007), "…*if the restructuring of a certain debt class involves multiple lenders, individual claimants have the incentive to "hold-out" or free-ride in the expectation that the concessions that ensure the success of the restructuring will be provided by others"*.[16]

In the hold-out problem all of the creditors have to agree unanimously on the way the debt is to be restructured. In such a situation a creditor doesn't have to be big to have a lot of influence and power in the negotiation process.[17] Even a small creditor can resist debt restructuring and claim overcompensation, which makes it difficult to complete the restructuring.[18]

[12] Jostarndt, P., 2007: p.72
[13] Franks, J., Sussman, O., 2005: p.6
[14] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010: p.3
[15] Franks, J., Sussman, O., 2005: p.6
[16] Jostarndt, P., 2007: p.81
[17] Marinč, M., Vlahu ,R., 2011: p.7
[18] Bolton, P., Scharfstein, D.S., 1996: p.1191

Thus, debt dispersion makes the renegotiations of a debt very difficult due to the coordination, hold-out, and creditors' run problems. A concentrated debt, on the other hand, could eliminate those problems and simplify the out-of-court restructuring.

It is easier to renegotiate a debt with a single lender because dispersed lenders can make such negotiations very difficult. Each of the many small lenders might want to liquidate the firm in order to satisfy all of his claims not caring about others. "*This creates a strong incentive to liquidate in case of default, as each lender ignores the fact that he satisfies himself at the expense of other lenders*".[19]

This raises the question about the factors, which influence debt dispersion of a company. If it is so difficult to renegotiate debt when it is not concentrated, what induces a company to decide in favor of debt dispersion?

One of the reasons in favor of debt dispersion is that it gives an opportunity for a company to make a commitment not to restructure its debt and it is a way by which a company may "*harden its budget constraint*" [20], as was pointed out by Franks and Sussman (2005).

Another reason is that there are some disadvantages connected to the concentration of debt in a form of a single baking relationship.

First of all, "*the bank may decide against keeping the good company going because it does not see the upside potential."* [21]

Secondly, the bank might not have any strong motives to pursue the highest possible sale price or the bank might be "lazy". The idea of "lazy banks" comes from Manove, Padilla, and Pagano (2001), who stated that "…*banks with highly collateralized loans have no incentive to screen, even when the screening costs are low enough that screening is socially efficient.*"[22] Franks and Sussman (2005) use their term "lazy banking" more broadly by stating that *"due to the fixed-repayment property of debt, the bank would avoid any costly action that would benefit other stakeholders. Banks may be "lazy", and avoid the effort and the risk involved in the restructuring of a distressed company."* [23]

Thus, there are problems associated with the concentration of debt, especially if we have a single bank relationship. And the out-of-court restructuring has also problems, especially when a company's debt is heterogeneous and dispersed among many creditors. This dilemma could be solved in the formal bankruptcy procedure.

[19] Franks, J., Sussman, O., 2005: p.5
[20] Franks, J., Sussman, O., 2005: pp.4-5
[21] Franks, J., Sussman, O., 2005: p.6
[22] Manove, L., Padilla A.J., Pagano, M., 2001: p.741
[23] Franks, J., Sussman, O., 2005: pp.6-7

Bankruptcy may also be preferable in case of **asymmetric information**, which hinders fair negotiations between the debtor and the creditors. "*In a court-supervised process additional disclosure rules, such as detailed inventory and a valuation of all assets, mitigate informational disadvantages of outsiders.*"[24] It is also true, that in a court-supervised bankruptcy process, the company with dispersed debt doesn't need the unanimous consent of all of its creditors in order to restructure its debt.

Another issue that speaks in favor of formal bankruptcy is the fact that a manager might have never dealt with a bankruptcy case in his life and the judge, on the other hand, deals with many bankruptcy cases yearly and therefore will have more experience on this matter.[25]

Talking about formal bankruptcy bring us to the next important issue, namely bankruptcy procedures. Next we will take a closer look at the two main types of in-court bankruptcy procedures: liquidation and reorganization.

[24] Jostarndt, P., 2007: p.80

[25] Doing Business 2012. Doing business in more transparent world, 2011: p.1

1.1.2. Liquidation vs. Reorganization

Most of the countries have two alternative procedures for corporate bankruptcy: liquidation and reorganization.

Liquidation can be defined as "*…a court-supervised procedure in which the firm is closed and sold for cash either as a whole or, more frequently, piecemeal*".[26]

The example of a liquidation law is Chapter 7 of U.S Bankruptcy Code. Under liquidation the incompetent and inefficient managers and owners are removed and the assets of a company could be used more effectively. However, this is not true in case of industry shocks. The assets of the company might not be used effectively if it is liquidated during the times when the whole industry is depressed.

Reorganization can be defined as "*…a court-supervised bankruptcy procedure aimed at restructuring a firm and making it viable in the long run*".[27]

In case of reorganization the managers of a company and its shareholders have a chance to save their company. Thus, more generally reorganization can be viewed as *"... the implementation of the rehabilitation plan in order to allow a firm to stay in business"*[28]

If the company is not liquidated but reorganized it carries on its operations and most of its assets are kept. "*The funds to repay creditors then come from the reorganized firm's future earnings rather than from sale of its assets*".[29]

The best known reorganization procedure is Chapter 11 of U.S. Bankruptcy Code. Similar reorganization procedures exist in other countries as well. "*In Britain reorganization is referred to as 'administration', in Germany 'vergleich', in France it is termed 'reglement aimable' and 'redressement judicaire' and in Italy 'administrazione controllata'.*"[30]

Reorganization procedures in different counties have their own specific features. According to some bankruptcy codes, the management of the company stays in charge of the firm in most cases (for example in the U.S.), while in others bankruptcy codes, the administrator is appointed (for example in Britain). [31]

In the literature it is often argued, that a replacement of the existing management may not be optimal. This is particularly the case when the entire industry is distressed. In such situation managers might not be fully responsible for company's bankruptcy; it might not be entirely their

[26] Marinč, M., Vlahu ,R., 2011: p.11
[27] Marinč, M., Vlahu ,R., 2011: p.12
[28] Bouckaert, B., De Geest, G., 2000: p.274
[29] White,M.J, 2007: p.1017
[30] Cabrillo, F., Depoorter, B., 2000: p. 274
[31] Bouckaert, B., De Geest, G., 2000: p.274

fault. Another reason for not replacing the management is the fact that they know their company better than anyone else. This knowledge can help them to restructure the company more effectively in bankruptcy, especially compared to new managers which have little or don't have any knowledge about this particular company.

The decision to liquidate the company, to reorganize it or to sell as an on-going concern should depend on which option creates the most value for its shareholders. There is a widespread belief that even in bankruptcy some part of company's value should be maintained for its shareholders. "*Otherwise, shareholders may do everything to prevent bankruptcy, including undertaking high-risk projects when the corporation is under distress*".[32]

The main benefit of reorganization is the fact that many unnecessary liquidations are avoided. On the other hand, critics of reorganization argue that it is inefficient because reorganization keeps bankruptcy away from reaching its main objective - "*the reallocation of the debtor's assets to more productive employments*".[33]

In the real life, however, a lot depends on the bankruptcy legislation and procedures of a particular country. Statistics show that *"European countries still deal with insolvent firms far more harshly than America does, and most such firms end up in liquidation"*.[34]

On the other hand, as was stated by Cabrillo and Depoorter (2000), "*some countries consider liquidation and reorganization of the firm as alternatives, without showing any special preference for one or the other. Other codes- such as the French law passed in 1985 – favor the rehabilitation of the firm*".[35]

Thus, the proportion of bankruptcy procedures that end up in actual liquidation of the companies, and not in their reorganization, varies across countries, depending on the bankruptcy regime. If we look at bankruptcy legislation, one of the important factors that influence bankruptcy rates across countries is different bankruptcy regimes: creditor-friendly or debtor-friendly. [36]

The next section is dedicated to such an important characteristic of the bankruptcy legislation as the extent to which the creditors and debtors are protected.

[32] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010:p.6
[33] Bouckaert, B., De Geest, G., 2000: p.274
[34] The Economist, 2008
[35] Cabrillo, F., Depoorter, B., 2000: p.275
[36]Lunati, M., Schlochtern, J.M., Sargsyan, G., 2010: p.6

1.1.3. Creditor-friendly vs. debtor-friendly bankruptcy regimes

Bankruptcy legislation is a set of bankruptcy laws and procedures of a country. Bankruptcy legislations around the world vary significantly. Some countries have more debtor-friendly, whereas other countries have more creditor-friendly bankruptcy laws (appendix I; figure 40).

It is important to look at these regimes because they impact the decision of a company to use formal bankruptcy or reorganize its debts privately. As was stated by White (1993), in debtor-friendly regimes there is a greater probability that firms, which face financial problems, will use in-court reorganization.[37] This in turn implies that in creditor-friendly regimes private workouts are preferred.

In case of bankruptcy, **creditor-friendly** bankruptcy laws ensure high payoffs to creditors and present a big threat to the inefficient managers, who could be fired.

Under creditor-friendly bankruptcy law, creditors expect to receive high returns if bankruptcy happens and they claim lower interest rates. Risk-taking is limited and safe projects become more attractive. Empirical research also shows that corporations take less risk under creditor-friendly bankruptcy regimes.[38]

It is interesting to look at bankruptcy regimes in the ex-ante and in the ex-post sense in order to see when and whom they work best for. The main points are presented in table 1. In the *ex-ante* sense, before bankruptcy occurs, bankruptcy law should derive appropriate incentives and evoke optimal behavior from debtors and creditors. Marinč and Vlahu (2011) stated that before bankruptcy occurs, bankruptcy regimes are not used to protect creditors, because they can protect themselves by having more severe lending policies or charging higher interests. They also added that "… *the design of bankruptcy law affects firm value in an indirect sense through its impact on incentives and behavior of creditors and debtors*".[39]

Empirical research shows that creditor-friendly bankruptcy law is more appropriate in ex-ante sense. Jensen (1986) argues that for companies that issue large amounts of debt "*the threat caused by failure to make debt service payments serves as an effective motivating force to make such organizations more efficient*". [40]

[37] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010: p.8
[38] Marinč, M., Vlahu ,R., 2011: p.7
[39] Marinč, M., Vlahu ,R., 2011: p.9
[40] Jensen, M.C., 1986: p.324

In the *ex-post* sense, when the debtor has already entered the bankruptcy, creditor-friendly bankruptcy law will no longer be optimal, because objectives of the bankruptcy law have changed.

If the company approaches bankruptcy, under the creditor-friendly bankruptcy law the existing managers would try to postpone the bankruptcy, because they view it as a threat. In this case the **debtor-friendly** bankruptcy law is more appropriate.

As was mentioned by Marinč and Vlahu (2011) in the ex-post sense, when a company is in bankruptcy, debtor-friendly bankruptcy law will cause more efficient restructuring than creditor-friendly one. They also argue that under creditor-friendly bankruptcy law, the manager can "*hide losses through the use of creative accounting, or simply free cash flows by spending less on R&D and on product quality*".[41]

Another important issue is that *"debtor friendly laws might encourage managers to seek bankruptcy protection from their creditors at an earlier point, which may influence the likelihood of firm's survival and may ultimately benefit its claimants".* [42]

Table 1 Bankruptcy regimes in the ex-ante and ex-post sense.

	Creditor-friendly	**Debtor-friendly**
in the **ex-ante** sense	more appropriate: • incentives for managers to be more sufficient not to lose their job • managers don't take a lot of risk	not optimal: • expropriation of free cash flow (if bankruptcy is not considered to be of sufficient threat)
in the **ex-post** sense	not optimal: • bankruptcy is viewed as a threat • managers try to postpone bankruptcy • creative accounting can be used to hide losses	more appropriate: • managers are not fired • bankruptcy is declared in time • managers know the company better and can restructure it more efficiently

Source: Based on Marinč, M., Vlahu, R., 2011 and Jensen, M.C., 1986

As we have seen, creditor-friendly and debtor-friendly bankruptcy regimes set different objectives for bankruptcy and have different incentives for managers and creditors, which influence their behavior. There is also a widespread view, that creditor friendly bankruptcy is more optimal in ex-ante sense and debtor- friendly in the ex-post sense. If we look at bankruptcy legislation around the world, we can see that various countries have different bankruptcy regimes, some of which are more creditor-oriented, while others are more debtor-oriented (figure 3). But

[41] Marinč, M., Vlahu ,R., 2011: pp.10-13
[42] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010 p.8

how do the countries decide which of the two bankruptcy regimes would work better for them? In this sense it is interesting to look at how the bankruptcy legislation varies among different countries and what might influence these differences.

Figure 3 Creditor and debtor orientation of corporate insolvency law
(Scale: 1= Most pro-creditor, 10= Most pro-debtor)

Source: Wihlborg, C., Gangopadhyay, S., 2001: p.50

Ayotte and Yun (2009) point out that for a debtor-friendly bankruptcy law strong judicial expertise is really important, because such expertise together with an adequate training is needed to determine which firms are viable and which are not. They also stated that in this case "*debtor-friendly bankruptcy law then minimizes excessive liquidation of creditor-friendly bankruptcy law. However, in the absence of judicial expertise and in an environment with weak enforcement rights, creditor-friendly bankruptcy law works better*".[43]

Djankov et al. (2008) found that high-income countries are better at complicated bankruptcy procedures such as reorganization, compared to the middle-income and lower middle-income countries, which perform better in liquidation.[44]

In the conclusion it is also important to mention that, in countries with strong investor protection and well-developed judicial system debtor-friendly bankruptcy laws work the best, while creditor-friendly bankruptcy laws should be used in countries with weak judicial expertise and weak investor protection.[45]

Having discussed main characteristics of bankruptcy regimes it is important now to look into the bankruptcy legislation in some details. The next section of the paper is devoted to the origin of bankruptcy law, its evolution and development.

[43] Ayotte, K., Yun, H., 2009: p.4
[44] Djankov, S., Hart, O., McLiesh, C., Shleifer, A., 2008: p.1125
[45] Marinč, M., Vlahu ,R., 2011: p.15

1.2. Historical background of bankruptcy legislation and its development

There is no doubt that good bankruptcy legislation is an essential element of the efficient bankruptcy system. The legal framework is considered to be the first of three building blocks, identified by the World Bank, necessary for an effective insolvency system of each country. The other two include the institutional and the regulatory frameworks.[46]

But when did bankruptcy law originate? And how has it developed since then? Which major changes in bankruptcy law and procedures were implemented over time? These important questions will be discussed in the next two sections of the paper.

1.2.1. The origin of bankruptcy law

"Laws in different countries are typically not written from scratch, but rather transplanted – voluntary or otherwise – from a few legal families or traditions."[47]

The earliest traces of bankruptcy can be found in the Code of the jurist-king Hammurabi, who ruled in Babylonia in the 18th century B.C, as was pointed out by White (1977). The **Code of Hammurabi** resembled the modern law in a way that it foresaw the liquidation of the debtor's asses and their proportional distribution between creditors.[48] The early implementation of bankruptcy law was closely connected to the widespread view that a debtor was a criminal who had to be punished severely for not being able to pay out his debts.

In **ancient Athens** under the severe code of Draco in 623 B.C bankruptcy was considered as a major crime. The death penalty was generally refrained from using but the debtor and his family were sold for slavery. The proceeds were then distributed among the creditors. In order to escape this punishment the debtor could leave the country, which became a general practice.[49]

Under the **Roman** law we can see the similar situation. "*The penalty for declaring bankruptcy in ancient Rome was slavery or being cut into pieces."* [50] The creditors were to decide about the punishment. Under the law of the Twelve Tables, written in 451 B.C., the borrower himself served as collateral. *"The creditors were not only empowered to sell or take the debtor into slavery, but as a final resort to divide the debtor's body into proportional shares. The laws were modified in 326 B.C to make the imprisonment for debt the rule*."[51]

[46] Johnson, G., 2000: p.71
[47] LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny,R.W.,1996: p.1115
[48] White, L.H., 1977: p.281
[49] White, L.H., 1977: p.281
[50] Doing Business in 2004: Understanding regulation, 2004: p.71
[51] White, L.H., 1977: p.281

By the Middle Age the situation had slightly changed and the handling of the debtor had softened.[52] In **medieval Italy** the merchant who couldn't pay his creditors would be thrown into prison and his possessions would be sold to cover the debt. But de facto insolvent merchants would generally leave town to escape the punishment.[53] "*In **French** medieval cities, bankrupts were required to wear green cap at all time and anyone could throw stone at them. In **England** bankrupt debtors were thrown into prison, often punished by putting in a pillory and occasionally had one ear cut off.*"[54]

The first **modern bankruptcy** law was the English bankruptcy law of 1732. In the US the first bankruptcy law was introduced in 1800, which copied that of England. In the early 19th century the first bankruptcy laws were passed in Germany, France, and Spain.[55]

The first modern bankruptcy legislation evolved considerably and was much different from the earliest approaches mentioned above. Main shift could be observed in terms of nature of punishment and its consequences.

Of course the development of bankruptcy law did not proceed in vacuum and cannot be considered independently from the development of other types of business, trade, tax, and fiscal regulations of a particular country and its legal system in general. Bankruptcy regulation was an integral part of the emerging economic system of a state in 18-19th centuries and reflected the needs of increased civil and commercial changes inside a country.

The changes, which happened on the national level, have played a major role in the development of bankruptcy law. Naturally, the peculiarities of the whole legal system and tradition of a state influenced the bankruptcy procedures as well.

On the other hand, it is obvious that bankruptcy legislation of different countries didn't evolve independently and was influenced to some extent through political and commercial interaction. Beck and Levine (2003) noticed in this regard that "… *different legal traditions that emerged in Europe over previous centuries and were spread internationally through conquest, colonization, and imitation help explain cross-country differences in investor protection, the contracting environment, and financial development today.*"[56]

Therefore it is important to take a brief look at the main legal systems that had been formed during the 18-19th centuries and how they influenced the bankruptcy legislation of different countries at different stages.

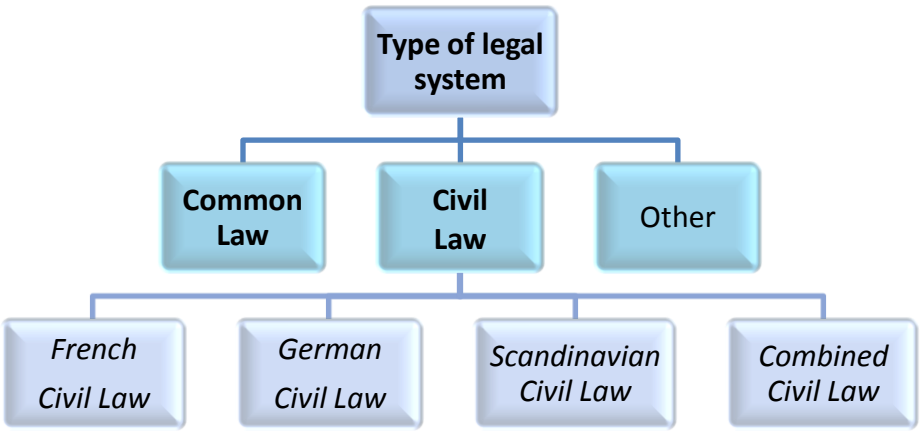
[52] Doing Business in 2004: Understanding regulation, 2004: p.71
[53] White, L.H., 1977: p.281
[54] Doing Business in 2004: Understanding regulation, 2004: p.71
[55] Doing Business in 2004: Understanding regulation, 2004: p.71
[56] Beck, T., Levine, R, 2003: p.1

From the point of view of legislation the distinction is generally made between two main legal systems: that of common and civil law. (Figure 4)

The **common law** (Anglo-Saxon) family includes the law of England and those modeled on English law. The main distinction of the common law is that it is formed by judges who have to resolve specific disputes. The common law is based on the precedents from judicial decisions, including those regarding bankruptcy, in contrast to the contributions made by scholars. Common law was spread to the British colonies, including the United States, Canada, Australia, India, and others.[57]

Civil law, on the other hand, is a system inspired by Roman law, the primary feature of which is that laws are written into collection, codified, and not, as in common law, developed by courts and other relevant practices. All countries in Europe except the United Kingdom and Ireland have legal systems based on civil law.[58] (Appendix II; Table 5) Civil law system is the oldest in nature, the most authoritative, and the most widely spread around the world.[59]

Figure 4 Main types of legal systems



Source: Based on LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny, R.W, 1996

Under the civil law three sub-groups can be determined, namely: French, German, and Scandinavian systems. Looking at the commercial codes of these sub-groups and at the extent of their influence around the world we should mention the following.

