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# Avoiding the insolvency of Georgia`s Insolvency Law

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## About the German Economic Team Georgia

The German Economic Team Georgia (GET Georgia) advises the Georgian government and other Georgian state authorities such as the National Bank on a wide range of economic policy issues. Our analytical work is presented and discussed during regular meetings with high-level decision makers. GET Georgia is financed by the German Federal Ministry for Economic Affairs and Energy. Our publications are publicly available at our website (www.get-georgia.de).


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**Executive Summary**
Georgia's Insolvency law of 2007 is primarily oriented towards a rapid liquidation of insolvent corporate entities and private entrepreneurs' businesses with subsequent distribution of remaining assets amongst the creditors. The number of insolvency cases dealt with by the local courts of Tbilisi and Kutaisi is fairly limited most probably due to insufficient assets in the insolvent entities to cover the costs of the insolvency procedure. The law is relatively short and leaves relevant aspects of insolvency procedures either unclear or unregulated. Areas with significant shortcomings and deficiencies are e.g. regulations on avoidance of transactions concluded prior to insolvency, the monopolistic position of the National Enforcement Bureau as trustee, the Conciliation Council, the rehabilitation procedure, the role and function of Insolvency Office Holders, the ranking of claims in the distribution process etc.

The 2007 Insolvency Law is far away from what has emerged internationally as "best practice" for insolvency frameworks. This is clearly documented in the very bad position Georgia has received within the World Bank's Doing Business Index 2016, sub-indicator Resolving Insolvency, where Georgia is ranked 101 out of 189 countries. European Bank for Reconstruction and Development's assessment of Insolvency Office Holders' regulation also shows Georgia on position 25 out of 27, far behind all neighbouring countries. Smaller amendments of the 2007 law will not be sufficient to significantly change these poor results.

Profound economic research of the last decade demonstrates that a poor insolvency law framework has a clear negative impact on a country's economic development. The effects are manifold. The largest impact is attributed to the possibility of continuation of business activities. This requires a clear change of the insolvency law's objective: From liquidation and asset distribution to business continuation where ever possible. This gives failing entities and entrepreneurs the "second chance" for a "fresh start". Growing self-confidence and growing entrepreneurial dynamic are consequences as well as positive influence on economic activity and GDP growth. A predictable rescue and rehabilitation framework also helps making new credit available and lowers financing costs. The banking sector as a whole can benefit from growing stability in the corporate business sector and reduced downward pressure from valuation adjustments in the loan book.

Georgia needs another Insolvency Law. Slight amendments will not be sufficient. Either the law is substantially redrafted or it is completely made new. Not less important is a completely changed approach towards objectives and procedures, roles and responsibilities of insolvency law

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# I. Introduction

A reliable and fair insolvency procedure is not less important for the functioning of a market economy than an unbureaucratic and rapid procedure to start up a company. A modern insolvency law usually serves a variety of objectives. If the debtor is unable to fulfil his payment obligations the remaining assets must be distributed in a fair, transparent and predictable procedure to the creditors. Reorganization and saving of viable businesses and maintaining jobs should also have a high priority in insolvency proceedings. Attracting new investment and new financing after commencement of the insolvency procedure for a continuation of the debtor's business activities often has much stronger and more positive economic effects than the liquidation of an insolvent company and distribution of its remaining assets amongst creditors.

Insolvency law has become a very political subject in recent years. Many countries in the world have modernized their insolvency law regimes. The reason for this is the clear link between a business friendly insolvency framework and the fostering of private entrepreneurship. The economic impact of insolvency law on business continuity and even more profoundly on self-employment and entrepreneurship in general is scientifically proven. Georgia's insolvency regime at present seems to constitute a weakness in the country's business environment that is generally very highly regarded. In the World Bank's 2016 *Doing Business* index, Georgia overall ranks 24th, a very strong position compared to its neighbours in the region. However, in the indicator *Resolving Insolvency*¸ Georgia only ranks 101st, indicating that reform in this field is strongly required. The insolvency of Georgia's insolvency law needs to be avoided.

