Issue No. 9 | March – April 2016

Reform of the insolvency law: A priority for economic policy

A modern insolvency law is a vital ingredient of a good business environment. Georgia's 2007 insolvency law is far away from international best practice and constitutes a weak spot of the generally very good business environment in Georgia. The law focuses on the liquidation rather than the rehabilitation of insolvent companies. Furthermore, the National Enforcement Bureau (NEB) handles all insolvency procedures as a trustee. Also, instead of private insolvency office holders, the NEB often acts as the bankruptcy and rehabilitation manager.

As a result, in Georgia only few insolvency cases are officially registered and instead there are many firms being stripped of their assets by creditors in an unsystematic fashion, leading to risks for investors and creditors alike. The importance of improving the business environment in this key dimension has recently been acknowledged by PM Kvirikashvili at the Investors Council. To this end, Georgia will need a fundamental reform, no incremental amendments of the present law, for which the technical advice provided by several donor-funded projects, including the GIZ and USAID, should be used.

Focus should be on rehabilitation

A reliable and fair insolvency procedure is as vital to the business environment of a country as is a non-bureaucratic and rapid procedure to start up a company. If a debtor becomes unable to fulfil his payment obligations, the remaining assets must be distributed to the creditors in a fair, transparent and predictable procedure. But reorganisation and saving of viable businesses and maintaining jobs should also have a high priority in insolvency proceedings. Attracting new investment and new financing after the commencement of an insolvency procedure for the continuation of the debtor's business activities often has much stronger and more positive economic effects than the liquidation of an insolvent company and the distribution of its remaining assets amongst creditors.

Georgia's business environment

Since the bold reform and deregulation campaign in the early 2000s, Georgia has consistently ranked very highly in international analyses of the business environment. In the 2016 edition of the World Bank's "Doing Business" report, Georgia overall ranks 24th out of 189 countries. However, it only ranks 101st in "resolving insolvency", Georgia's worst rank across any of the 11 areas under consideration in the ranking.

Current insolvency law

The current insolvency law was introduced in 2007, replacing a predecessor law from 1996. The law serves the objective of equally protecting the rights of the debtors and the creditors. A key feature of the law, apart from its relative brevity and resultant lack of clarity on several aspects of regulation and proceedings, is its focus on the liquidation rather than the rehabilitation of insolvent companies.

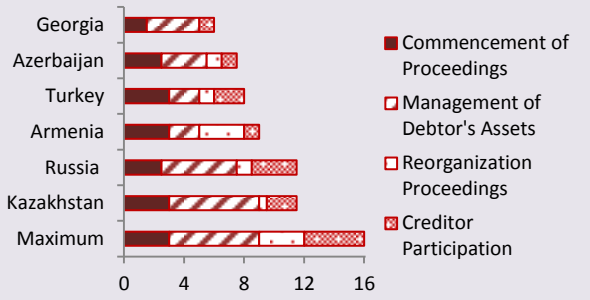
The law differentiates between bankruptcy and insolvency proceedings. Whereas the bankruptcy proceeding is aimed at complete settlement of creditors' claims, the insolvency proceeding can lead either to a bankruptcy proceeding or to a rehabilitation proceeding depending on the decision of a Conciliation Council, a body formed by one representative of the debtor, one of the creditors and one by agreement between the two parties. The formation and authorisation of a Conciliation Council is a peculiarity of the Georgian Insolvency Law. However, in both cases the ordinary procedure as foreseen by the Insolvency Law is the sale of the debtor's property through auctions with the aim of a full settlement (bankruptcy case) or a partial settlement (insolvency case) of creditors' claims. Rehabilitation is the exception and requires a respective decision of the Conciliation Council. This shows that the Insolvency Law is clearly focused rather on the liquidation of the debtor than on its rehabilitation.