The **French Commercial Code** was written in 1807. The armies of Napoleon brought it to Belgium, the Netherlands, a part of Poland, Italy, and western regions of Germany, as was pointed out by LaPorta (1996). The legal influence of France was also considerable in such countries as Spain, Portugal, Luxembourg, some of the Swiss cantons, and Italy. In the colonial era it had also been spread to the Near East and Northern and sub-Sahara Africa, Indochina, Oceania, and French

[57] LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny,R.W.,1996: p.1119
[58] Business Dynamics: Start-ups, Business Transfers and Bankruptcy, 2011: p.115
[59] LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny,R.W.,1996: p.1118

Caribbean Islands (Glendon et al. 1994) [60] Even in the United States some states (Louisiana) adopted a French approach as well as Quebec in Canada.

The **German Commercial Code** was written after the unification of Germany, in which Bismarck has played a big role. It was not as extensively adopted as the French Commercial Code; one of the reasons could be because several decades separated them. The German Commercial Code was written only in 1897. But it still has considerably affected the legal theory of such countries as Austria, Czechoslovakia, Greece, Hungary, Italy, Switzerland, Japan, Korea, and others. The laws of Taiwan were adopted from China. And China, during its modernization phase, based its laws to a large extent on the German Code.[61]

One of the distinctions between the two codes was that Napoleonic Code was written to be fixed and unchanged, while the German Code was designed to evolve. "*France technically denies judicial review of legislative actions, while Germany formally recognizes this power and German courts actively exercised it*".[62] This has caused differences in many regulations including those regarding bankruptcy procedures.

The **Scandinavian law family** is generally viewed "*as a part of the civil-law tradition, although it is very limited in terms of countries which use it and is less derivative of Roman law than the French and German families"* (Zweigert and Kotz, 1987) [63], having also some distinctive peculiarities of local tradition.

There is no doubt that the type of the legal system had impact on the formation and evolution of bankruptcy law, which gradually became a separate institute within a national legal system. But the type of legal system is not the only exclusive factor which influenced the development of bankruptcy legislation.

Some researchers even argue that the legal system of a country plays only a limited role in explaining the variation of its bankruptcy approaches. It is a common case when countries within the same legal system have very distinct bankruptcy laws and regulations. In certain cases, like with the US and UK, they can even be viewed as opposite.

Thus, we should also look at how the modern bankruptcy legislation has changed over time on a national level and what might have caused those changes. The evolution and development of the modern bankruptcy laws around the world is discussed in detail in the next section of the paper, with the emphasis made on the legislation of the United States, the United Kingdom, Germany, and Russia.

[60] LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny,R.W., 1996: p.1118
[61] LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny,R.W., 1996: pp.1119-1118
[62] Beck, T., Levine, R., 2003: p.8
[63] LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny,R.W., 1996: p.1119

1.2.2. The evolution of bankruptcy legislation in some countries

"Bankruptcy is still in its infancy in many countries, and reform continues even in the best-performing jurisdictions."[64]

As we have seen, even in ancient times bankruptcy rules and procedures played an important role in the everyday economic and commercial life. Regulations, which existed at those times, greatly reflected the negative attitude towards bankruptcy. The main concepts, which can be drawn, are that bankruptcy was viewed as a crime, which had to be severely punished. Such approach lasted for a long time and imprisonment remained a common punishment even in modern bankruptcy law. Bankruptcy was seen primarily as a mean to liquidate financially distressed entities and distribute their remaining assets among creditors.

The primary aim of a bankruptcy law was the protection of creditor's interests and relevant proceedings were always initiated by creditors. A voluntary bankruptcy in most countries wasn't introduced until the nineteenth century.[65]

An **elementary rehabilitation procedure**, intended to reorganize the debt of a bankrupt entity in a way that it could keep operating, was developed in Austria in 1914 but was not used very often. "*Similar procedures were introduced in Spain in 1922, in South Africa in 1926, and in Belgium, France, Germany, Netherlands, and the United States in 1930s*".[66]

Actually a modern reorganization procedure didn't appear until 1978, when such approach was adopted by the United States. *"In the next 25 years a wave of bankruptcy reforms brought reorganization procedures to Italy in 1979, France in 1985, the United Kingdom in 1986, New Zeeland in 1989, Australia and Canada in 1992, Germany in 1994 and 1999, Sweden in 1996, and Japan and Mexico in 2000…"*[67]

Each country has gone its own unique way in the development of the bankruptcy legislation and procedures. In this section we'll try to take a closer look at the evolution of bankruptcy legislation in some leading countries. From the common law family the Great Britain and the United States will be examined in more detail. From the civil law family the more attention will be paid to Germany and Russia.

In England the first bankruptcy law was actually passed in 1542, during the reign of Henry VIII. It was called "*An act against such persons as do make bankrupts*". Under this first law debtors were viewed as almost criminals and it provided additional remedies in the hand of

[64] Doing Business in 2004: Understanding regulation,2004: p.71
[65] Bouckaert, B., De Geest, G., 2000: p.268
[66] Doing Business in 2004: Understanding regulation, 2004: p.71
[67] Doing Business in 2004: Understanding regulation, 2004: p.71

creditors. A more comprehensive bankruptcy law was passed in 1570 during the reign of Queen Elizabeth I.[68]

The bankruptcy law was only employed to merchant debtors. This restriction lasted until the nineteenth century. Thus, at that time *"... the bankruptcy laws were viewed as a necessary concomitant to the experiences of commerce, but no more. Credit generally was viewed as immoral and almost fraudulent."*[69]

Due to economic changes, which were caused by the fast development of trade and overall economic activity, the attitude towards debtors was changing. It became clear that bankruptcy was not directly connected to fraud. This caused an introduction of a debt discharge notion, which can be viewed as "*the revolutionary instrument*". [70] Under the Statute of Anne, 1705, the debtors who cooperated in bankruptcy proceedings were released from their debts. While the quasi-criminal nature of bankruptcy remained, the *Stature of Anne* for the first time set the base for a more liberal legislative treatment of the honest but unlucky debtor.[71]

Some words should be also said about the severe punishment of fraudulent bankrupts. Bankruptcy was no different from most property crimes of that era. Death penalty was still used at that time against bankrupts. But such use should not be overstated. As was mentioned by Tabb (1995) "*at most five executions occurred in the 115 years that death penalty for fraudulent bankruptcy was on the books*".[72]

With the Industrial Revolution, the attitude towards bankruptcy was changing slowly because of the developing commerce and credits relations, although the law remained strongly creditor-friendly.

Great Britain became the world's first industrial nation. It was sometimes called the *"workshop, banker, and trader of the world. It produced one half of the world's coal and manufactured goods: its cotton industry alone in 1851 was equal in size to the industries of all other European countries combined"*.[73]

Changes in bankruptcy laws in England in favor of debtors could be seen throughout the nineteenth century. In 1842 the creditor consent to the discharge was abolished, in 1844 voluntary bankruptcy was allowed, and in 1844 eligibility was extended to non-merchants.[74]

[68] Tabb, C.J., 1995: p.2
[69] Tabb, C.J., 1995: p.3
[70] Di Martino, P., 2008: pp.263-264
[71] Tabb, C.J., 1995: p.4
[72] Tabb, C.J., 1995: p.4
[73] Spielvogel, J.J., 2010: p.616
[74] Tabb, C.J., 1995: p.7

As was mentioned by Di Martino (2008), the changes to bankruptcy procedures did not always come from formal transformation of rules but were also driven by judicial interpretation. Courts recognition of the "floating charge" became a key element of the corporate insolvency introduced in 1890.[75]

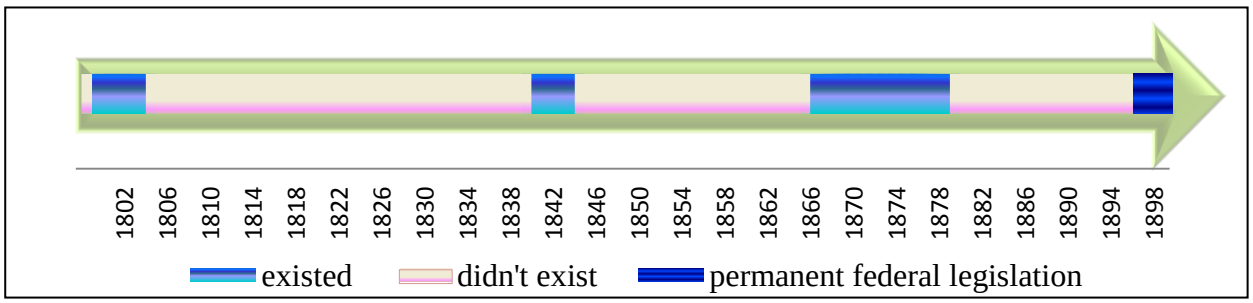
From the example of Great Britain we have seen that changes in bankruptcy legislation were greatly influenced by such factors as the rise of industrialization. Spielvogel (2010) states that, "*beginning first in Great Britain, industrialization spread to the Continental countries of Europe and the United States at different times and speed during the nineteenth century.*"[76]

Another country from the common law system that we'd like to look at is the United States. It is interesting to mention that the laws of Great Britain and the US regarding bankruptcy are sometimes viewed as opposite, despite of their common legal origin. One possible factor in explaining such a diversity of laws could be "*the timing and depth of economic transformation*", as was mentioned by Di Martino (2008). He noted that "*having started earlier than any other country, the English legislator was able to produce in 1883 a complete and satisfactory law whose structure benefited from the results of previous experiments and transformations*". [77]

Berflof, Rosental and von Thadden (2002) underline, that bankruptcy law "… *exhibits tremendous variations across time".* One of the best examples that illustrate this is the evolution of bankruptcy system in the USA.[78]

The first **United States** bankruptcy law was passed in 1800, which was modeled on the English Statue of Anne. During the whole nineteenth century, various attempts to passing a national law took place, but none of them proved successful. '*The 1800 law was repealed in 1803. A subsequent act, passed in 1841, did not last longer than 2 years while a further law enacted in 1867 was repetitively amended and finally repealed in 1878*".[79] (Figure 5)

Figure 5 Federal bankruptcy law in the USA



Source: Based on Tabb, C.J., 1995

[75] Di Martino, P., 2008: p.265
[76] Spielvogel, J.J. 2010: p.616
[77] Di Martino, P., 2008: pp.263-264
[78] Berglöf, E., Rosenthal, H., von Thadden, E-L., 2002: p.8
[79] Di Martino, P., 2008: p.265

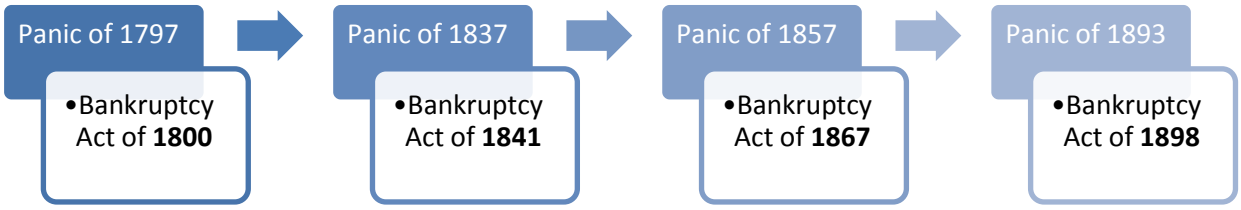
"The Bankruptcy Act of 1898 was in substance and procedure almost dramatically opposed to that of England."[80] But what factors might have influenced these changes?

In the US various states had different laws in a colonial era; some were insolvency laws, others were bankruptcy laws. Imprisonment for debt was a common practice until the nineteenth century, but some states had a more debtor friendly regimes compared to that of England.[81]

During the times when there was no stable federal bankruptcy legislation, the states adopted their own bankruptcy laws. As was mentioned by Tabb (1995), "…*permanent federal legislation did not go into effect until **1898**. Thus, states were free to act in bankruptcy matters for all but 16 years of the first 109 years after the Constitution was ratified*".[82]

In the USA the changes in federal bankruptcy legislations in each case followed a major social and financial disaster (Figure 6).

Figure 6 Timeline of bankruptcy legislation in the USA



Source: Based on Berglöf, Rosenthal, and von Thadden, 2002

As the result of the crash in 1792 and panic of 1797 thousands of debtors were imprisoned because of the widespread ruin, this contributed to the development of national bankruptcy legislation of 1800. The bankruptcy Act of 1841 was enacted due to the pressures caused by the economic depression of 1819-1820 and the Panic of 1837. For the next bankruptcy act (that of 1867), pressure has been brought by the Panic of 1857 and the financial cataclysm, which followed the Civil War. [83] Main characteristics of these bankruptcy acts of these times are outlined in Table 2.

Some important factors that influenced the development of bankruptcy legislation in the United States were also lobbying and political pressures, as was mentioned by Di Martino (2008). For example, the US railways at that time were one of the major driving forces of economic development in the country. Finding a solution to the railway crisis was one of the important issues which influenced the development of its bankruptcy legislation. "G*iven the importance of the industry as the core of the American economic development, with all possible consequences in*

[80] Berglöf, E., Rosenthal, H., von Thadden, E-L., 2002: p.8
[81] Tabb, C.J., 1995: p.5
[82] Tabb, C.J., 1995: p.5
[83] Tabb, C.J., 1995: p.5

terms of lobbying and political pressure, judges accepted the principle of the necessity of keeping railways as ongoing concerns rather than looking at ways to liquidate them."[84]

Table 2 Characteristics of the changing bankruptcy acts in the USA

Bankruptcy Acts	**Characteristics**	**Notes**
Act of 1800	- very similar to the 1732 English Act - purely creditors' remedy - only involuntary bankruptcy - only merchants were eligible debtors - fraudulent bankruptcy is a criminal offense - no death punishment	"The *Act marked a transformation in the moral and political economy of eighteenth-century America*".[85]
Act of 1841	- voluntary bankruptcy for all debtors - marriage of the concepts of "bankruptcy" and "insolvency"	*"The 1841 law, with its marriage of the concepts of "bankruptcy" and "insolvency", could be called the first "modern" bankruptcy law".*[86]
Act of 1867	- restriction of involuntary bankruptcy to merchants was dropped - any person is subject to the threat of involuntary bankruptcy	- proved a failure - was repealed in1878

Source: Based on Tabb, C.J., 1995

The first comprehensive national bankruptcy legislation in the US was introduced in 1898. It continued to operate until the 1930s when the affects of the Great Depression pushed for another institutional change.[87]

After the Depression one the important changes in the US bankruptcy law were introduced by the Chandler Act of 1938. "*The Chandler Act substantially revised virtually all of the provisions of the 1898 Act."*[88] In the next years the legislation on bankruptcy had been continuously amended by the Congress, but only a few of changes were relatively significant.

The next comprehensive reform of the federal bankruptcy law, since the Chandler Act, was the Bankruptcy Reform Act of 1978, which is called the Bankruptcy Code. It governs bankruptcy procedure in the USA even today. It is interesting to mention that, "*the 1978 Act is unique in the history of nation's bankruptcy legislation in that it was the first major enactment that was not enacted as a response to a severe economic depression*".[89]

As we have seen, the development of the bankruptcy legislation in the United States was relatively dynamic. Economic downturns have contributed to the gradual development of new

[84] Di Martino, P., 2008: pp.265-266
[85] Mann, H.B., 2002: p.2
[86] Tabb, C.J., 1995: p.7
[87] Di Martino, P., 2008: p.266
[88] Tabb, C.J., 1995: p.12
[89] Tabb, C.J., 1995: p.13

bankruptcy laws. On the other hand, if we look at the bankruptcy legislation of Germany, the situation is very much different. The changes in bankruptcy legislation of Germany were not so rapid. One of the possible explanations could be the differences in legal traditions of these countries. In this connection, Berglöf, Rosenthal, and von Thadden (2002) indicate that, *"part of this inertia may be due to the nature of the legislation in the civil law tradition. While in the US runs of trial and error in the court often precede changes in legislation, the civil law tradition with its intricate codifications lends itself to piecemeal change."*[90]

Germany is an illustration of great inertia in the reform of a bankruptcy law. On the one hand, "*the German bankruptcy code of 1877 was widely praised as a major piece of legislation, characterized by its consistency, clarity, and practicability*", as was pointed out by Berglöf, Rosenthal, and von Thadden (2002). But they also added, that there were certain flaws, such as the lack of a reorganization procedure or the devastating role of net-worth standards for the opening of bankruptcy procedures, which had been criticized for more than a century without essential improvement happening. "*Decades of attempts at reform only succeeded in 1999 when the code was replaced by the new Insolvency Code*".[91]

The changes in the German bankruptcy legislation were mainly influenced by economic pressures and financial crises. Thus, the global financial crisis of 2008 which contributed significantly to the changes in bankruptcy regimes around the world had a profound impact on Germany's bankruptcy legislation. As was mentioned in the World Bank Working Paper, during this crisis "G*ermany revised its long-standing rule requiring company management to file for bankruptcy in certain situations, or face imprisonment*".[92] Originally this rule was established to discipline debtors and to insure creditors' confidence. During the crisis viable companies could be forced to turn to bankruptcy proceedings and subsequently to liquidation, which is not desirable. But the law changed because it proved to be inadequate for the changing environment.

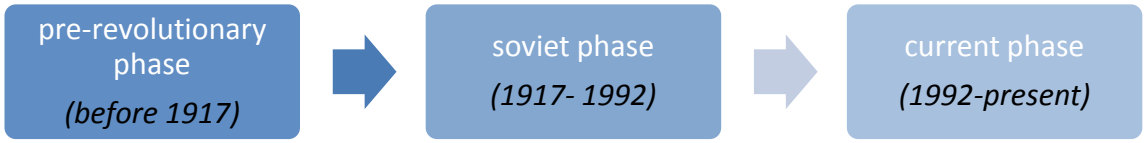
The frequency of modifications of bankruptcy laws is not the most important factor in terms of efficient legislation. The changes in bankruptcy laws are not always as effective as they are envisaged to be. In this sense it is interesting to look at the development of Russian bankruptcy legislation.

In the **Russian Federation** the evolution of bankruptcy legislation can be divided into three phases: current (the latest), soviet, and pre-revolutionary phase (figure 7). Such division is

[90] Berglöf, E., Rosenthal, H., von Thadden, E-L., 2002: p.10
[91] Berglöf, E., Rosenthal, H., von Thadden, E-L., 2002: pp.9-10
[92] Cirmizi, E., Klapper, L., Uttamchandani, M., 2010: p.6

linked to the major political events, which were accompanied by the important changes in social life and gave rise to the new legislative systems.[93]

Figure 7 Phases of development of Russian bankruptcy legislation

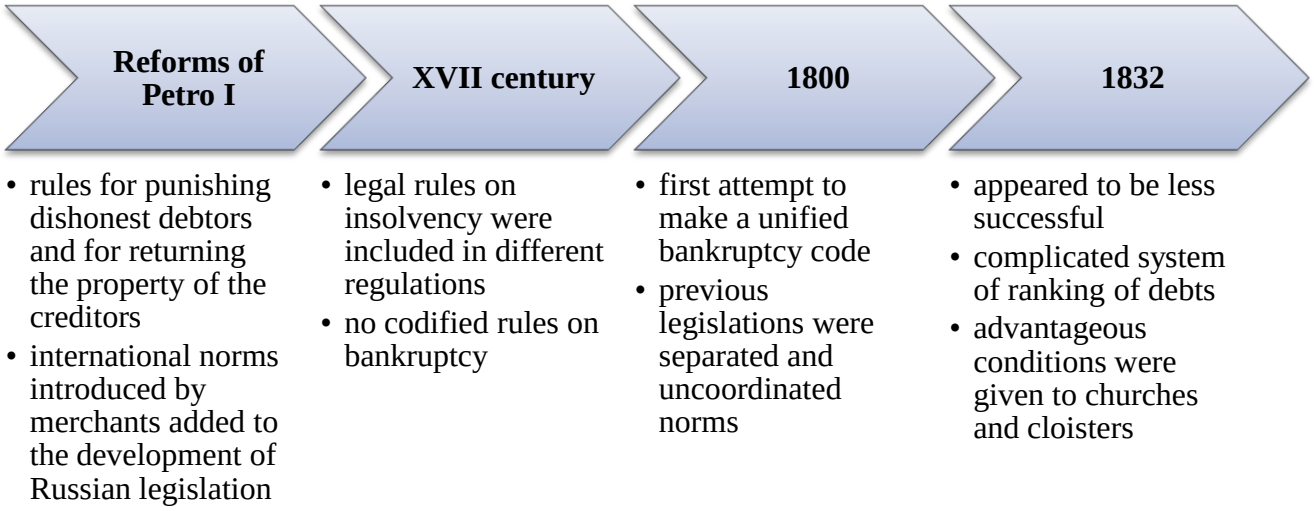


Source: Based on Folgerova, U., 2012

Although the word "bankruptcy" in Russian law appeared much later, the regulations concerning insolvency were present already in XI-XII century in Russkaya Pravda.[94] It was the first legislative act in Kievan Russia (current Ukraine), part of which Russia was at that time.