In this Policy Paper, the German Economic Team (GET) Georgia presents an analysis of the Georgian Insolvency Law with a specific focus on identifying shortcomings of the current legislation and making recommendations for reforms. It is not the intention of this paper to provide proposals for the detailed writing of an amended or new Insolvency Law for Georgia. We make recommendations on how to modernize the insolvency legislation with the aim to improve the stability of the corporate sector, to strengthen the legal environment and make Georgia more attractive for foreign direct investment. These recommendations should also effect a significant improvement of Georgia's ranking in the World Bank's "Doing Business" index on the indicator "*Resolving Insolvency*".

This paper first highlights in chapter 2 that a drastic increase in insolvency cases is expected in emerging markets in the coming years that may have knock-on effects on Georgia. We analyse the current Georgian insolvency law in chapter 3 and compare it against international best practices in insolvency law worldwide in chapter 4, carefully considering important international organisations and their work on setting standards for modern insolvency legislation. A specific contribution of this paper is to highlight the economic impacts of insolvency procedures and their legal framework on economic growth, self-employment, entrepreneurship and availability and costs of credit for the enterprise sector in chapter 5. In chapter 6, we discuss the consequences from Georgia's EU association for insolvency law. Chapter 7 summarises our recommendations.

## II. Global Trends in Insolvencies

For Georgia, no comprehensive official statistical information on numbers and volumes of insolvency procedures could be obtained. Some information has been made available by the Tbilisi City Court statistical department to the team of USAID for their report on Georgia's insolvency law. The statistical analysis in the USAID Report from June 2015 indicates that the number of open insolvency cases in the Tbilisi and Kutaisi city courts of Georgia has been in the range between 30 and 50 cases per year in the last five years[1]. Of newly filed insolvency cases, the vast majority (ca. 75 %) is usually being rejected, mostly because the debtor's assets are insufficient to cover the costs of the insolvency proceedings. The average duration of cases which were closed in the last years increased significantly and peaked in 2013 with an average duration of 3.6 years. 2014 showed a decrease to 2.25 years. Overall it must be stressed that statistical data on insolvency proceedings in Georgia is difficult to obtain and insufficient for a quantitative and qualitative analysis.

Global trends of insolvency developments are regularly analysed and published by various organizations and companies. On a national level the statistical authorities usually publish information about insolvency proceedings[2]. Such data are available for ca. 50 countries of the world. Georgia does not belong to these countries as mentioned above.

The most reliable sources of statistical information on insolvency developments and of forecasts for the possible future developments of insolvencies are the large credit insurance companies, most notably Euler Hermes Group of France with their subsidiaries and representative offices in more than 50 countries in the world. The most recent economic research paper on Global Business Insolvencies Worldwide has been published by Euler Hermes under the title "The insolvency U-turn" in autumn 2015[3].

Euler Hermes predicts for 2016 an unprecedented increase in bankruptcies for emerging markets[4]. The reasons for this abrupt U-turn after six years with decreasing numbers of insolvencies since the global financial crisis are manifold: High corporate debt levels, worsening companies' payment behaviour, credit crunch and low economic growth in major industrialized countries are only a few of the major reasons. The predicted increase also affects some of Georgia's major export markets, e.g. Bulgaria + 10%, Turkey + 6%, Russia + 4% and China + 20%[5].

Increasing numbers of insolvencies in countries with close economic relations with Georgia may also become a risk for Georgian trading partners because they might trigger knock-on effects for companies located in Georgia.

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[1] USAID Report "Assessment of the insolvency System in Georgia". Governing for Growth (G4G) in Georgia, p. 13 and Appendix C: Statistical Information on all open proceedings provided by NBE, p. 39-43. http://pdf.usaid.gov/pdf_docs/PA00KJJB.pdf

[2] In Germany in 2011 a specific Law on Insolvency Statistics has been made as part of a broader legislative package for rescue and restructuring of corporate entities, see "Gesetz über die Insolvenzstatistik" (InsStatG), BGBl. I 2011, p. 2582.

[3] Euler Hermes, Economic Outlook No. 1220-1221, September-October 2015.

[4] Euler Hermes, Economic Outlook No. 1220-1221, September-October 2015.

[5] National Statistics Office of Georgia shows as top six export markets in 2015 the following countries: Azerbaijan, Bulgaria, Turkey, Armenia, Russia and China. See Geostat: External Trade of Georgia in 2015 (Preliminary), published 20.01.2016. For Azerbaijan and Armenia insolvency forecasts for 2016 are not available.