The National Enforcement Bureau (NEB) acts as mandatory trustee and is responsible for all auctions of the debtors' property in any case of insolvency or bankruptcy. Bankruptcy and rehabilitation managers are to be appointed by the creditors, but in the case of disagreement, the NEB is appointed as bankruptcy manager by court decision. The mandatory fees for the NEB's involvement are the most senior tranche among all claims in the proceedings.

International best practice

There are two key aspects, in which the Georgian framework fails to conform to international best practice: firstly, the focus on liquidation of insolvent companies and secondly, the absence of an established profession of private insolvency office holders (with the NEB instead usually taking on major aspects of this role). In the "Doing Business" ranking of the World Bank, this is reflected in very low scores for "reorganisation proceedings" and "creditor participation".

Doing Business: Strength of insolvency framework (scores)



Source: The World Bank, Doing Business Report 2016

Although the current insolvency law states – though in stark contrast from normal practice – the objective of equally protecting the rights of debtors and creditors, the rights of creditors are not sufficiently sharpened. A focus on company rehabilitation could allow for a focus on creditor rights and maximising the recovery of creditor assets. Hence, a focus on the liquidation of insolvent companies creates the risk of not maximising the recovery value of assets for creditors. Many decisions, such as the sale of assets through auction by the NEB, do not require the consent of creditors.

Negative consequences of the current system

One consequence of the current system is a strikingly low number of registered insolvency cases. Only 30-50 cases are open per year in the courts of Tbilisi and Kutaisi, considerably less than one should expect for a country of Georgia´s size. The focus on liquidation may deter filing for insolvency by companies in distress. Correspondingly, it is probable that a significant amount of assets is stripped of the insolvent companies by those creditors with superior leverage and information, which occurs outside the legal framework creating major risks for creditors.

The economic consequences of a sub-optimal insolvency framework are well documented. Firstly, an inadequate insolvency framework can lead to unnecessary loss of economic substance. Secondly, stability and quality of the legal environment are decisive factors for foreign investors when considering possible locations for their direct investments. Finally, risks in resolving insolvencies drive up interest rates for corporate loans, which in part may explain the high credit costs in Georgia.

The shortcomings of the current framework have been registered in the Georgian policy debate. In a recent meeting of the Prime Minister Kvirikashvili with the Investors Council, reforming the insolvency law was highlighted as an economic policy priority. However, an amendment of the current law will at best constitute a marginal improvement but fails to address the major weaknesses of the current system.

Conclusion

A fundamental reform is necessary to improve Georgia's insolvency law. This includes a shift of the focus towards rehabilitation away from liquidation, a sharpening of creditor rights and a better organisation of insolvency proceedings, which should entail less influence of the NEB and re-definition of the role and the strengthening of the capacities and qualifications of insolvency office holders. Such a reform does not need to start from a blank page. Several donor-financed projects, most notably the GIZ programme "Legal and Judicial Reforms in the South Caucasus" and the USAID-funded G4G (Governing for Growth in Georgia) project have already produced detailed analyses and recommendations geared specifically at the Georgian situation. Taking on board the advice by these programmes will allow a significant speed-up of the much necessary reform of the Georgian insolvency framework.

Authors

David Saha, saha@berlin-economics.com
Hans Janus, office@hansjanus.eu

Note: A more comprehensive analysis of the topic is provided in the Policy Paper PP/01/2016 – "Avoiding the insolvency of Georgia`s Insolvency Law", available at www.get-georgia.de

German Economic Team Georgia (GET Georgia)
GET Georgia advises the Georgian government on a wide range of economic policy issues since 2014. It is financed by the German Federal Ministry for Economic Affairs and Energy.

Editors
Dr Ricardo Giucci, David Saha

Contact
German Economic Team Georgia
c/o Berlin Economics
Schillerstraße 59
D-10627 Berlin
Tel: +49 30 / 20 61 34 64 0
Fax: +49 30 / 20 61 34 64 9
info@get-georgien.de
www.get-georgia.de