The origin of civilized norms of bankruptcy is connected to economic reforms of the Russian tsar Petro I in XVI century. The development of trade relations and appearance of international participants required, among others, clear rules for "punishing" of dishonest debtors. Main characteristics of the pre-revolutionary phase of Russian bankruptcy legislation are shown in Figure 8.

Figure 8 Pre-revolutionary bankruptcy legislation in Russian Federation



Source: Based on Durova, N., 2012

With the judicial reform of XVIII century and the emergence of different national courts there was a need for the regulation of the questions connected with the jurisdiction over insolvency affairs. These questions were solved by the Russian Senate decree of 1868. At that time the distinction was also made between trade and non-trade insolvencies.[95]

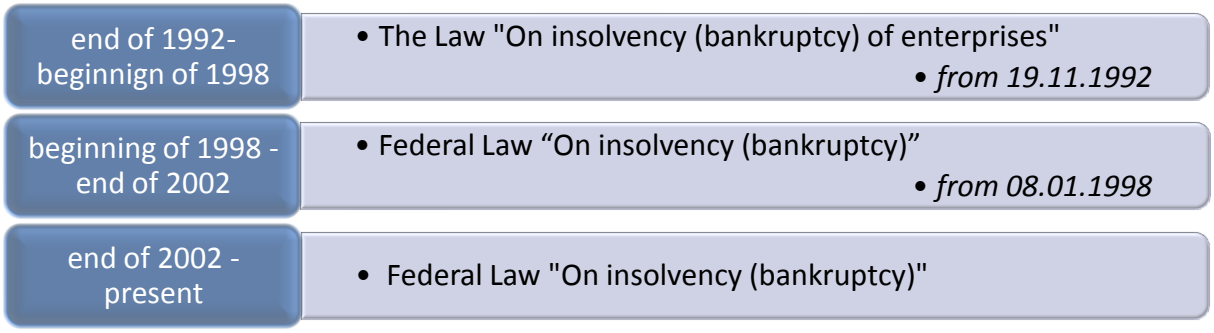
[93] Folgerova, U., 2012: p.50
[94] Durova, N., 2012: p.124
[95] Durova, N., 2012: p.126

The beginning of the **soviet phase** of Russian bankruptcy legislation is estimated from the November of 1917, when the operation of all normative legal documents of tsarist Russia was canceled.[96] The Russian Revolution of 1917 influenced the development of insolvency law in the way that major changes were made in the area of state law. The next phase of the development of insolvency (bankruptcy) institutions in communist Russia was the adoption in 1923 of the civil code and the code of civil procedure of the Russian Soviet Federative Socialist Republic.[97]

It is interesting to note that, from the 1930s the legal relationship to bankruptcy of enterprises was practically not regulated at all. The official communist doctrine didn't recognize the bankruptcy of institutions, because with the planned socialist economy, as was affirmed, "*there was no place for bankruptcy*".[98] All business enterprises during communism belonged to a state and were governed by it.

The renewal of bankruptcy regulation in Russia can be connected to the formation of the basis of market relations at the end of the 80's, beginning of 90's, when there was a need for a legislative settlement of causes and consequences of insolvency cases.[99] The present history of the development of bankruptcy legislation could be divided into three periods. (Figure 9)

Figure 9 Current phase of Russian bankruptcy legislation



Source: Based on Durova, N., 2012

The first legislative act "On insolvency (bankruptcy) of enterprises" of 1992 was valid for 6 years. During the time of its enforcement dozens of different acts were issued, the huge practice was developed, which showed big drawbacks of the acting law.[100] As was stated by Thompson (2003) "*Russia's first bankruptcy law, adopted in 1992, was woefully inadequate and barely functioned at all.*"[101] Mogiliansky, Sonin, and Zhuravskaya (2003) also share this view stating that the 1992 law was completely ineffective. Only a small number of companies went bankrupt between 1992 and 1998. This could be explained by the fact that the procedures were highly

[96] Folgerova, U., 2012: p.50
[97] Durova, N., 2012: p.127
[98] Durova, N., 2012: p.128
[99] Durova, N.,, 2012: p.128
[100] Durova, N., 2012: p.128
[101] Thompson, W., 2003: p.154

complicated which made it difficult to apply the law and thus it failed to bring about financial discipline. [102]

The new federal law was enacted in 1998, but due to its weak protection of creditors and debtors and other drawbacks there was a need for a new reform in bankruptcy law. [103] Inefficiency of this law was also discussed by Mogiliansky, Sonin, and Zhuravskaya (2003) who noted that this law was unable to create new incentives for restructuring and it *"...may have even prevented it when managers were interested in pursuing restructuring. Indeed, in the model when official regional taxes are small, the governor wants to prevent restructuring, because he can extract bribes only from the insolvent firm."*[104]

The new law was enacted in 2002. The principal novelty was the fact that debtor became the participant of bankruptcy procedure as well. Thus the western analogue of bankruptcy law was created, which balanced the interaction of creditors and debtors.[105]

But there were also some problems connected with this law. After the enactment of the law poorly performing regions were mainly unaffected by bankruptcy procedures. Only small and medium-size enterprises were initiated in liquidation procedures. In contrast, large and politically important firms in politically and economically strong regions were engaged in external management procedures.[106] This situation seems to be the same even today.

To sum up, from the examples of different countries we can see that bankruptcy legislation didn't stay the same over the time, but was constantly changing.

According to the "Doing Business" report of 2006, since WWII about 90 countries made major reforms to bankruptcy laws. More than half of the reforms happened in the past 15 years and most of them were in rich countries.[107]

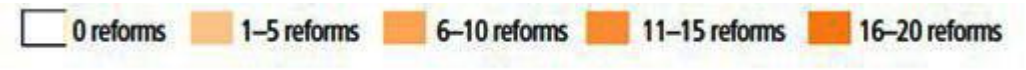
In the past seven years 109 insolvency reforms were registered by "Doing Business", majority of which occurred in OECD high-income economies and in Eastern Europe and Central Asia. (Figure 10) "*Sub-Saharan Africa has seen a recent surge in bankruptcy reforms, many of them aimed at overhauling an outdated system or introducing new legislation*".[108]

[102] Mogiliansky, A.L., Sonin, K., Zhuravskaya,E., 2003, p.6
[103] Durova, N., 2012: p.129
[104] Mogiliansky, A.L., Sonin, K., Zhuravskaya,E., 2003, p.3
[105] Durova, N., 2012: p.129
[106] Mogiliansky, A.L., Sonin, K., Zhuravskaya,E., 2003, p.7
[107] Doing Business in 2006: Creating jobs, 2006: p.67
[108] Resolving Insolvency, 2011: p.3

Changes in insolvency regimes may be induced by economic or financial crises or be a part of larger state judicial or legal reforms. In some countries new bankruptcy laws are passed or new company acts are adopted while in others amendments are made to commercial codes.[109]

Figure 10 Regulatory bankruptcy reforms

	DB 2006	DB 2007	DB 2008	DB 2009	DB 2010	DB 2011	DB 2012	Total number of reforms
OECD high income *(31 economies)*								40
Eastern Europe & Central Asia *(24 economies)*								32
Sub-Saharan Africa *(46 economies)*								13
East Asia & Pacific *(24 economies)*								11
Latin America & Caribbean *(32 economies)*								9
Middle-East & North Africa *(18 economies)*								3
South Africa (8 *economies)*								1



Note: An economy can be considered to have only 1 *Doing Business* reform per topic and year. The data sample for DB2006 (2005) includes 174 economies. The sample for DB2012 (2011) also includes The Bahamas, Bahrain, Brunei Darussalam, Cyprus, Kosovo, Liberia, Luxembourg, Montenegro and Qatar, for a total of 183 economies.

Source: Resolving insolvency, 2011

In poor countries bankruptcy is rarely used, and this is not because there are fewer cases of companies' failure, but rather because of the complexity in bankruptcy proceedings. For example, the bankruptcy law of Vietnam of 1993 was hardly used at all. For around 10 years only 45 businesses were declared bankrupt, a great number of which was owned by state.[110]

The enhancement of bankruptcy laws and procedures of different countries around the world was stimulated by the global financial crisis. From the beginning of the crisis in 2008, more than 65 economies have made significant modifications in their insolvency regimes.[111] For example "*the Philippines adopted an insolvency law in 1909- and only revised it a century later in the wake of the global recession. Many companies were facing financial difficulties, and it quickly became clear, that the bankruptcy system was ill equipped to help them recover.*"[112]

[109] Resolving insolvency, 2011: p.3
[110] Doing Business in 2006: Creating jobs, 2006: p.68
[111] Resolving Insolvency, 2011: p.1
[112] Resolving insolvency, 2011: p.1

Berglöf, Rosenthal, and von Thadden (2002) also stated that in most countries reforms were usually, "*... triggered by severe economic downturns and, in more trade-dependent European countries by the pressure to harmonize"*.[113]

As we have seen, there are many factors that influence the changes in bankruptcy legislation. Di Martino (2008) mentioned that such factors as economic transformations, cultural change, and general institutions modifications had a strong impact on bankruptcy laws, procedures and enforcement mechanisms. These factors have to also be considered together with industrialization, separation of ownership and control and changes in attitude toward debt. [114]

Many scholars that analyze the economic efficiency of law support the idea that law evolves with a view to attaining a greater degree of efficiency. Levratto (2007) indicated that "*the evolutions of bankruptcy law seek to reach many aims: economic safety, firms' creation and expansion in a capitalist economy, protection of the interests of the agents involved in transactions and prolongation of the activity of viable firms*".[115]

But if all countries strive to create efficient bankruptcy legislation, why didn't they come up with an optimal bankruptcy law yet? Is then international bankruptcy code possible? To answer these questions we have to look first at the measures of efficiency of bankruptcy system and procedures and at the factors which influence such efficiency.

[113] Berglöf, E., Rosenthal, H., von Thadden, E-L., 2002: p.4
[114] Di Martino, P., 2008: p.263
[115] Levratto, N., 2007: p.2

2. The efficiency of bankruptcy system and bankruptcy legislation

"Bankruptcy is hopelessly inefficient in many countries."[116]

2.1. Measuring effectiveness of bankruptcy procedures

It is not a secret that efficient bankruptcy system favors the business environment of a country and contributes to the stability of its financial system and to the health of the whole economy. That is why the question of effective bankruptcy procedures was studied by many researches and is gaining an increasing interest by international institutions such as the World Bank, the International Monetary Fund (IMF), the European Bank for Reconstruction and Development (EBRD), etc.

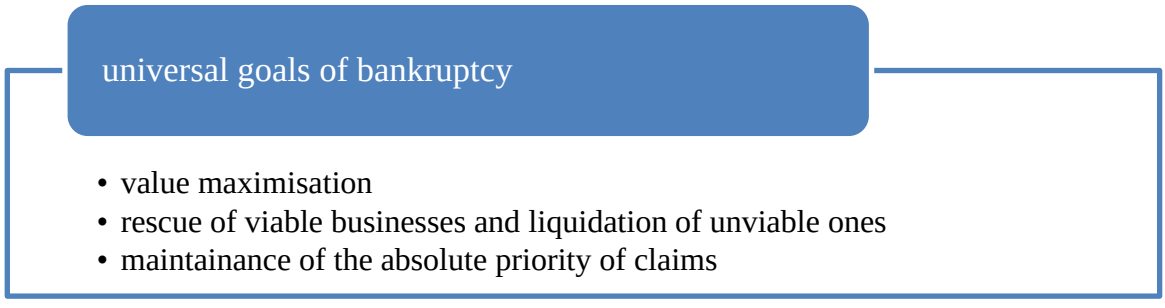
But what does it mean to have the effective bankruptcy legislation? How can it be defined and what factors influence the efficiency of bankruptcy law of a country?

2.1.1. Main goals and principles of modern bankruptcy law

In order to measure the efficiency of bankruptcy law we have to consider its main goals, principles and objectives and the extent to which they can be achieved. Depending on the objective of the study, various researches emphasize the importance of different aspects of bankruptcy legislation, such as the high payoffs to the creditors or preserving viable companies as going-on concerns, etc.

According to the World Bank, the three universal **goals** of bankruptcy are maximization of the value of total proceeds received by creditors, shareholders and other stakeholders, rescue of viable businesses, and compliance with the rank of creditors (figure 11).[117]

Figure 11 Main goals of bankruptcy law



Source: Based on Doing Business in 2004: Understanding regulation, 2004: p.72

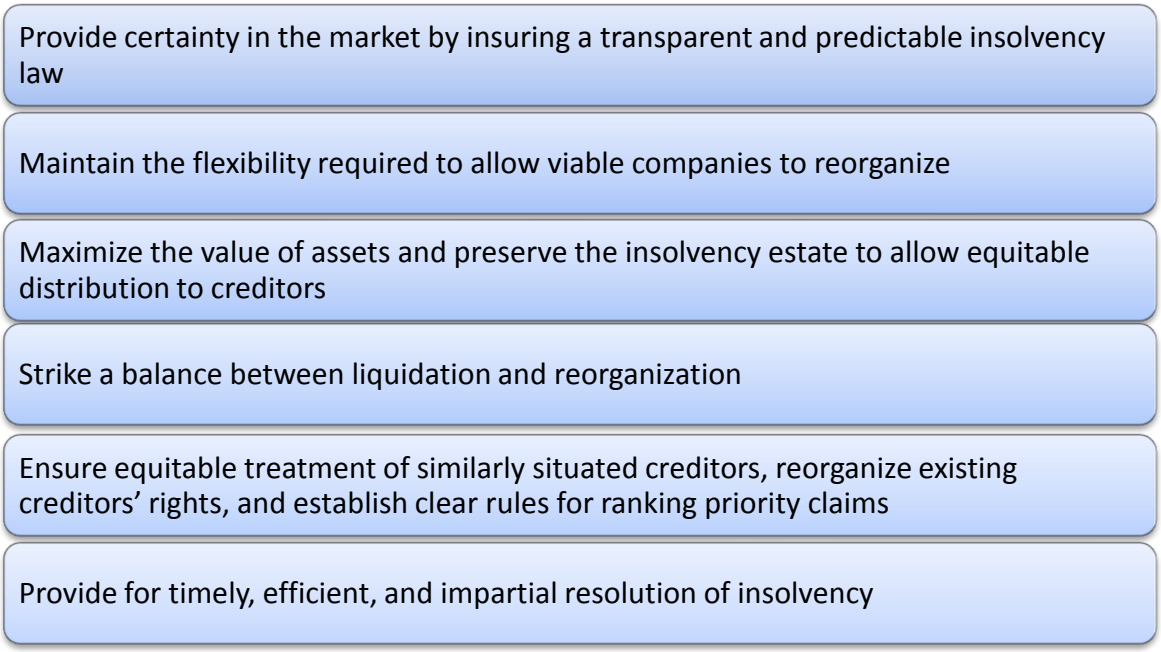
[116] Doing business in 2006: Creating jobs, 2006: p.69
[117] Doing Business in 2004: Understanding regulation, 2004: p.72

It is interesting to note that the rescue of viable businesses is considered today as one of the most important goals of bankruptcy. Thus, Levratto (2007) argues that the most important goal of a bankruptcy system is saving viable businesses alive and that a good bankruptcy regime should prevent early liquidation of stable businesses.[118] Cirmizi, Klapper, and Uttamchandani (2010) also pointed out that, "…*in a narrow context, the efficient resolution of insolvency depends on the ability to reorganize viable firms and to liquidate the unviable ones at a low cost.*"[119] But, it doesn't mean that only this goal has to be achieved. As was stated by the World Bank, "*good bankruptcy laws generally achieve the three goals*".[120]

Achievement of these goals is not the exclusive indicator of effective bankruptcy law. We also have to consider its principles, objectives and policies which may give us a broader picture.

In the literature there are different approaches to identification of the principles of bankruptcy regime. Value maximization, rehabilitation of viable companies as well as establishing rules for ranking priority claims, are considered to be among the most important of them (figure 12). Thus, we can see that they are closely connected and echo the main goals of bankruptcy law.

Figure 12 Principles that underlie the design of a good bankruptcy regime



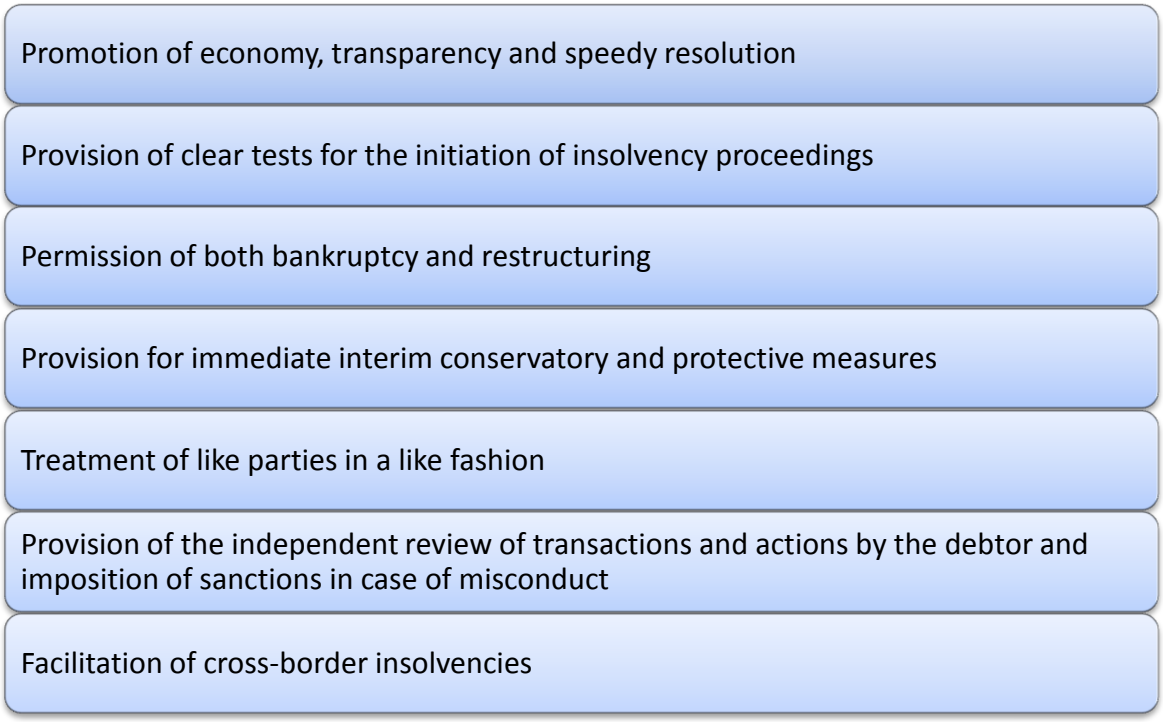
Source: Based on Cirmizi, E., Klapper, L., Uttamchandani, M., 2010: p.7

Another, more general, way to define the principles was made by the European Bank for Reconstruction and Development (EBRD) (figure 13).

[118] Levratto, N., 2007: p.2
[119] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010: p.3
[120] Doing Business in 2004: Understanding regulation, 2004: p.72

It is worth mentioning that these principles should not be considered as precise instructions, they only represent flexible guidelines and recommendations for countries to use.

Figure 13 The core principles of the modern insolvency regime by EBRD



Source: Based on EBRD, Core principles for an insolvency law regime

Even though there are some distinctions in the identification of the main principles, figures 12 and 13 have a lot in common. They both include such issues as transparency, reorganization, speedy resolution, equal treatment of creditors, etc.

Another institution that we have to consider while analyzing the efficiency of bankruptcy procedures is the World Bank. *"Development of universal, international precepts and policies for bankruptcy laws is the current subject of The World Bank Insolvency initiative",*[121] as was stated by Averch (2006). In 2001 the World Bank has developed principles for effective insolvency and creditor rights, which were based on international best practices on design of these systems. The process of developing the principles included many conferences (which involved officials and experts from more than 70 countries), the Global Forum on Insolvency Risk Management (in 2003), as well as several working group sessions of the Global Judges Forum, where the judges helped to review the principles and to develop new and more detailed recommendations in this sphere.[122]

According to the World Bank (WB), efficient insolvency system has to be aimed at fulfilling objectives and policies which are shown in figure 14.