## III. Current Georgian Insolvency Law

### 1. The 2007 Law of Georgia on Insolvency Proceedings

The current "Law of Georgia on Insolvency Proceedings" (Insolvency Law)[6] has replaced two preceding laws of 1992[7] and 1996[8]. The 1996 insolvency law followed more or less the German insolvency law patterns and in particular the Insolvency Law for Eastern Germany of 1990[9]. Later substantial reforms in German Insolvency Law have not been reflected in the Georgian Insolvency Law. The law of 1996 was much more focused on rehabilitation than on liquidation. In Article 1 of the law there was even stated that liquidation could be done only after a rehabilitation attempt had failed[10]. In this respect the 1996 law has been more modern than its succeeding legal act. One of the major weaknesses of the 1996 Insolvency Law was the long duration of the court proceedings. This should be changed with the insolvency law reform of 2007. The 2007 Insolvency Law of Georgia is a completely different law. Despite the fact that several amendments to the Insolvency Law have been made since its coming into force there is a vast amount of criticism concerning the quality of the law[11].

### 2. The Criminal Code of Georgia

The Criminal Code of Georgia[12] contains in Articles 205-207.1 provisions regulating cases of Unlawful actions in case of insolvency (Art. 205), Concealment of property using fraudulent and/or sham agreements (Art. 205.1), Breach of the procedure for books of account in the case of insolvency (Art. 206), Failure to file an application for initiating of insolvency proceedings in the case of insolvency (Art. 207), Non-performance of the person responsible for the management and representation of the debtor of the obligation to provide information to the trustee (Art. 207.1).

### 3. Short characteristic of Georgian 2007 Insolvency Law

The Insolvency Law serves the objective to "equally protect the rights of the debtor and of the creditor(s)" (Art. 1). The law applies for the Insolvency of commercial entities / companies, non-commercial legal entities, unregistered unions and co-partnerships and individual entrepreneurs. The Law does not apply to physical persons, legal entities of public law, banks, non-banking deposit institutions and insurance companies, whose insolvency issues are regulated by specific laws[13]. Georgia has not (yet) introduced an insolvency procedure for physical persons (consumers).

Certain actions carried out prior to filing insolvency are deemed "harmful" to creditors (Art. 35). This is the case if such actions took place six months before filing insolvency and either prevent equal and

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[6] Law of Georgia on Insolvency Proceedings, Parliament of Georgia, 28th of March 2007, (No. 4522).
[7] Decree of the State Council of Georgia of 08.09.1992.
[8] Law on Bankruptcy. Parliament of Georgia, 25.06.1996 (No. 286).
[9] Gesamtvollstreckungsordnung (GesO) dated 06.06.1990, BGBl 1991 I, p. 1186; Falke, Zum Stand des georgischen Konkursverfahrensgesetzes, WiRO 2005, p. 43.; Chanturia in: Knieper/Chanturia/Schramm, Das Privatrecht im Kaukasus und in Zentralasien, 2010, p.203. Although this book has been published only in 2010, the statements of Chanturia refer to the 1996 insolvency law of Georgia; Thieme, Reform und Transformation des Insolvenzrechts, 1996, p. 303; USAID Report "Assessment of the insolvency System in Georgia". Governing for Growth (G4G) in Georgia, p. 18.
[10] This has been changed in 2001, Falke, Zum Stand des georgischen Konkursverfahrensrechts, WiRO 2005, p. 43.
[11] Very detailed comments can be found in USAID: Assessment of the Insolvency System in Georgia, 2015, p. 21-34 and in Onusseit/Schnitger, Memorandum zur Reform des georgischen Insolvenzrechts, p. 10-15.
[12] Criminal Code of Georgia, Parliament of Georgia 22.07.1999 (No. 2287).
[13] For insolvencies of banks and non-banking deposit institutions see the law of Georgia on "Commercial Bank Activities", Art. 32 and 37 and Organic Law of Georgia on "National Bank of Georgia", Art. 49. See Ioseliani, Aspects of Bank Insolvency, https://www.nbg.gov.ge/uploads/discussion/aspects_of_bank_insolvency.pdf. For Insurance companies see Law of Georgia on "Insurance", Art. 33.1. – 33.5.

proportionate satisfaction of creditors or grant privilege to a specific creditor. The same applies to actions which result in a depreciation of trusted property. If the person benefitting of such actions is related to the debtor or debtor's relatives the deadline is 12 months.