[121] Avrech, C.H., 2000: p.27
[122] The World Bank principles , 2011: p.1

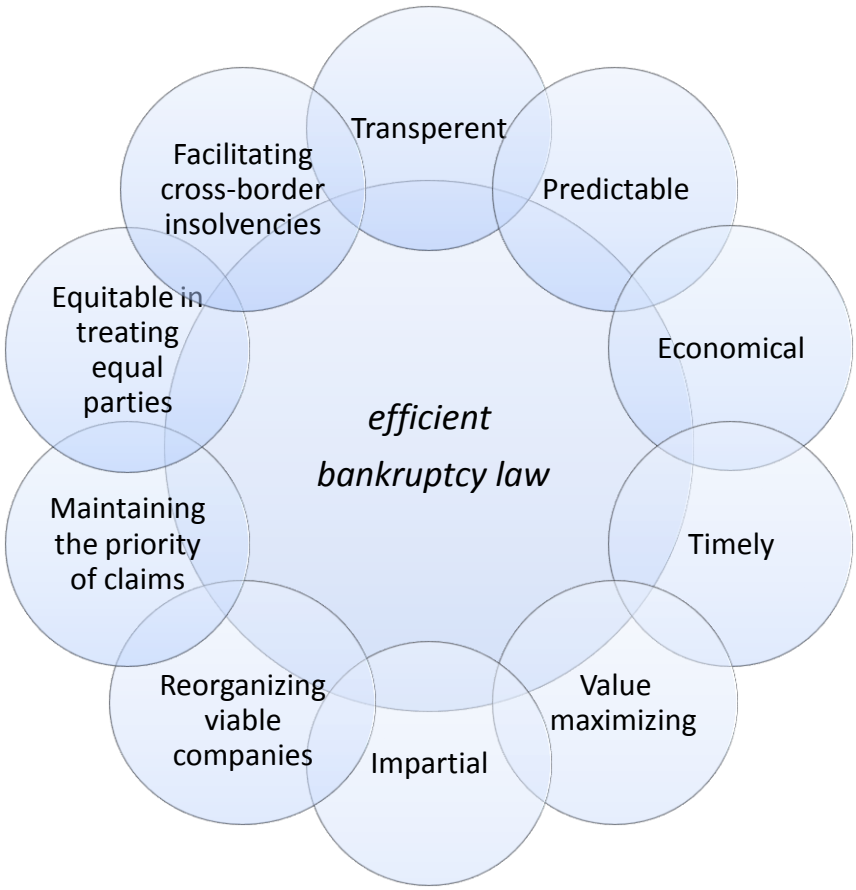
Figure 14 The WB key objectives and policies of an effective insolvency system

Source: The World Bank principles, 2005

As we have seen from the figures 12-14, there seems to be a common approach to the identification of the main principles of an effective bankruptcy regime. The main difference is that in one case we find a more general classification (figure 13), while in the other we observe more extended version, which includes concrete issues (figure 14). It can also be stated that the most comprehensive and detailed description of principles was developed by the World Bank with the help of officials, experts and judges from different countries. This may indicate the existence of a common understanding of the modern principles.

Summarizing the information above, we can identify the most common features of good bankruptcy legislation. What we can see is that the main goals of the effective bankruptcy legislation are also embedded in its principles. The summary of what the efficient bankruptcy law should be and should aim to achieve is shown in figure 15.

Figure 15 Main principles and objectives of an effective bankruptcy law



Source: Based on figures 12-14

As we can see, there are many principles and objectives of an effective bankruptcy law. Because of their variety it seems hardly possible to reach all of them simultaneously. And due to the fact that these principles and objectives represent only guidelines and recommendations each country may decide on the priority of the most important principles for itself. Thus, this raises the question about the factors that influence this decision and about different aspects of the efficiency of bankruptcy law. The most important issues which have to be considered in the analysis of the efficiency of bankruptcy law of a country will be discussed in the next section of the paper.

2.1.2. Different aspects of bankruptcy law efficiency

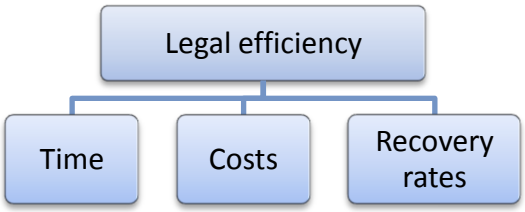
"While lawyers focus on fairness and equity in their discussion of insolvency law, economists are concerned with economic efficiency, growth and business cycle fluctuations."[123]

The analysis of the efficiency of bankruptcy procedures is usually done from some kind of perspective. Traditionally bankruptcy law was researched by lawyers and not by economists. But nowadays more and more economic studies are published concerning the efficiency of bankruptcy law. Of course, the efficiency primarily deals with the fairness of the law and its implementation. But it is also connected to the economic efficiency, the outcomes of which have significant influence on the economic health of a country.

Cabrillo and Depoorter (2000) stated in this connection, that "*economists analyze bankruptcy law as a legal instrument to achieve the best possible outcome, which implies minimization of social costs. Traditional legal theory, however, usually focuses its analysis on the fairness and equity aspects of bankruptcy.*"[124]

From the point of view of **legal efficiency**, the most important indicators of bankruptcy proceedings are the duration of the liquidation process, the cost of a bankruptcy and the rate of recovery, as was stated by Levratto (2007).[125] (Figure 16)

Figure 16 Indicators of legal efficiency of bankruptcy proceedings



Source: Based on Levratto, N., 2007

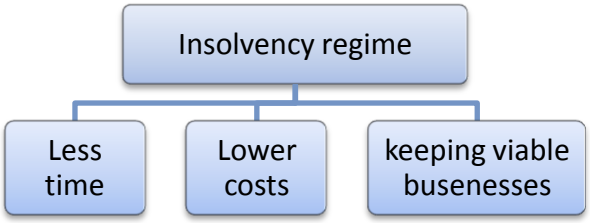
Another important aspect is the **administrative efficiency,** which means efficient court procedures and implementation of the law. It includes such issues as the time spent in bankruptcy procedures, the costs of bankruptcy once the matters reach the court as well as possible misinterpretations of the law or corruption.

Berglöf, Rosenthal, and von Thadden (2002) stated that "*not much can be expected of legislated reforms in bankruptcy matters unless the courts and the bureaucracy are likely to implement these reforms faithfully*"[126].

[123] Wihlborg C., Gangopadhyay S., 2001: p.4
[124] Cabrillo, F., Depoorter, B., 2000: p. 262
[125] Levratto, N., 2007: p.3
[126] Berglöf, E., Rosenthal, H., von Thadden E-L., 2002: p.14

But bankruptcy is not only about legal or administrative efficiency. What we also have to consider is its **economic efficiency**. The main factors connected with it are: bankruptcy costs, time spent in bankruptcy and keeping viable businesses alive. (Figure 17)

Figure 17 Indicators, positive for economics



Source: Based on Doing Business 2010: Reforming through difficult times, 2009

Many studies confirm the link between these indicators and economic efficiency of bankruptcy legislation. As was pointed out in the World Bank report on the challenges of bankruptcy, lower bankruptcy costs can compel inefficient firms to exit and foster greater entrepreneurial activity and new firm creation.[127]

Time in bankruptcy is another important factor that influences economic efficiency of the bankruptcy procedures. Crimizi, Klapper, and Uttamchandani (2010) stated in this connection that "*speedier court resolutions can also reduce uncertainty for entrepreneurs, creditors, and management, and improve assets value and transparency*".[128]

In assessing the main characteristics of insolvency regimes in the top-performing economies we also have to take a look at continuation of viable businesses operations.[129] In fact, keeping viable businesses alive is considered one of the most important factors while analyzing the economic efficiency of the bankruptcy law. Cirmizi, Klapper, and Uttamchandani (2010) argued that preserving businesses as going on concerns for as long as possible is recognized by many governments as important element of bankruptcy reform.[130]

They also stated that, *"ideally, only the best users of economic resources would continue as active companies, while less performing companies would be taken over by more capable owners or liquidated through asset sales. In reality, however, there are many constraints to the efficient reallocation of capital. Primary among these constraints is existing legislation.*"[131]

As we have seen, introduction of shorter time limits and lowering of the costs are important indicators which are present in different efficiency analysis of bankruptcy procedures. That is why we should look at these two concepts in more detail.

[127] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010:p.4
[128] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010:p.5
[129] Doing Business 2010: Reforming through difficult times, 2009: p.61
[130] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010:p.21
[131] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010:p.3

The costs of bankruptcy can be subdivided into two groups: *direct* and *indirect costs* (table 3). Direct costs are easier to measure. They usually consist of the costs which were submitted to the court and approved by it. Indirect costs, on the other hand, are more difficult to measure and to specify. They include such opportunity costs as lost sales, loss of employees and key suppliers due to bankruptcy, etc. [132]

Table 3 Bankruptcy costs

Direct costs	Indirect costs
• lawyer fees • administrative fees • consulting fees • accounting fees, etc.	• opportunity costs of management's time • loss of sales • loss of employees and key suppliers • potentially negative reputational effects • underinvestment, etc.

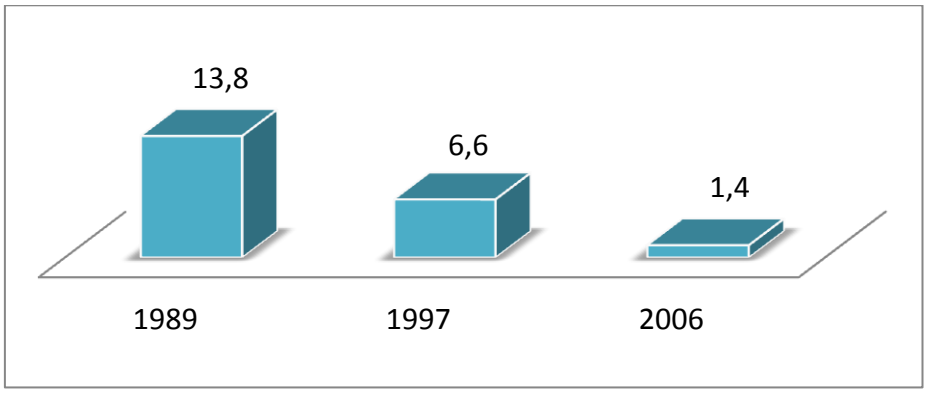
Source: Based on Marinč, M., Vlahu, R., 2011 and Thorburn, K.S., 2000

Bankruptcy costs also differ if we look at different bankruptcy procedures. Different costs are involved if we talk about liquidation or reorganization.[133]

The **time in bankruptcy** is also one of the most important indicators of the efficiency of bankruptcy law. It can be viewed as a noisy proxy for indirect bankruptcy costs. The idea behind it is that indirect bankruptcy costs such as bankruptcy's unfavorable influence on product and capital markets rise with the time that firms spend in bankruptcy.[134]

Having understood the importance of those factors, countries are adjusting their bankruptcy laws. In Macedonia, for example, in 2006 Bankruptcy Law greatly reduced the average duration of bankruptcy cases (figure 18).[135]

Figure 18 Duration of bankruptcy cases in Macedonia, in years

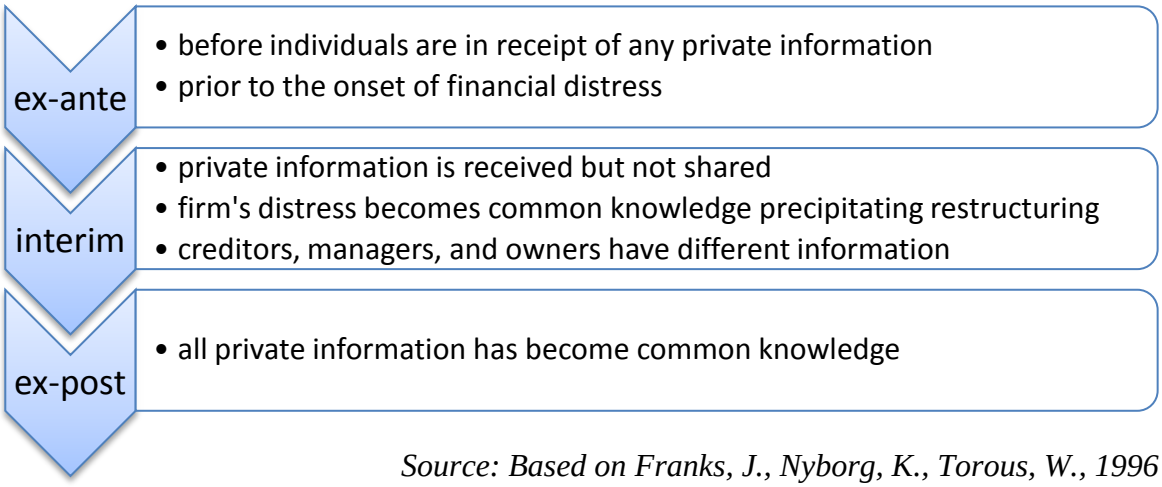


Source: Based on Doing Business 2012, Doing business in more transparent world, 2011

[132] Marinč,M., Vlahu,R., 2011: p.11
[133] Bris, A., Welch, I., Zhu, N., 2006: p.1278
[134] Bris, A., Welch, I., Zhu, N., 2006: p.1270
[135] Doing Business 2012: Doing business in a more transparent world, 2011: p.30

Another important aspect of bankruptcy law efficiency is the fact that it can be analyzed at different stages. Thus, Franks, Nyborg, and Torous (1996) note that, "e*fficiency can be evaluated at three stages in the bankruptcy process – ex-ante, interim, and ex-post – depending upon the information available at the time.*"[136] (Figure 19)

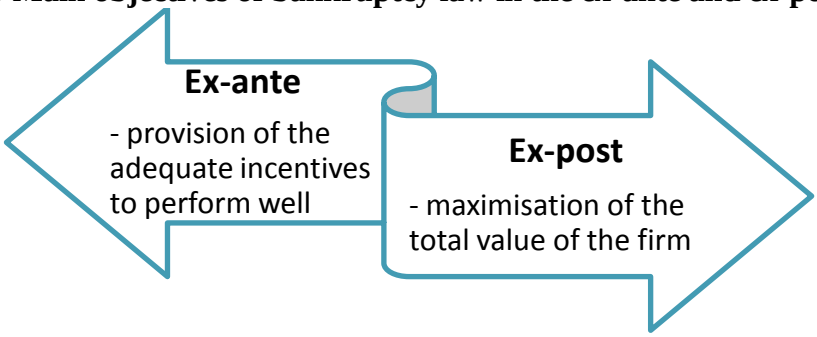
Figure 19 Stages of the bankruptcy process



Source: Based on Franks, J., Nyborg, K., Torous, W., 1996

It is also important to mention that depending on the stage of the bankruptcy process bankruptcy laws may have different objectives (figure 20) which might even sometimes conflict with each other.

Figure 20 Main objectives of bankruptcy law in the ex-ante and ex-post sense



Source: Based on Cabrillo, F., Depoorter, B., 2000

In the *ex-ante* sense, before bankruptcy takes place, the main objective of the law is to provide right incentives for managers to be more efficient, to make right decisions and not to take a lot of risk. Gabrillo and Deeporter (2000) noted that "*from an ex-ante point of view the objective could be to impose costs on individuals and firm managers, in order to provide them (**ex-ante**) with adequate incentives to perform well. Historically these costs were imposed by criminal sanctions to the bankruptcy debtor*" [137].

[136] Franks, J., Nyborg, K., Torous, W., 1996: p.86
[137] Cabrillo, F., Depoorter, B., 2000: p. 264

In the *ex-post* sense, when the debtor has already entered bankruptcy, the main objective is the maximization of the firm value. (Figure 20)

The conflict between these objectives arises because in the ex-ante sense bankruptcy is viewed as a threat, which makes managers more worried of responsibilities and consequences. The bankrupt firm can be closed if they are not sufficient and they will lose their jobs. From the ex-post point of view, closing the plant is not always the right decision. Bankruptcy may not be solely manager's fault. For this reason Gabrillo and Deeporter stressed that "…*bankruptcy law should be designed to strike the right balance between both objectives*".[138]

As we have seen, the efficiency can be analyzed from the ex-ante and ex-post point of view, as well as from the legal, administrative and economic perspective. In the latter case the time spent in bankruptcy and bankruptcy costs are among the most important factors in the efficiency analysis. But if all countries share the same objectives, why do their bankruptcy laws differ? To answer this question we have to look at the specific factors which influence the bankruptcy systems of different countries.

[138] Cabrillo, F., Depoorter, B., 2000: p. 264

2.1.3. Factors influencing the effectiveness of bankruptcy system

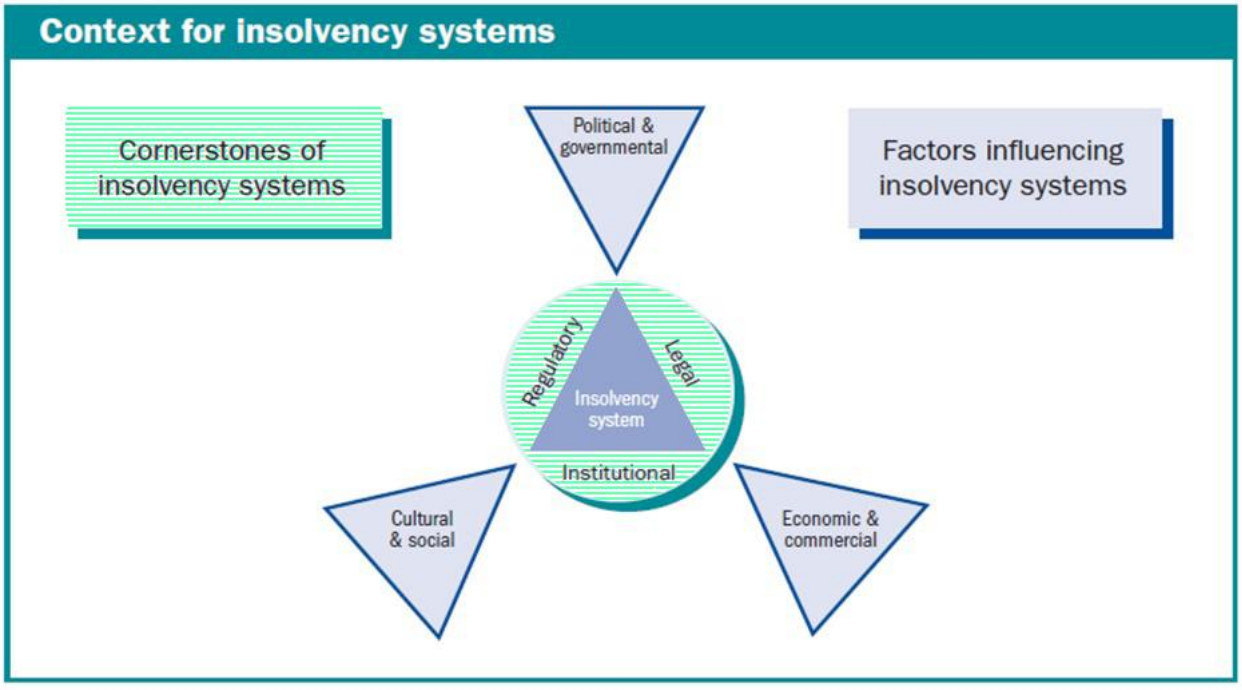
"*Principles must be considered in the context of the unique political structure, legal structure, and economical and social framework of each country*."[139]

In order for the bankruptcy law to be efficient it has to comply with certain principles, goals and objectives, which were discussed earlier. But the efficiency of bankruptcy system is also influenced by other factors besides the law. Most of the researchers agree that unique country characteristics have to be considered apart from its legislation.

Johnson (2000) pointed out that we have to integrate insolvency law into the legal, commercial and socio-political context of a country in order to "…*consider the available capacity of the institutions and the system for implementing the law effectively, and to assure operational integrity through the process*".[140]

According to the World Bank, insolvency system depends on such features as regulatory, legal and institutional frameworks of a country. Other factors which influence the insolvency system are: political, governmental, economic, commercial, cultural and social. (Figure 21)

Figure 21 Factors and cornerstones of insolvency systems

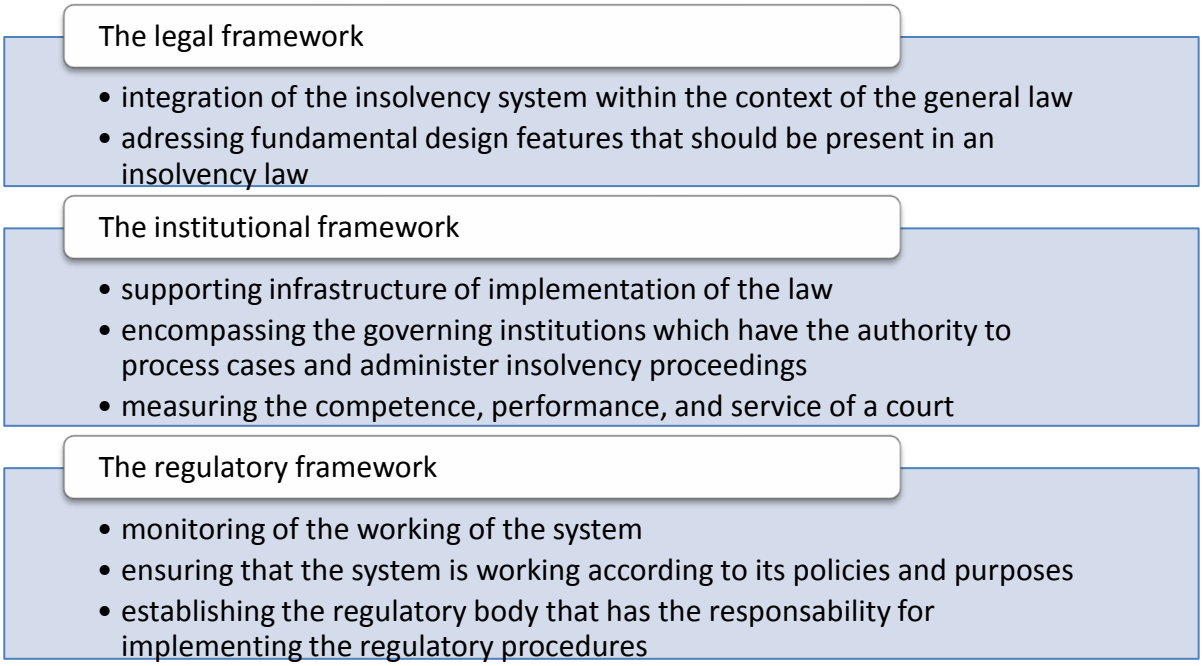


Source: Avrech, C.H., 2000: p.28

The World Bank defined three main **building blocks** which are essential for an effective insolvency system: the legal, institutional, and regulatory frameworks. [141] (Figure 22)

[139] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010:p.7
[140] Johnson, G., 2000: p.3
[141] Avrech, C.H., 2000: p.28

Figure 22 Building blocks of an effective insolvency system



Source: Based on Johnson, G., 2000

Along with these building blocks, the World Bank and the International Monetary Fund developed a system of **benchmarks** (listed in the Report on the Observance of Standards and Codes (ROSCs)), which can be used to evaluate the strength of countries' insolvency laws (appendix III; figure 41). The main elements of these benchmarks are the creditor rights, legal frameworks, institutional frameworks and informal corporate workouts and restructurings.[142]

The **legal framework's** most important features include addressing the principles and policies that should be present in a good insolvency law and the consideration of the bankruptcy law within the broader legal and commercial framework in which it operates (figure 22,figure 41). As was mentioned by the World Bank, "…*each insolvency system must be complementary to, and compatible with the legal system of the society in which it is rooted*".[143]

The **institutional framework** is the second building block which influences the effective bankruptcy procedure. (Figure 22 and figure 41) It is related to the infrastructure which helps to implement the laws effectively.

Well functioning bankruptcy courts and qualified judges are a part of the institutional block. As was mentioned in the Doing Business report of the World Bank, "*the court systems in many economies lack the infrastructure, training, and technical experience to resolve commercial disputes in a timely way*".[144]

[142] Insolvency ROSC Assessments
[143] Johnson, G., 2000: p.4
[144] Doing Business 2010: Reforming through difficult times, 2009: p.63

The establishment of specialized bankruptcy courts is also one of the important issues. "*Many economies face more insolvencies that they can reasonably handle. Jamaica has a 3-year backlog of insolvency cases. Promoting specialized courts is among the most efficient ways to ensure that insolvency cases receive the attention more quickly*".[145] But, unfortunately, not all of the countries can allow themselves to establish specialized bankruptcy courts. The solution to this problem was suggested by the World Bank, which proposed that "*while emerging market countries may not be equipped to establish specialized bankruptcy courts, they could appoint specialized insolvency judges within the courts of general jurisdiction*".[146]

The **regulatory framework** is the last of the three building blocks of the effective insolvency system. Its main concern is the proper application of the law as well as monitoring and regulating the functioning of the whole bankruptcy system (figure 22). Again, "*not much can be expected of legislated reforms in bankruptcy matters unless the courts and the bureaucracy are likely to implement these reforms faithfully*."[147]

There are many other factors which influence the effectiveness of the bankruptcy system of a country. For example, Djankov et al. (2008) found that "*legal origins and per capita income are the most important cross-country determinants of efficiency*".[148]

Claessens and Klapper (2005) stated that "*the usage of legal procedures associated with bankruptcy varies significantly around the world, due to differences in legal traditions, accounting standards, regulatory frameworks, and macroeconomic factors*".[149]

The study of different counties showed that "*the richer countries are vastly more efficient at debt enforcement than the poorer ones*".[150]

It is actually difficult to say which of the factors or country characteristics don't influence the effectiveness of the bankruptcy system, either directly or indirectly. And many of these characteristics are interconnected or have some indirect impact on the others. Thus, it would be difficult to make a comprehensive list of them. It is also important to note that these factors should be taken into account in evaluation of the effectiveness of the bankruptcy law of a country, with special emphasis on account legal, political, social, cultural differences, etc.

As we have seen, the concept of the effective bankruptcy law was studies by many researches and international institutions. Most of them agree on the key principles of the effective

[145] Resolving insolvency, 2011: p.5
[146] Johnson, G., 2000: p.4
[147] Berglöf, E., Rosenthal, H., von Thadden E-L., 2002: p.14
[148] Djankov, S., Hart, O., McLiesh, C., Shleifer, A., 2008: p.1107
[149] Cirmizi,E., Klapper,L., Uttamchandani,M., 2010: p.2
[150] Djankov, S., Hart, O., McLiesh, C., Shleifer, A., 2008: p.1124

bankruptcy law. So we know what a “perfect” bankruptcy law should look like and what goals and objectives it should achieve.

But, why isn’t there an optimal bankruptcy legislation which can be used internationally? Having all of this knowledge of the best working principles and practices, why an optimal international bankruptcy code has not been developed yet? To answer these questions first we have to look at the main approaches and sources of international bankruptcy. And second – into the role of international organizations in this matter and the existing challenges to international bankruptcy law. These issued will be discussed in the next chapter of this paper.

3. International bankruptcy: challenges and development

3.1. International bankruptcy

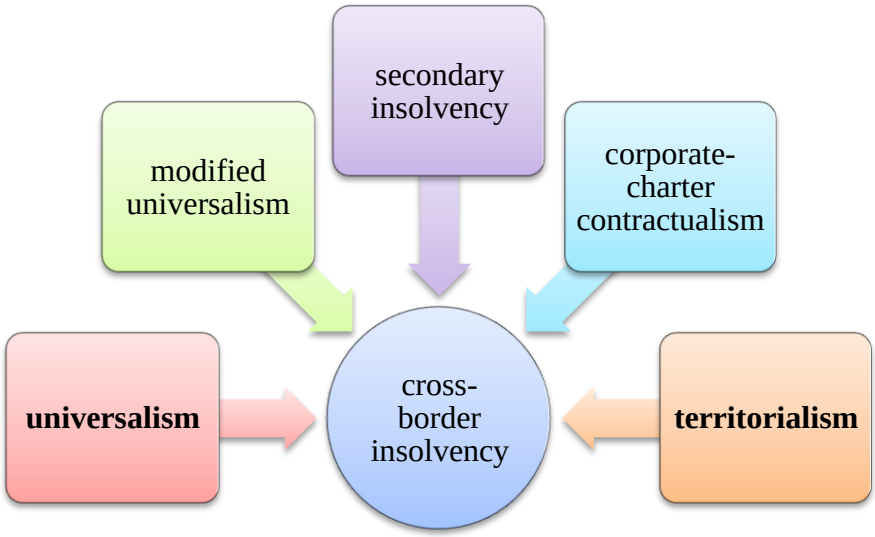
In a globalised world, business failures do not only affect the home country of a company. Other countries, where company's assets, subsidiaries or creditors are located, are affected as well. Fair resolution of such failures requires cooperation between countries. It requires an effective, predictable and cost saving bankruptcy system.

The question of resolving international bankruptcy cases has been attracting a lot of attention for a long time. It is one of the core subjects which concerns different scholars and international institutions. But regardless of their efforts, there is no optimal international bankruptcy law which would be used by all the countries today. But how do countries resolve international bankruptcy cases?

3.1.1. Universalism vs. territorialism

There are several approaches for addressing international insolvency, such as universalism, modified universalism, secondary insolvency, corporate-charter contractualism, and territorialism (figure 23). The two dominant models are that of universalism (universality) and territorialism (territoriality) which are often viewed as two opposite approaches.

Figure 23 Approaches to a cross-border insolvency



Source: Based on Anderson, K., 2000: p.687

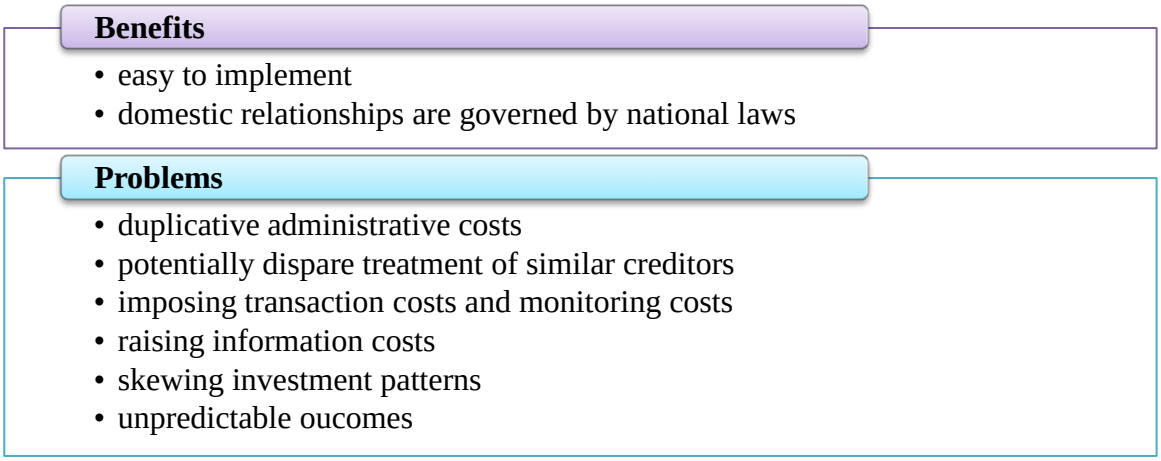
As was stated by Garrido (2011) "*territorialism is the most ancient approach to insolvency*".[151]

[151] Garrido, J.M, 2011: p.466

Territoriality can be described as an approach in which "*each nation conducts its own insolvency proceedings with respect to the assets located within its jurisdiction and disregards any parallel proceedings in a foreign nation*."[152] In other words it can be described as "*a concept that each individual country holds the sovereign right to govern within its own borders*."[153]

The main benefits and problems connected with territorialism are shown in figure 24. As we can see, there are many problems connected with this approach. They include, among others, potentially unequal treatment of creditors situated in different countries as well as high transaction and information costs due to multiple bankruptcy proceedings.

Figure 24 Some of the benefits and problems connected to the territorialism



Source: Based on Pottow, J., 2006, Anderson, K., 2000, and Garrido, J.M., 2011

Interestingly, Tung (2001) noted that "*analysts agree that territoriality is and has always been the dominant practice*"[154], regardless of the fact that territoriality defeats an equal treatment of similar creditors, which is being described by Trautman, Westbrook and Gaillard (1993) as "*a fundamental tenet of the bankruptcy policies of most civilized countries*".[155]

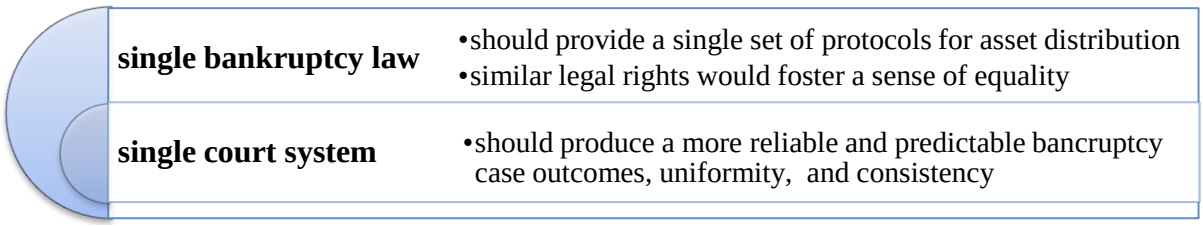
In order to understand this contradiction fully we have to look at another important model of bankruptcy law - universalism.

The idea of universality and the shift of attention from the territorial approach of cross-border bankruptcy law to the universalism model dates back to the 1970's.[156] LeMaster, Downey, and Brewerton (2007) argued that "*universalism is viewed as a simpler and more effective way to manage the complexities of multinational insolvency cases*"[157]

[152] Bufford, S., Adler, L., Brooks, S., Kreiger, M., 2001: p.3
[153] LeMaster, J., Downey, C., Brewerton, F.,J., 2007: p.32
[154] Tung, F., 2001: p.10
[155] Trautman, D.T., Westbrook, J.L., Gaillard, E., 1993: p. 575
[156] Anderson, K., 2000: p.681
[157] LeMaster, J., Downey, C., Brewerton, F.,J., 2007: p.33

Universalism can be described as a model in which "*a court of a bankrupt multinational company's home country should have a world-wide control and should apply the home country's law to the core issues of the case*".[158] Necessary elements of a universalism include a single bankruptcy law and a single bankruptcy court.[159] (Figure 25)

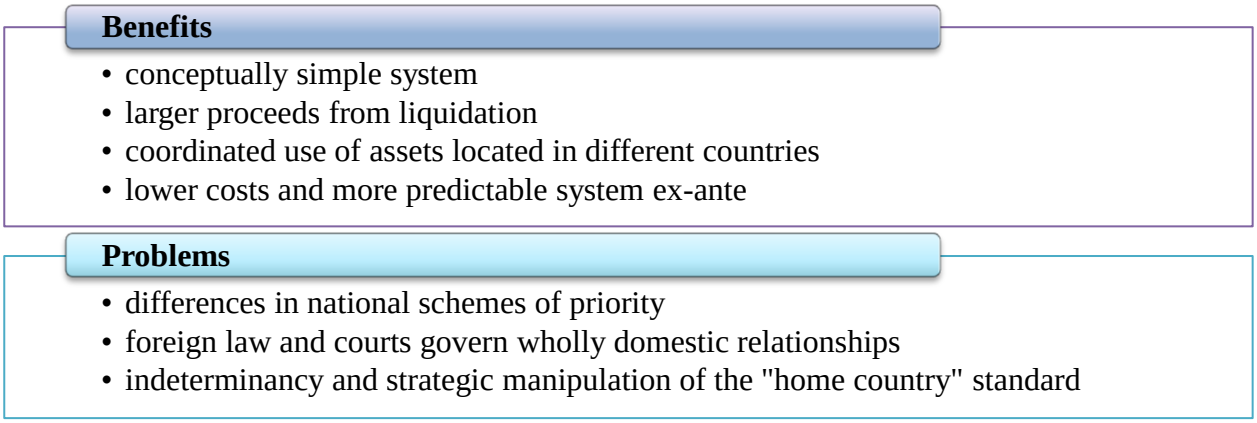
Figure 25 Essential components of universalism



Source: Based on LeMaster, J., Downey, C., Brewerton, F.J., 2007: p.33

Tung (2001) also pointed out that "*the basic universalist principle is "one law, one court"*."[160] The main benefits and problems connected to this system are shown in figure 26.

Figure 26 Some of the benefits and problems connected to the universalism



Source: Based on LoPucki, L. M., 1999 and Garrido J.M., 2011

Universalism is considered to be the most influential theory, which has received more attention from scholars[161], but as we can see from figure 26, there are many problems which limit the use of universalism. Among the most important issues are the differences in national schemes of priority and the absence of a clear rule for determining a debtor's home country.

As was stated by LoPucki (1999), "*when the country of incorporation, the country of headquarters and the country with the largest share of the debtor's assets are different, the courts and commentators differ widely on which to deem the home country*".[162] He also argues that "*without a clear resolution of this issue… universalism would be unpredictable*".[163]

[158] LoPucki, L. M., 1999: p.696
[159] LeMaster, J., Downey, C., Brewerton, F.,J., 2007: p.33
[160] Tung, F., 2001: p.10
[161] Garrido, J.M., 2011: p.469
[162] LoPucki, L. M., 1999: p.714
[163] LoPucki, L. M., 1999: p.724

On the other hand, Garrido (2011) argued that "o*ne of the most important obstacles to universalism is the existence of different priority regimes*."[164]

It is important to mention, that the advantages of universalism depend on its widespread adoption and use. Tung (2001) stated that "*universalism yields superior predictability, reduces monitoring costs, and renders asset location irrelevant only if all states adopt it*".[165]

Harmonization might require a lot of time and some authors argue that universalism is not likely to be adopted at all. One of the biggest problems with its adoption comes from the fact that countries are not willing to permit foreign laws and courts to control and influence domestic relationships.[166] This idea is supported by Tung (2001) who pointed out that "s*tates will be reluctant to commit to enforcing the decisions of foreign courts applying foreign bankruptcy laws against local parties*".[167] He also argues that because of these problems "*universalism is politically implausible and likely impossible*".[168]

Due to the problems related to universalism and territorialism some new modified systems of the management of the cross-border insolvencies were proposed, namely: the modified universalism, secondary insolvency, and corporate contractualism (figure 23). We will not examine them in detail because it is not the aim of the paper, but it is important to mention that from the practice it can be seen, that today modified universalism is preferred.[169] *Modified universalism* supports universalism, but courts from foreign countries can refuse to cooperate with the home country's court, in case they feel that their fundamental domestic policies are offended.[170]

Thus, in order to have an effective unified system for resolving multinational bankruptcy cases, the issues of coordination and harmonization are essential. Such coordination and cooperation is challenged by a number of problems which include uncertain commitments, large number of parties involved, and large transaction and information costs of writing complete contracts. Tung (2001) also pointed out that, "…*cooperation that overcomes these hurdles typically occurs within the context of international regimes and institutions*".[171]

In this sense international treaties and conventions play an important role in resolution of multinational insolvency cases. Some of the most important treaties and documents dealing with international insolvencies will be looked at in the next section of the paper.

[164] Garrido, J.M., 2011: p.470
[165] Tung, F., 2001: p.59
[166] LoPucki, L. M., 1999: p.696
[167] Tung, F., 2001: p.3
[168] Tung, F., 2001: p.3
[169] Garrido, J.M., 2011: p.471
[170] Pottow, J., 2006: p.1919
[171] Tung, F., 2001: p.59-61

3.1.2. International elements of bankruptcy law

"*Bankruptcy is particularly difficult area for international harmonization or cooperation.*"[172]

The sources of international bankruptcy law can be found in international treaties and conventions as well as in national provisions. The main source remains the national private law of a country which contains an international element concerning insolvency issues. But as the practice shows it is not enough. The lack of uniformity in resolving international insolvency cases due to the variations in bankruptcy regulations causes uncertainty and unpredictability.

Efficient resolution of cross-border insolvencies depends on cooperation between countries and on harmonization of their laws. As was pointed out by Garrido (2011), "*the common point of all modern solutions to the problem of international bankruptcy is the focus on cooperation*".[173] Cooperation and harmonization are encouraged also by international treaties and conventions. The main international treaties are shown in figure 27.

Figure 27 International treaties on transnational insolvency matters

- Chapter X of the Montevideo Treaty of 1889
  - Argentina, Bolivia, Columbia, Peru
- Code Bustamente (Convention on Private International Law of 1928)
  - Bolivia, Brazil, Chile, Costa Rica, Cuba, the Dominical Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Peru, Venezuela
- The Nordic Bankruptcy Convention of 1933
  - Dennmark, Finland, Iceland, Norway, Sweeden

Source: Based on Bufford, S., Adler, L., Brooks, S., Kreiger, M., 2001: pp.53-54

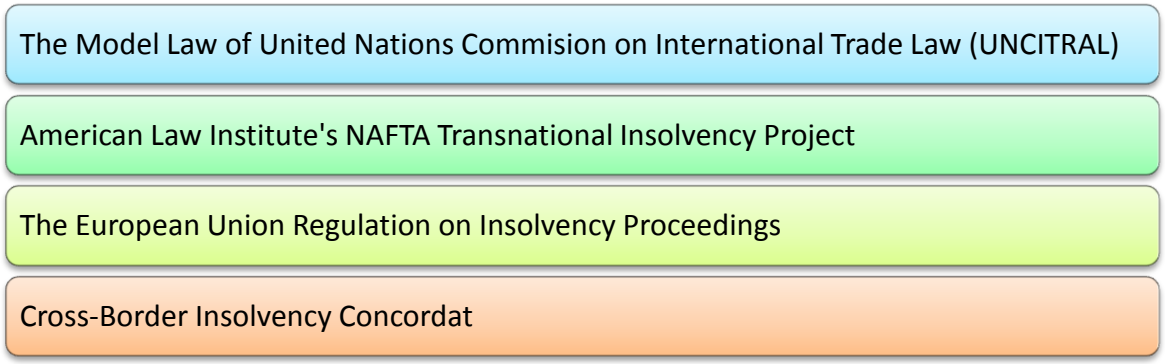
The problem with those treaties is that they "*specifically govern transnational insolvency matters, but only among the states that are parties to the applicable convention*", as was stated by Bufford, Adler, Brooks, and Kreiger (2001).[174]

But efficient resolution of bankruptcy cases requires uniformity. What we need is a system "*which can be credible in all or most countries which can provide a basis on which a quick but careful judgment can be made as to whether a particular trader can benefit from a rescue regime*"[175], as was argued by Kono, Paulus, and Rajak (2002).

[172] Tung, F., 2001: p.15
[173] Garrido, J.M., 2011: p.471
[174] Bufford, S., Adler, L., Brooks, S., Kreiger, M., 2001: p.53
[175] Kono, T., Paulus, C.G., Rajak, H., 2002: p.152

On a more global scale there are several other important documents that help with resolution of international insolvencies (figure 28). The most important of these documents in cross-border insolvency are the UNCITRAL Model Law and the EU Insolvency Regulation.

Figure 28 Documents dealing with transnational insolvencies

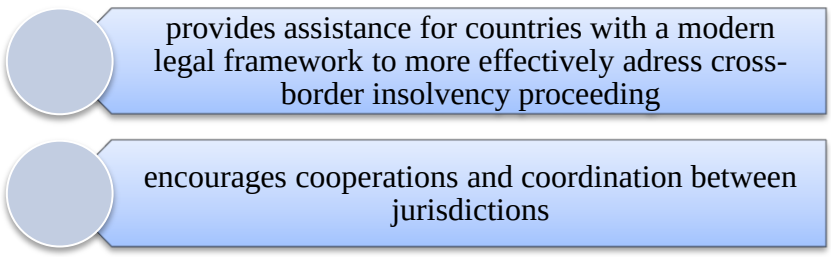


Source: Based on Bufford, S., Adler, L., Brooks, S., Kreiger, M., 2001: p.55

The **UNCITRAL Model Law** (the Model Law) was adopted in 1997. "*The Model Law is not a treaty but, as its name suggests, a model that countries may voluntarily incorporate into their domestic legal framework*".[176]

Locatelli (2008) points out that the main aim of the law is to encourage better conditions in cross-border matters and to provide assistance to the resolution of such cases "… *rather than modifying jurisdictional rules on international private law in insolvency matters that are already in place in the enacting State*".[177] The purpose of the Model Law is shown in figure 29.

Figure 29 The purpose of the Model Law



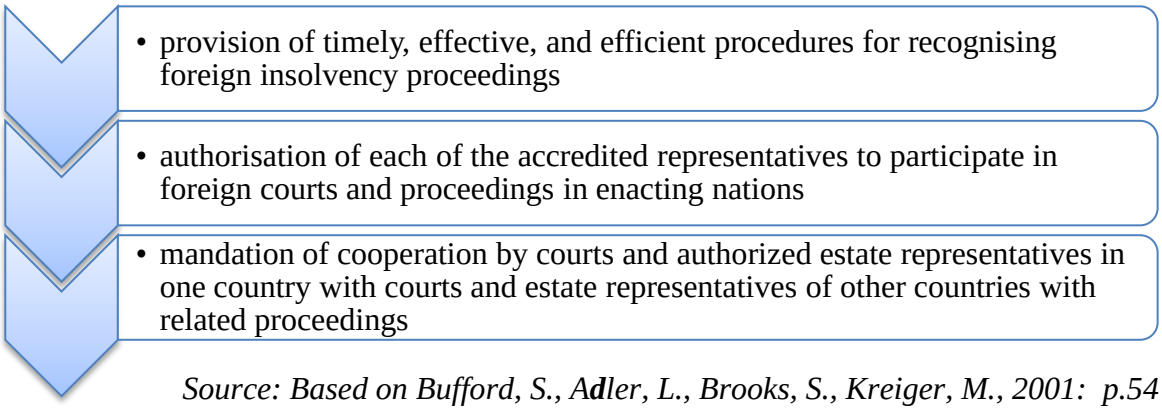
Source: Based on UNCITRAL

One of the key characteristics of the Model Law is that it is not compulsory. Countries can decide whether they wish to adopt it and to which extent they want to do it. "*The UNCITRAL Model Law approaches the problem of cross border insolvency through the slow co-operative route of voluntary harmonization as opposed to the wild idealistic and now largely described route of enforced universalism*".[178]

[176] IMF, 2010: p.17
[177] Locatelli, F., 2008: p. 326
[178] Kono, T., Paulus, C.G., Rajak, H., 2002: p.153

In the literature the Model Law is usually referred to as an example of a modified universalism.[179] And as was mentioned by Garrido (2011), "*practical experience shows that modified universalism is the preferred position, both in theoretical and practical terms*."[180]

Figure 30 Principal features of the Model Law



Source: Based on Bufford, S., Adler, L., Brooks, S., Kreiger, M., 2001: p.54

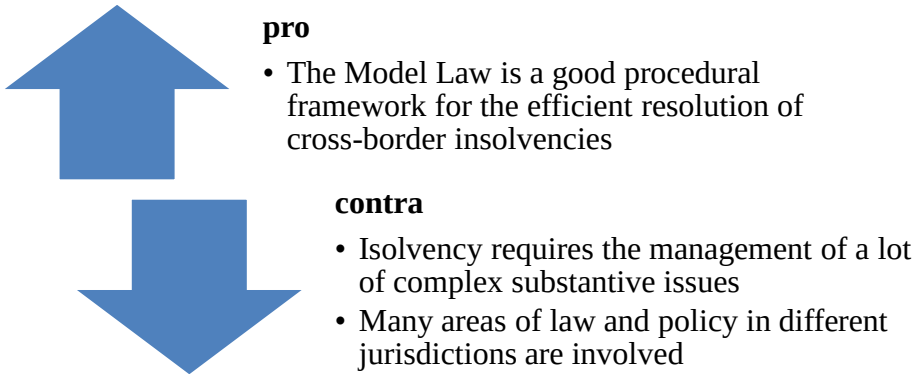
It is important to note that if the Model Law is interpreted or implemented by countries in many different ways; such legislation is unlikely to coordinate the resolution of insolvency cases very effectively, as it was meant to.[181]

Kono, Paulus, and Rajak (2002) support this observation by stating that, "*obviously the more common provisions that are inserted into national legislation, the more harmonization there will be in the way in which different countries deal with cross border disputes*".[182]

Unfortunately the statistics show that "*the Model Law has been adopted in only 19 countries in the last 15 years and that too in many different ways*".[183] The list of countries that adopted the Model Law is shown in table 6, appendix IV.

Some advantages and disadvantages in accepting the Model Law are shown in figure 31.

Figure 31 The acceptance of the Model Law



Source: Based on Mohan, S.C., 2012: p.27

[179] New Zeland Report 52, 1999: p.6
[180] Garrido, J.M., 2011: p.472
[181] McCormack, G., 2012: p. 158
[182] Kono, T., Paulus, C.G., Rajak, H., 2002: p.153
[183] Mohan, S.C., 2012: p.1

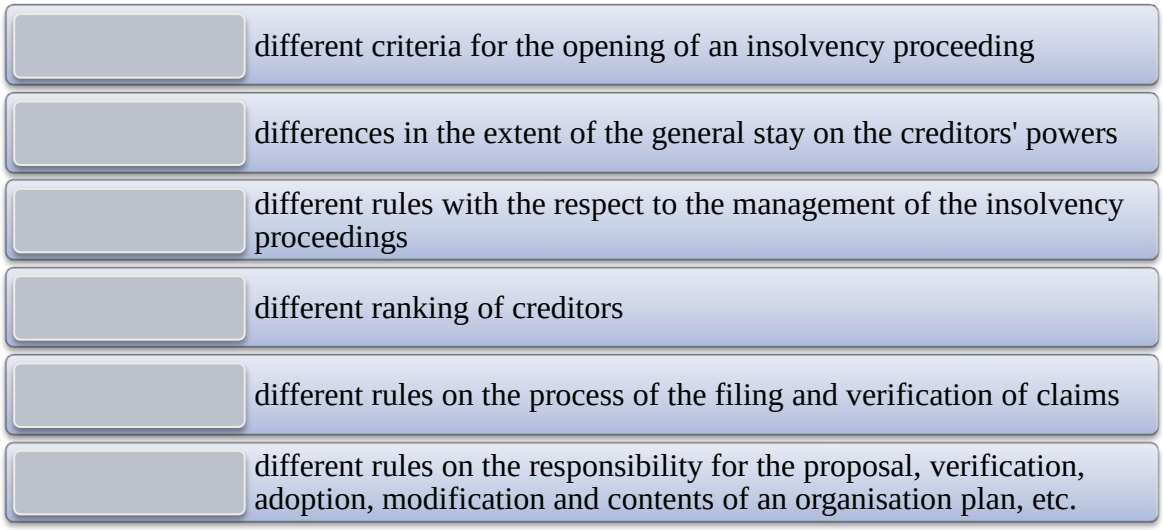
As was stated in the INSOL Europe report (2010), there seem to be "*some inherent problems with the acceptance of the Model Law, judging by the small number of countries that have adopted the Model Law and the diverse manner in the extent to which they have done so*".[184]

Another important document used for the resolution of cross-border insolvency cases is the **European Union Insolvency Regulation**. "*EU rules clearly represent a special case, not comparable with other attempts of international rule making, given that this new European cross-border insolvency regime was adopted within the existing EU legal and institutional framework.*"[185] But even in the European Union the question of harmonization of insolvency laws was not so easy. As was stated in the INSOL Europe report (2010) "*there are a limited numbers of areas where harmonization may be desirable and achievable*".[186]

Tung (2001) also supports this idea by pointing out that "*the history of EU negotiations over a cross-border insolvency convention exemplifies states' reluctance to contract on the basis of ambiguous commitments*."[187] He also stated that "*at one stage of negotiations, universalism had been considered and extensively discussed, but indeterminacy in the specification of the home country was a striking point*".[188]

It is also important to mention that even in the European Union "*procedural and substantive differences between the national insolvency laws of the EU Member States still exist*".[189] (Figure 32)

Figure 32 Some of the aspects of insolvency law within the EU



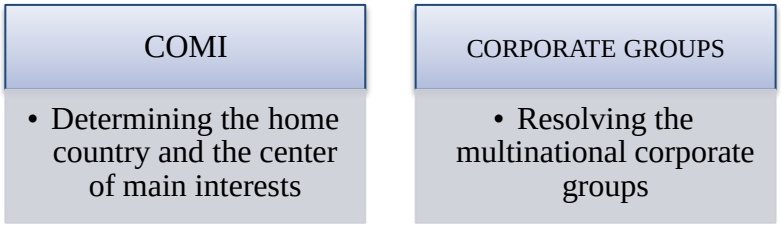
Source: Based on INSOL Europe, 2010: p.8

[184] Mohan, S.C., 2012: p.27
[185] Nierop, E., Stenström, M., 2002: p.9
[186] INSOL Europe, 2010:p.6
[187] Tung, F., 2001: p.46
[188] Tung, F., 2001: p.46
[189] INSOL Europe, 2010: p.26

The problems with harmonization can be explained in the way that insolvency law is an integrated part of the whole legal system, regulating such issues as contractual obligations, court procedures, land, employment, etc. *"Until these are all harmonized, it will not be possible to harmonize all aspects of insolvency law*".[190]

As we have seen "*the existing regimes are far from perfect*".[191] Some of the most important problems shared by the Model Law and the EU Regulations, which hinder the full harmonization of the bankruptcy law, are shown in figure 33.

Figure 33 Some of the obstacles to cross-border insolvency regimes



Source: Based on Bernardo, 2012: pp. 811,822

Thus, "*despite these commendable efforts, we are still some way away from a workable international bankruptcy system*".[192] But what challenges are there on the way to the development of an international bankruptcy code?

[190] INSOL Europe, 2010: p.27
[191] Bernardo, P.,J., 2012: p.830
[192] Kono, T., Paulus, C.G., Rajak, H., 2002: p.152

3.2. Challenges to international bankruptcy

3.2.1. Interests of local creditors and local sovereigns

"…the utopian unity offered by globalization proved no match for national self-interest, particularly when dealing with distressed or failed corporations."[193]

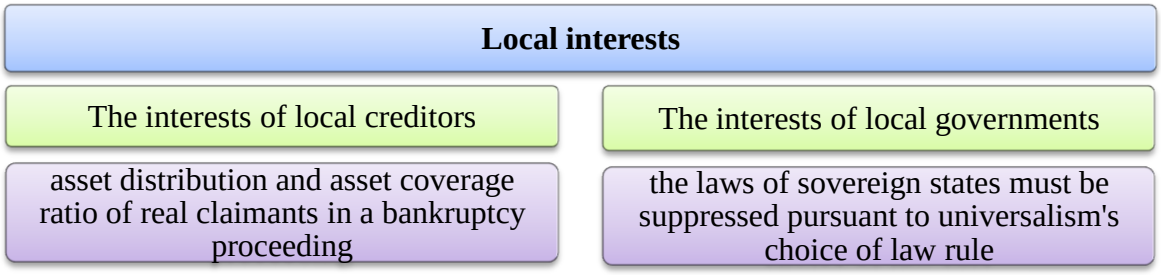
A unified international bankruptcy law could have many benefits. It would most likely make the resolution of multinational bankruptcy cases more reliable and predictable. But, as we can see from the practice, despite the efforts to create an international insolvency regime, countries are unwilling to make substantial changes to their legislation in order to reach the needed level of harmonization. This can be clearly seen from the example of the UNCITRAL Model Law, which was adopted only by few states and with modifications.

As was stated by Locatelli (2008), countries can exercise the right to use only a part of the Model Law and modify some of its provisions with the purpose of "*… protecting their national interests and applying restrictions based on public policy exemptions*".[194]

Mohan (2012) also pointed out that "*the need to protect local parties and economic interests is immensely important to most states, despite the temptation to articulate a seemingly enlightened universalist approach*".[195]

Referring to this situation Wessels (2003) uses the term "local interests" stating that countries use their national laws because "*the territorial proceedings protect local interests*".[196] The problem of local interests can be viewed as a combination of several matters - interests of local creditors and interests of local governments (figure 34).

Figure 34 The problem of local interests



Source: Based on Pottow, J., 2006: pp.1905-1906

Interestingly, it is not always the case that local creditors prefer territorialism over the universal approach. Interests of local creditors depend on each individual situation. Some issues regarding their interests and preferences are shown in table 4.

[193] Bernardo, P.J., 2012: p.801
[194] Locatelli, F., 2008: p.327
[195] Mohan, S.C., 2012: p.20
[196] Wessels, B., 2003: p.487

Table 4 Interests and preferences of local creditors

	payoffs	priority rules
creditors prefer **territorialism**	the ratio of local assets to local claims can be higher than the global average	local creditors could benefit under a priority rule of local law compared to a foreign law that has no such priority provision
creditors prefer **universalism**	the global average can be higher that the asset base located within the country's territory	creditors could benefit from a priority rule under the application of foreign law – a priority benefit unknown in their home law

Source: Based on Pottow, J., 2006: pp.1908-1911

Pottow (2006) underlines that "*from a theoretic point of view there is no intrinsic reason to assume that domestic priority rule will privilege a given domestic creditor any more than a foreign law will*".[197] He also adds that "*the most straight forward way in which domestic creditors might be privileged by local bankruptcy law is by overt, direct legal discrimination*".[198]

Another interesting point is that, irrespective of the benefits that local creditors might get from the universalism model, *"each state naturally prefers its own set of policy choices to those of other states*".[199] This can be explained by the fact that bankruptcy remains a complicated topic which involves many parties with different interests.

Tung (2001) describes bankruptcy as a radical type of legal proceedings with a wholesale effect because "*it provides for the comprehensive restructuring of a firm and every legal relationship between the firm and its creditors and other interested parties*".[200]

Pottow (2006) also stated that the interest in using own jurisdiction "… *has nothing to do, at least directly, with privileging local creditors or other individual stakeholders. Rather, it has to do with the desire of state's legal actors to see that their state's laws are enforced*."[201]

Thus, local interests present significant challenges on the way to a single international bankruptcy code. But this is not an exclusive factor which has to be considered and taken into account. Other challenges connected to the creation of an effective international bankruptcy code include forum shopping between jurisdictions, strategic bankruptcy, and bankruptcy fraud and crimes.

[197] Pottow, J., 2006: p.1911
[198] Pottow, J., 2006: p.1912
[199] Tung, F., 2001: p.18
[200] Tung, F., 2001: p.17
[201] Pottow, J., 2006: p.1915

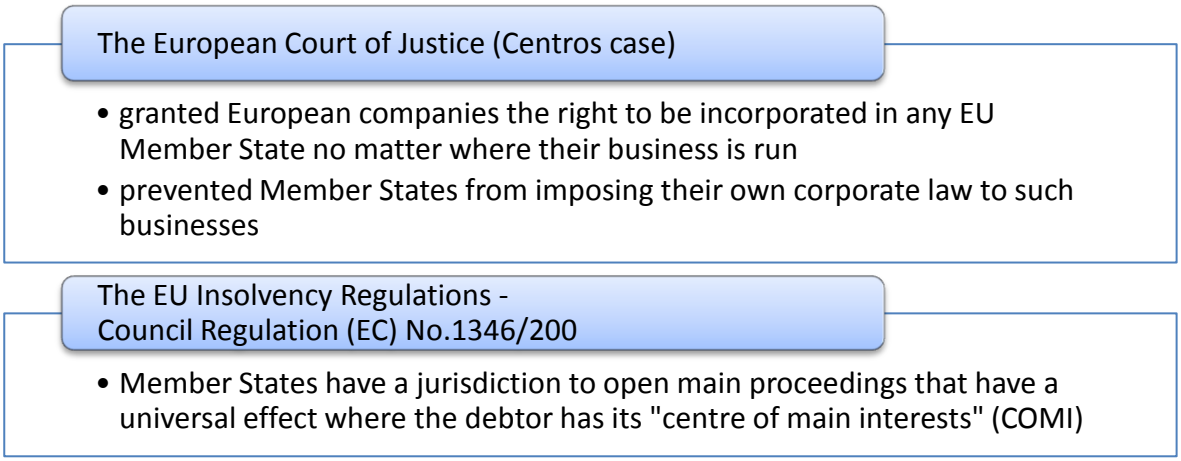
3.2.2. The forum shopping between jurisdictions

As we have seen from the attempts to harmonize bankruptcy law on a global level (the Model Law and the UE Insolvency Regulations), one of the main problems is the identification of the debtor's center of main interests (figure 33). In this sense forum shopping represents a big challenge to the international bankruptcy and to the development of a single bankruptcy code.

The term **forum shopping** can be defined as "*the act of filing in a court that does not serve the geographical area of the debtor's corporate headquarters*".[202] It refers to the situation in which corporations or individuals "… *seek to exploit the differences between insolvency regimes in different jurisdictions*".[203]

The problem with the Model Law and with the UE Insolvency Regulations is that there is no clear rule on how to determine the home country of a debtor. As was stated by Bernardo (2012), "*no specific guidance is provided for this determination*".[204] Thus, Gelter (2006) pointed out that, two factors have facilitated the possibility of forum shopping and corporate arbitrage in the European Union (figure 35).

Figure 35 Factors which have facilitated the use of forum shopping in the EU



Source: Based on Enriques, L., Gelter, M., 2006: p.4

In the Centros case Wymeersch (1999) defines that, "*the court adopted a positive attitude towards the idea that it is not abusive to take advantage of differences in regulation, and therefore to choose for the least restrictive regime*".[205]

It is important to remember that the EU bankruptcy legislation is not fully harmonized. Because of this, laws of some countries offer better protection for creditors, which makes them

[202] Eisenberg, T., LoPucki, L.M., 1999: p.968
[203] Cowan, N., Axford, C., 2010: p.1
[204] Bernardo, P.J., 2012: p.812
[205] Wymeersch, E.O., 1999: p.15

more attractive. "*Gains from regulatory arbitrage can be made by shopping between different European bankruptcy regimes.*"[206]

The UNCITRAL Model Law also allows modifications and partial implementation into a national legal system. Thus, "*among the countries that have incorporated the UNCITRAL Model Law, there are significant differences*".[207] This makes the forum shopping possible in such countries as well.

But forum shopping can be found even within the borders of one country. For example, in the US the two main jurisdictions that attract the forum shoppers there are New York and Delaware. Interestingly, the reason for forum shopping in the USA in the 1980 and 1990's was not the efficiency or convenience. As was stated by Eisenberg and LoPucki (1999), "*debtors shopped to New York and now shop to Delaware in large part to secure particular judges or avoid the judges in their home districts*".[208]

There are different points of view on whether forum shopping represents only a negative issue. It is also argued that forum shopping allows bankruptcy proceedings to be made in a more efficient way, because there is the possibility to choose between different courts.[209]

But even if it was possible to come up with an optimal bankruptcy law in which forum shopping wouldn't be a problem, there are some other challenges to an international bankruptcy. One of them is bankruptcy fraud. Even perfect laws can be violated. As was stated by Salinger (2005), "*the prospect of business failure can lead executives to attempt various forms of debt restructuring fraud*".[210] But what are these frauds? What other crimes connected to bankruptcy do we have to consider? These issues will be discussed in the next section of the paper.

[206] Enriques, L., Gelter, M., 2006: p.53
[207] Garrido, J.M., 2011: p.473
[208] Eisenberg, T., LoPucki, L.M., 1999: p.968
[209] Enriques, L., Gelter, M., 2006: p.3
[210] Salinger, L., 2005: p.246

3.2.3. Bankruptcy fraud and crimes

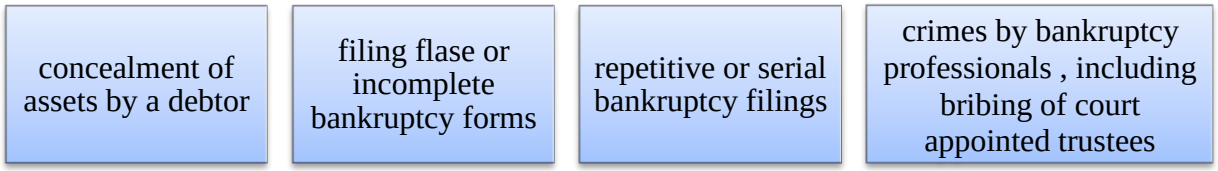
"Corruption is a widespread problem favoring debtors and particular creditors".[211]

Another important challenge to the international bankruptcy is a bankruptcy fraud. It's not only the creditors, who suffer from the fraudulent schemes, but the whole economy faces losses due to such behavior.

Bankruptcy fraud, bankruptcy offences, and prohibited actions all constitute bankruptcy crimes. **Bankruptcy crime**, falling into category of white-collar crimes, can be defined as "*a criminal act committed in connection with bankruptcy or liquidation proceedings.*" [212] It can also be characterized as a financial and manipulation type of crime (appendix V; figure 42). [213]

The list of prohibited bankruptcy activities can be very long (figure 43, appendix VI). It is hard to generalize those activities across jurisdictions, because each country has its own peculiarities. But there are some major types of bankruptcy fraud, which can be found in many countries. These include, among others, concealment of assets, filing false or incomplete bankruptcy forms, bribery of court appointed trustees (figure 36).

Figure 36 Four general types of bankruptcy fraud



Source: Based on Berker, K., Stowell, N., Polansky, C., Kieffer, D., 2010: p.79

As was stated by Shanty and Mishra (2008), "*the concealment of debtor's assets remains the most significant problem area within bankruptcy worldwide*".[214] Another type of bankruptcy fraud which is very common is filing false or incomplete statements. In fact, "*according to the FBI, 70% of all bankruptcy crimes involve both of these schemes and are hard to separate since concealment of assets automatically assumes false or incomplete statements*".[215]

In the United States, in terms of bankruptcy fraud, there are so called "Chapter 11 tricks", which were analyzed by Salinger (2005), who stated that "*although the majority of fraud in bankruptcy proceedings consists of the concealing or transfer of assets, there are a number of*

[211] Wihlborg C., Gangopadhyay S., 2001:p.27
[212] Gottschalk, P, 2010: p.16
[213] Gottschalk, P, 2010: p.16
[214] Shanty, F., Mishra, P., 2008: p.229
[215] Berker, K., Stowell, N., Polansky, C., Kieffer, D., 2010: p.80

schemes designed primarily to maximize company profits prior to bankruptcy filings, including burst-outs, bleed-outs, and parallel entities".[216] (Figure 37)

Figure 37 Chapter 11 tricks

burst-out
- creation of a business that is designed to fail from its very inception
- after establishing a good credit history the business obtains a large amount of merchandise on credit
- this merchandise is then sold for cash or transfered to business associates
- bankruptcy is then filed, leaving creditors without any resource for collection

bleed-out
- is similar to bust-out
- but, involves depleeting the assets of an existing company over a relatively long period of time

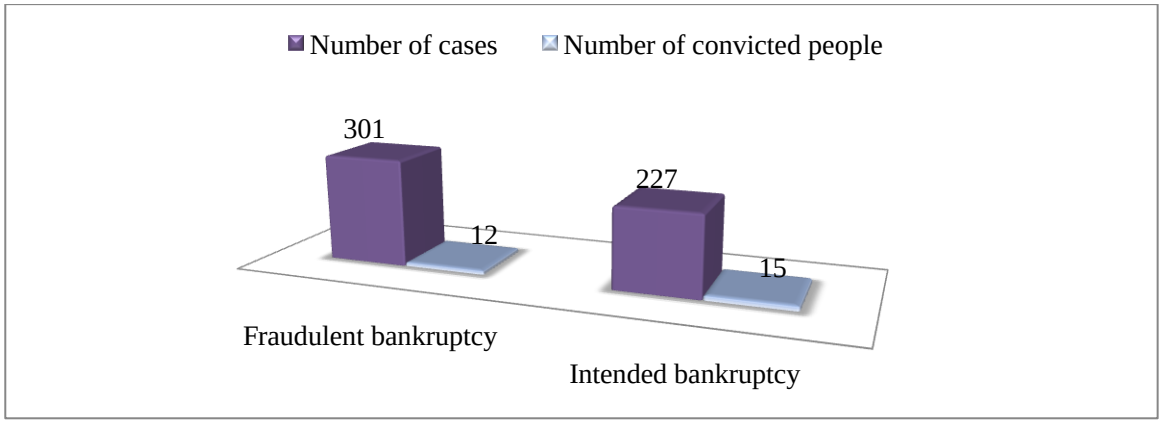
parallel entities
- creation of a second business which mirrors the first business, prior to or immediately after a bankruptcy filing
- business owners continue to operate their business until they have succsessdully transferred all inventory, recievables, etc., to a new company

Source: Based on Salinger, L., 2005: pp.246-247

It is interesting to know that in many countries bankruptcy frauds are not always punishable at the end of a process.

Despite the fact that there are many norms of administrative and criminal liability for fraudulent bankruptcy in Russian law, all of them are difficult to be used in full (figure 38). One of the reasons lies in proving of such cases per se, what requires "… *10 evidentiary facts which have to be supported by 61 evidentiary arguments*".[217]

Figure 38 Number of fraudulent and intended bankruptcy cases in Russia, 2001



Source: Based on Abdiushev, R., 2012: p.65

[216] Salinger, L., 2005: p.246
[217] Abdiushev, R., 2012: p.65

Statistics from Europe show that "*despite the fact that only 4-6% of bankruptcies are fraudulent, public opinion makes a strong link between business failure and fraud*".[218] This attitude is derived from the historically negative notion of bankruptcy, which was mainly associated with criminal actions and severe punishment. Only later it became obvious that not all of the bankruptcies are fraudulent or caused by the bad management of a company. A company might experience financial problems due to some external factors such as distressed industries, turbulent environment or even bad luck. In this case bankruptcy is rather a tool which helps to save a good company facing just temporary troubles.

Using bankruptcy as an instrument for some purpose is closely connected to the next challenge of international bankruptcy, namely, strategic bankruptcy.

[218] Business Dynamics: Start-ups, Business Transfers and Bankruptcy, 2011: p.114

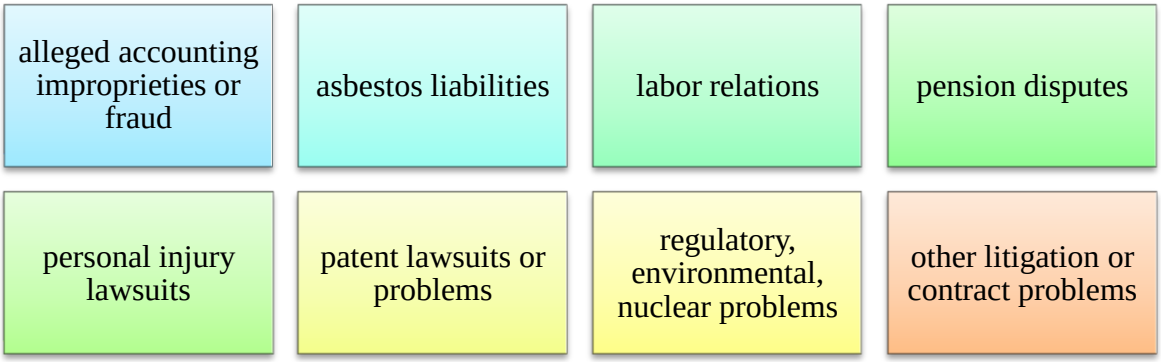
3.2.4. Strategic bankruptcy

"*In a great many cases, bankruptcy is no longer seen as failure but a strategy that can be employed to give a firm a fresh start.*"[219]

In the modern world bankruptcy becomes very often a separate strategy used by companies to achieve their goals. Delaney (1998) stated in this regard that "*bankruptcy has become a strategic, political device used by large corporations and commercial creditors. Recent cases suggest that firms are beginning to view bankruptcy, not as something to be avoided, but as another weapon in the corporate arsenal*".[220]

Rose-Green and Dawkins (2002) also argued that "*in the US economically viable firms may choose to file bankruptcy petitions for strategic reasons*".[221] They distinguish between financial bankruptcies and strategic bankruptcies. Bankruptcy may be called strategic for one of the reasons shown in figure 39. Other bankruptcies are considered by the authors as financial.

Figure 39 Some of the reasons for strategic bankruptcies



Source: Based on Rose-Green, E. and Dawkins, M., 2002: p.1321

Boatright (2004) in this regard mentioned that solvent firms may file for bankruptcy in order to "*defer or avoid payments, renege on contracts, stop litigation, evade legal liability, break unions, and get rid of pension plans*".[222]

But what makes it possible for a company to use bankruptcy for strategic reasons?

It is important to note, that the concept of strategic bankruptcy is usually connected to the United States. The reason for that was pointed out by Sheppard (1992), who argues that "*the law may have removed so much of the risk from bankruptcy that filing is now considered an effective management strategy*".[223]

[219] Sheppard, P., 1995: p. 184
[220] Delaney, K.J., 1998: p.1
[221] Rose-Green, E. Dawkins, M., 2002: p.1319
[222] Boatright, J.R., 2004: p.142
[223] Sheppard, J.P., 1992: p.183

Boatright (2004) supports this idea by stating that "*the use of bankruptcy as a management strategy has been facilitated by a system that enables, indeed encourages, distressed or insolvent firms to reorganize instead of liquidating*". [224] The rationale behind this is that once a firm files for bankruptcy under Chapter 11 (reorganization) of the US bankruptcy code, the managers of the firm are left in control for some period of time (120 days), to develop a reorganization plan. Usually, such plan reduces the claims of creditors and specifies how they will be met.[225] As was argued by Johnson, Baliga, and Blair (1986), "*several profitable companies are employing Chapter 11 to protect themselves, claiming imminent bankruptcy, from lawsuits and contracts that damage their competitiveness*".[226]

Strategic bankruptcy sometimes is compared to the insider's game. Delaney (1998) explains it the way that *"it takes a good deal of money, knowledge, and experience to play the game well. As such, the "repeat players" who make their living in bankruptcy have amassed more social power than at any time in recent history, and corporations continue to use bankruptcy in innovative ways"*.[227]

One of the most controversial bankruptcy cases was that of a Manville Corporation – once the asbestos industry leader, who has filed for protection under Chapter 11 in 1982 when more than 17 000 people had asbestos-injury suits pending against the company.[228]

These issues also pose a challenge on international bankruptcy law because "*while legal, such actions are of a questionable ethical nature*".[229]

Thus, there are many factors which challenge the creation of a single bankruptcy code, but one of the most important challenges is the countries themselves. They are too different in many ways, and their *"bankruptcy laws are infinitely diverse"*.[230] What works in one country would most likely not work in another. Country differences, as a challenge to an international bankruptcy law, will be discussed in the last section of this paper.

[224] Boatright, J.R., 2004: p.143
[225] Boatright, J.R., 2004; p.143-144
[226] Johnson, B., Baliga, J.B., Blair, J., 1986:p.51
[227] Delaney, K.,J., 1998: p.ix
[228] The New York Times, 1988
[229] Johnson, B., Baliga, J.B., Blair, J., 1986:p.51
[230] Avrech, C.H., 2000: p.29

3.2.5. Country differences as a challenge to international bankruptcy

"*Cross-border insolvency proceedings can be inefficient, prolonged and costly. This is largely because insolvency rules in different languages, in different countries, under different legal systems and traditions are not always uniform or consistent*."[231]

International bankruptcy code, if possible at all, should be designed in a way to make the resolution of international bankruptcy cases in different countries efficient and predictable. But the problem with efficiency is that countries may see it differently.

Partially, this difference can be explained by **legal origin** (common law vs. civil law) and by **historical development** and evolution. As we have seen earlier, historical developments have left a footprint on bankruptcy systems of various countries, which have been changing their laws each in their own unique way. And because of such diversity of bankruptcy systems that we have today, there is still a long way to go to a unified international bankruptcy law.

It is not a secret that **differences in bankruptcy policies** and approaches hinder cooperation and harmonization of an insolvency law. As was stated by Bernardo (2012), "*various developed nations have achieved very high level of standards of living under very different arrangements*".[232]

Among the most important distinctions are the differences in bankruptcy regimes. Some countries are more creditor-friendly (Great Britain, Germany etc.), while others are more debtor-friendly (France, United States, etc.).

Another important issue is the difference in the treatment of secured creditors. For example, under Russian bankruptcy law secured creditors are deprived of their security in a bankruptcy proceeding, while under laws of western countries secured creditors are usually protected by various bankruptcy policies.[233]

Differences in court involvement also constitute important factors, which challenge the creation of a unified bankruptcy code. For example, in the UK the main reorganization procedure has very little court involvement, if any. The US law, on the other hand, as well as practice from continental Europe allow more regulatory and court involvement.[234] But even with such a highly integrated system as the European Union it is still difficult to harmonize the bankruptcy law of the EU member states.

[231] Mohan, S.C., 2012: p.2
[232] Bernardo, P.,J., 2012: p.834
[233] Avrech, C.H., 2000: pp.27-29
[234] Bolton, P., 2003: pp.13-15

Other factors that have impact on insolvency systems of various countries and contribute to their diversity are economic, social, cultural, political, and institutional. If we take a closer look at them it becomes clear why they challenge the creation of an international bankruptcy law.

The importance of **social** and **economic** factors was consistently stressed by different scholars. Locatelli (2008), for example, stated that *"because countries differ widely in their legal systems, as well as in their economic and social needs, harmonization has been very difficult*".[235] Djankov, Hart, McLiesh, and Shleifer (2008) argued that "*per capita income is a crucial determinant both of getting the right outcome and of the overall efficiency of debt enforcement*."[236] Reorganization, as a complicated procedure in itself, is better performed in high-income countries, while low-incomes countries are better at liquidation.[237]

It is interesting to note, that "s*everal poor and lower-middle-income countries – Egypt, Kenya, Nepal, Panama, Uganda, Zambia, etc. - do not have a rehabilitation procedure*."[238] Thus, a unified international bankruptcy law might not be optimal for all the countries. "One size fits all" approach is not likely to work because of the huge difference between various countries.

Cultural traditions should also be considered as another factor that impacts bankruptcy systems of different countries. Kono, Paulus, and Rajak (2002) noted that *"the courts of different countries are governed by different cultural traditions, something which may well result in different implementations of the same provisions*".[239]

The way cultures view financial failures influences how a society treats debtors.[240] For example, it is argued that Chapter 11 of the US bankruptcy code doesn't take into account community interests and that reorganization can be used for strategic reasons to escape from different pension liabilities, agreements with unions, etc.

Even with the existence of a unified bankruptcy law, the cultural difference in its implementation might result in various outcomes of similar bankruptcy procedures in different countries. This in turn may trigger the possibility of forum shopping between the jurisdictions, which was discussed earlier.

Political dynamics of a country play an important role in the process of development of bankruptcy legislation in different countries as well. Berglöf, Rosenthal, and von Thadden (2002)

[235] Locatelli, F., 2008: p.325
[236] Djankov, S., Hart, O., McLiesh, C., Shleifer, A., 2008: p.1124
[237] Djankov, S., Hart, O., McLiesh, C., Shleifer, A., 2008: p.1125
[238] Doing Business in 2004: Understanding regulation, 2004: p.80
[239] Kono, T., Paulus, C.G., Rajak, H., 2002: p.153
[240] Avrech, C.H., 2000: p.32

point out that "*because bankruptcy law has such sharp distributional consequences, the development of bankruptcy law will be inherently political*".[241]

Political factors are directly connected to the issue of local interests and the desire to see the national laws enforced. "*Some countries may be reluctant to adopt a robust cross-border insolvency regime due to concerns about how such a regime would affect, as they see it, their national sovereignty*".[242] Pottow (2006) states in this regard that "e*ach country is likely to think that its regime makes the most sense and comports the most closely with its conception of fairness*."[243] This makes the process of bankruptcy law harmonization very difficult and the possibility of creating an international bankruptcy code very unlikely.

Institutional framework is another challenge on the way to an optimal international bankruptcy law. It is considered one of the three main building blocks, identified by the World Bank, which comprise the effective insolvency system of a country.[244] "*Good laws poorly applied do not make a good system."* [245] Hagan (2000) also noted that "*experience has demonstrated, in fact, that the existence of a strong institutional infrastructure is more important that the design of an insolvency law*".[246]

The differences in qualification and training of judges and the presence of specialized courts and law enforcement play an indispensible role in a cross-country analysis. It was noted that "*in rich countries, a specialized court can improve insolvency procedures, because specialized judges have better teaching and more expertise…*"[247]

But, also such traditional factors as excessive bureaucracy, overregulation, corruption, lack of transparency, etc., remain important for business environment and development of a country.[248] Even in countries with perfect laws, **bankruptcy fraud** would make it difficult to reach the desired level of predictability and efficiency in bankruptcy regulations. "*Laws that work well in developed market economies may produce unexpected outcomes in a corrupt environment*".[249]

National interests of countries and the lack of political will also challenge the creation of a unified bankruptcy law. Countries are reluctant to change their national bankruptcy laws because they are **satisfied with the existing regimes**. For example, insolvency practitioners from Canada

[241] Berglöf, E., Rosenthal, H., von Thadden E-L., 2002: p.12
[242] Kargman, S., 2012: p.12
[243] Pottow, J., 2006: p.1917
[244] Johnson, G., 2000: p.71
[245] European Commission, 2011: p.9
[246] Hagan, S., 2000: p.52
[247] Doing Business in 2004: Understanding regulation, 2004: p.81
[248] World Economic Forum, 2011: p.4
[249] Mogiliansky, A.L., Sonin, K., Zhuravskaya,E., 2003, p.1

argued against the adoption of the UNCITRAL Model Law because "*they believed that the Canadian and the US insolvency courts had already established a good working relationship to resolve cross-border problems*".[250]

Another obstacle on the way to an international bankruptcy code is the **problem with cooperation** between a large number of countries. It is more realistic to reach regional cooperation between countries that are similar in some way. On the global level, on the other hand, such cooperation and harmonization of bankruptcy laws is not likely due to the number of countries involved. With a large number of parties involved it is more difficult to establish and maintain cooperation and the existence of commonly shared interests is less likely.[251]

As was stated in the INSOL Europe report (2010) "*insolvency law is an integrated part of the whole legal system*".[252] Such issues as contractual obligations, court procedures of different countries, commercial laws, tax laws, laws on land and employment, and others are closely connected to the insolvency law of a country. "*Each insolvency system must be complementary to, and compliable with, the legal system in which it is rooted, and whose value system it must ultimately sustain*."[253] This is another factor why the full harmonization of the insolvency law on the international level is very difficult to achieve.

It has been often stressed that *"multinational companies, like financial institutions, are global in life but national in death".*[254] This statement attributed originally to Mervyn King[255], the current Governor of the Bank of England, precisely reflects the reality. Until there is a common international bankruptcy code or regulation each country is likely to pursue the usage of its own set of rules and procedures to the bankruptcy cases, which involve local creditors or assets.

Drawing the conclusions we come to the point that the existing country differences and protection of national interests do not allow the creation of a single international bankruptcy instrument, at least in the nearest future. In the short term it is very unlikely that countries may agree to subordinate their sovereign rights of regulating bankruptcy to an international mechanism.

[250] Mohan, S.C., 2012: p.25
[251] Tung, F., 2001: p.54
[252] INSOL Europe, 2010: p.27
[253] Johnson, G., 2000: p.72
[254] Bernardo, P.J., 2012: p.802
[255] Treasury Committee, 2009: p. EV 32

Conclusions

Efficient bankruptcy system is an essential element of a well functioning business environment. It helps financially distressed companies to resolve their debts. Efficient resolution of bankruptcy cases fosters economic growth and prosperity of a country. Originally bankruptcy was viewed as a crime and something that had to be punished. With time this attitude was gradually changing and now bankruptcy can even be used as a strategic tool to reach some goals.

Historically bankruptcy laws of different countries underwent a long and unique process of development and today bankruptcy systems are very diverse. Some of the researchers argue that the type of a legal system (common law or civil law) contributed to this variation. But the evolution of bankruptcy laws of different countries was influenced by other factors as well: economic changes, financial crises, major political events, etc. Thus, even within the same legal system, there are big distinctions in bankruptcy regimes of different countries (the vivid example is the US and UK).

Many scholars and international institutions have studied the question of an efficient bankruptcy system and they seem to agree on its main principles, objectives and goals. The most important elements of efficiency include saving viable companies while liquidating the unviable ones, time spent in bankruptcy, and bankruptcy costs. There are also different aspects of the bankruptcy law efficiency. It can be viewed from a legislative, administrative, and economic point of view, or it can be also seen form the ex-ante and ex-post perspectives. Each country seems to have its own idea on the system that works the best for it.

Many countries are still reforming their laws with the aim to achieve an efficient bankruptcy regime. Trying to reach the same goals, having the similar targets, countries still happen to come to different solutions. This can be explained by the fact that bankruptcy legislation is very complex body and has to be considered in the unique context of each country. Different country characteristics, such as economic, political, cultural, etc., influence the bankruptcy system of each country in an individual way.

Thus, on the way to an optimal bankruptcy law there seems to be not one solution, but different variations depending on each individual case. The situation becomes even more complicated when we have an international bankruptcy case that involves not one but many countries. With the increase in the number of parties involved the resolution of such bankruptcy cases becomes more complex. It is more difficult to find the shared interests between the parties. But efficient resolution of international bankruptcy cases requires predictability and uniformity.

International institutions play an important role in fostering cooperation between countries. Among the most important documents dealing with transnational insolvencies are the UNCITRAL Model Law and the European Union Regulations. Being distinct in their nature and not perfect in implementation they both show that the process of harmonization of bankruptcy laws is far from being easy.

There are many challenges that hinder the creation of unified international bankruptcy legislation. Among them are such essential issues as country differences (political, economic, institutional, etc.) and the protection of national or local interests. Countries usually think that their laws are the best for the case and that they should be used exclusively for the resolution of cross-border insolvency disputes. But application of local regulations in international bankruptcy cases (territorialism approach) has proven to have many problems, such as potentially unequal treatments of creditors situated in different countries, duplicative administrative costs, etc.

Because bankruptcy cases with a cross-border element are more complex in nature, they require a unified approach to make the resolution of such cases more predictable. The single law and single court approach (universalism) is viewed today as a preferred and more influential theory, which has received more attention among scholars. Unfortunately, the process of law harmonization requires strong cooperation between countries, and is prolonged and difficult.

Due to this fact and the problem of protectionism in general, full harmonization of international bankruptcy law, if possible at all, will likely take a very long time. We come to a conclusion that country differences and existing approaches continue to make complete unification of bankruptcy procedures unachievable, at least in the nearest future.

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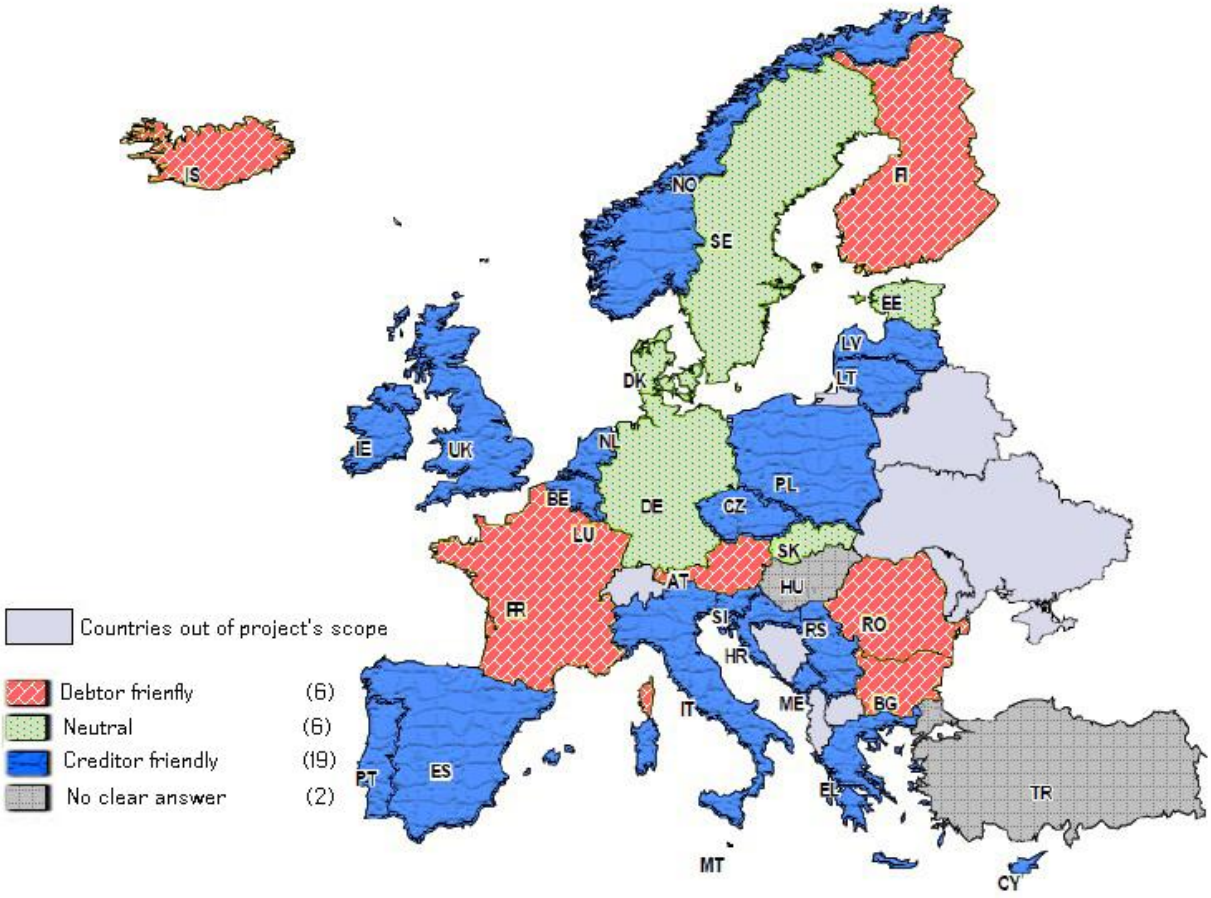
Figure 40 Debtor-friendly/ creditor-friendly courts in Europe



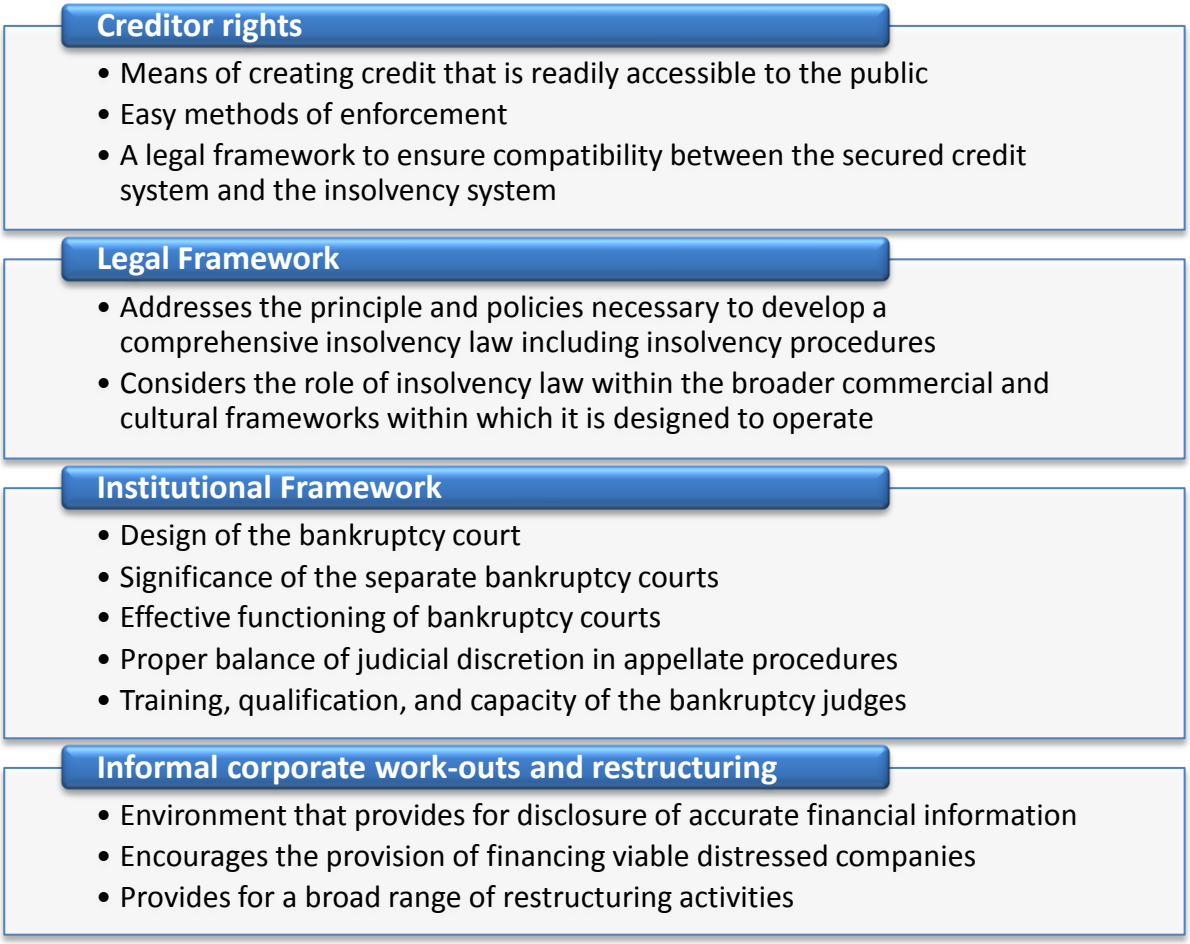
Source: Business Dynamics: Start-ups, Business Transfers and Bankruptcy, 2011: p.129

Table 5 Types of legal systems in Europe

Origin of Bankruptcy Law					
English Common Law	*Civil Law*				*Pluralistic law (elements from Common and Civil Law)*
	French Civil Law	*German Civil Law*	*Scandinavian Civil Law*	*Combined civil law (French and German civil law)*	
Ireland, United Kingdom	Belgium, France, Italy, Luxembourg, Netherlands, Romania, Spain	Austria, Croatia, Czech Republic, Estonia, Germany, Latvia, Montenegro, Serbia, Slovakia, Slovenia, Turkey	Denmark, Finland, Iceland, Norway, Sweden	Bulgaria, Greece, Hungary, Lithuania, Poland, Portugal	Cyprus, Malta

Source: Business Dynamics: Start-ups, Business Transfers and Bankruptcy, 2011: p.117 (based on LaPorta, R., Lopez de-Silanes, F., Shleifer, A., Vishny, R.W., 1996)

Figure 41 Some of the ROSC Benchmarks used to evaluate the strength of insolvency law



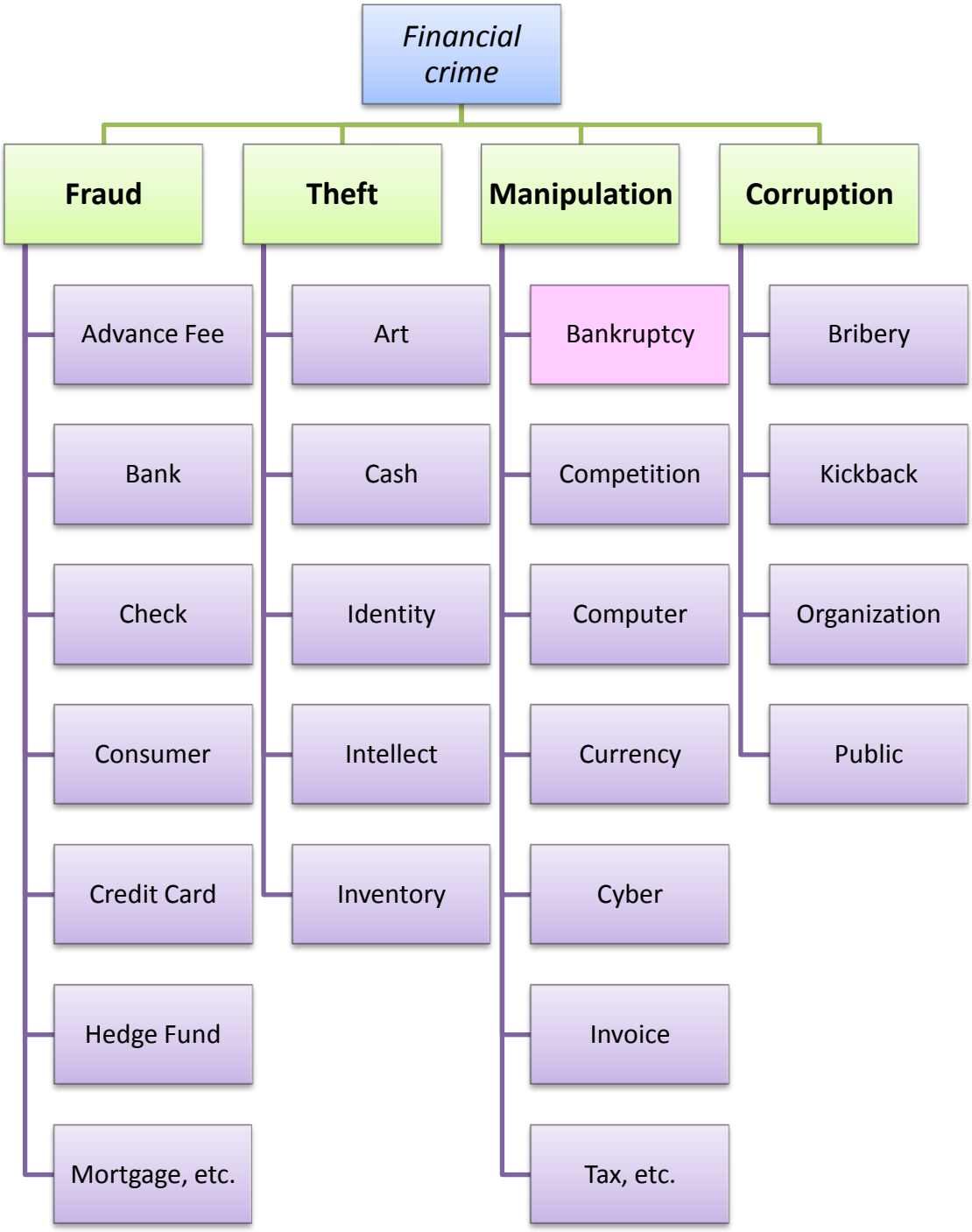
Source: Insolvency ROSC Assessments

Table 6 Adoption of legislation based on the UNCITRAL Model Law

State		Notes
Australia	2008	
Canada	2005	
Colombia	2006	
Eritrea	1998	
Greece	2010	
Japan	2000	
Mauritius	2009	
Mexico	2000	
Montenegro	2002	
New Zealand	2006	
Poland	2003	
Republic of Korea	2006	
Romania	2002	
Serbia	2004	
Slovenia	2007	
South Africa	2000	
Uganda	2011	
United Kingdom of Great Britain and Northern Ireland		
British Virgin Islands	2003	*Overseas territory of the United Kingdom of Great Britain and Northern Ireland*
Great Britain	2006	
United States of America	2005	

Source: UNCITRAL Model Law on the Cross-Border Insolvency

Figure 42 Main categories and subcategories of financial crime



Source: Gottschalk, P, 2010: p.7

Figure 43 Prohibited activities related to bankruptcy

- Concealing property belonging to a debtor from officers of the court or creditors in a bankruptcy case
- Making a false oath or account in relation to a bankruptcy case
- Making a false declaration, certificate, verification or statement under penalty of perjury
- Presenting any false claim for proof against the estate of a debtor, personality, or by agent, proxy, or attorney
- Receiving any material amount of property from a debtor after the filing of a bankruptcy case to defeat bankruptcy law
- Giving, offering, receiving or attempting to obtain any money or property, remuneration, compensation, reward, advantage or promise thereof for acting or forbearing to act in a bankruptcy case
- Transferring or concealing property in a contemplation of a bankruptcy case with intent to defeat bankruptcy law
- Concealing, destroying, mutilating, falsifying or making a false entry in books, documents, records or papers relating to the property of financial affairs of the debtor after the filing of a bankruptcy case
- Withholding any recorded information related to the property or financial affairs of a debtor from an officer of the court entitled to its possession.

Source: Rakoff, J., Goldstein, H., 1989: p. 228

Abstract (English)

The purpose of this paper is to review the existing research on the issues of bankruptcy in order to identify the possibility of achieving an optimal and unified international bankruptcy law that could be used by all countries. Existing legislation and legal regulations which are used to resolve international bankruptcy disputes are usually based on the territoriality principle and are national in their nature. They have proven to be not very efficient in resolving bankruptcies with cross-border element, which involve more complex legal issues. The introduction of a unified international bankruptcy law could provide predictability and efficiency for such cases.

The paper will begin by examining the main theoretical concepts of bankruptcy and summarizing briefly the origin and evolution of bankruptcy legislation in leading countries. The first section deals with the evolution of bankruptcy laws in different countries and factors which have influenced such evolution. Particular focus is made on the fact that many countries are still reforming their regulations in order to make them more efficient. The notion of efficiency is then discussed in section two with a detailed review of different perspectives on bankruptcy procedures and factors that influence its efficiency. The purpose of the third section is to look into the international bankruptcy. It discusses the main approaches to a cross-border insolvency and considers international elements of bankruptcy law. The section three stresses the challenges which arise on the way to a unified international bankruptcy code.

The paper's main conclusion is that country differences and existing approaches make global unification of bankruptcy legislation and procedures not achievable, at least in the nearest future, and that the full unification and harmonization of international bankruptcy legislation is very difficult if possible at all.

Abstract (German)

Der Zweck dieser Arbeit ist es, die schon betriebene Forschung über Insolvenzverfahren zu überprüfen, um festzustellen, ob es möglich ist, ein optimales und einheitliches internationalen Insolvenzrecht, welches von allen Ländern genutzt werden kann, zu etablieren. Bestehende Gesetze und gesetzliche Vorschriften, die verwendet werden, um die internationalen Insolvenzstreitigkeiten beizulegen, basieren in der Regel auf dem Territorialitätsprinzip. Sie haben sich nicht als sehr effektiv im Umgang mit grenzüberschreitenden Insolvenzen erwiesen, weil sie komplexere rechtliche Fragen beinhalten. Die Einführung eines einheitlichen internationalen Insolvenzrechts könnte Berechenbarkeit und Effizienz für solche Fälle bieten.

Die Arbeit beginnt mit der Untersuchung der grundlegenden theoretischen Konzepte der Insolvenz und mit einer kurzen Zusammenfassung über die Entstehung und die Entwicklung des Insolvenzrechts in den führenden Ländern. Das erste Kapitel beschäftigt sich mit der Entwicklung des Insolvenzrechts in verschiedenen Ländern und mit Faktoren, die diese Entwicklung beeinflusst haben. Besonders betont wird die Tatsache, dass viele Länder immer noch die Reformen ihrer Gesetze durchführen, um sie effektiver zu machen. Das Konzept der Effizienz wird in Kapitel zwei diskutiert. Eine detaillierte Übersicht über die unterschiedlichen Perspektiven auf Insolvenzverfahren und Faktoren, die die Effizienz beeinflussen, wird ebenfalls im Kapitel zwei dargestellt. Der Zweck des dritten Kapitels ist eine Überprüfung der internationalen Insolvenz. Es werden die wichtigsten Ansätze für eine grenzüberschreitende Insolvenz und internationale Elemente des Insolvenzrechts diskutiert. Kapitel drei unterstreicht die Herausforderungen, die auf dem Weg zu einem einheitlichen internationalen Insolvenzrecht entstehen.

Die wichtigste Schlussfolgerung aus dieser Arbeit ist, dass die globale Vereinheitlichung von Rechtsvorschriften und Verfahren des Insolvenzrechts, zumindest in der nächsten Zukunft, nicht erreichbar ist. Die bestehende Ansätze und die Unterschiede zwischen den Ländern machen die vollständige Vereinheitlichung und Harmonisierung des internationalen Insolvenzrechts sehr kompliziert, wenn überhaupt möglich.

Curriculum Vitae

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