The reason for opening insolvency proceedings is insolvency or expected insolvency of the debtor (Art. 13). The exclusive jurisdiction in the first court instance lies with the City Courts of Tbilisi and Kutaisi (Art. 4 par. 2). Authorized to file an insolvency application are the debtor and public law entities with overdue claims of a magnitude of no less than 50,000 GEL. Private creditors may file for insolvency only under quite restrictive conditions when representing high claims and/or jointly as groups of two or three creditors (Art. 14).

The law differentiates between bankruptcy and insolvency proceedings. Whereas the bankruptcy proceeding is aimed at complete satisfaction of creditors' claims (Art. 3 lit. s, Art. 17 par. 1 and Art. 36 par. 2) the insolvency proceeding can lead either to a bankruptcy proceeding or to a rehabilitation proceeding depending on the decision of a Conciliation Council (Art. 33 par. 3). The Conciliation Council is a body formed by one representative of the debtor, one of the creditors and one by agreement between the two others. This important body is a particularity of Georgian Insolvency Law.

The sale of the debtor's property through auction(s) and the distribution of the receivables amongst the creditors with the aim of a full satisfaction (bankruptcy case) or a partial satisfaction (insolvency case) of creditors' claims is foreseen in the Insolvency Law as the ordinary procedure (Art. 38). Rehabilitation is the exception and requires a respective decision of the Conciliation Council. This shows that the Insolvency Law is clearly focused on the liquidation of the debtor rather than on its rehabilitation.

After opening of an insolvency procedure the "stay" of individual enforcement actions against the estate is established (Art. 21 par. 2 lit. c) and a trustee is appointed. In bankruptcy procedures a bankruptcy manager needs to be appointed (Art. 17 par. 1). In insolvency proceedings the trustee assumes control over the management and representation of the debtor (Art. 26 par. 2 lit. a). The National Enforcement Bureau (NEB) acts as mandatory trustee and is responsible for all auctions of debtors' property in insolvency and bankruptcy cases. In rehabilitation cases a rehabilitation manager needs to be appointed by the creditors (Art. 44 par. 2).

## IV. International "best practice" in insolvency law

Internationally many initiatives have been undertaken in order to harmonize national insolvency laws and to let international best practices for insolvency laws emerge. Major players and major sources for insolvency law best practices have been the World Bank with its "Principle Guidelines for Effective Insolvency and Creditor Rights Systems" of 2001[14], the International Monetary Fund with its Legal Department's research report "Orderly & Effective Insolvency Procedures" of 1999[15] and the UNCITRAL with its "Legislative Guide on Insolvency Laws" Parts 1&2 of 2005[16], Part 3 of 2011[17] and Part 4 of 2013[18]. The most recent document is the EU Commission's Recommendation of 12.03.2014 on a new approach to business failure and insolvency. This clearly demonstrates how internationally coordinated and harmonized the activities to introduce best practice based insolvency laws have become.

### 1. The World Bank's "Doing Business Index"

The current rank of Georgia in the Doing Business Index 2016 is 24, with no change compared to the year before. This is a fairly strong position compared to Georgia's neighbouring countries. The strongest individual rankings have been achieved for *Registering Property* (3), *Starting a Business* (6) and *Getting Credit* (7).

Time, cost and outcome of insolvency procedures as well as the strength of the insolvency framework are essential indicators within the World Bank's Doing Business Index. The current Index is based on figures for June 2015. There have been several changes in methodology in 2016, but none of those affecting the indicator *Resolving Insolvency.*[19]

By far the worst ranking for Georgia has been attributed to the indicator *Resolving Insolvency* (101). This is a slight improvement compared with 2015 (105), but no legislative changes or procedural adjustments have been reported. The positive change therefore is probably only attributable to changes for other countries which led indirectly to the respective upgrade of Georgia. Except Turkey (124) all neighbouring countries are positioned significantly better than Georgia[20].

The ranking for the indicator *Resolving Insolvency* is based on two elements with equal value of 50% each. These elements are the Recovery Rate and the Strength of insolvency framework index.

Whereas the ease of doing business ranking in general and for the individual indicators, e.g. *Resolving Insolvency,* as such only compare economies with one another, an additional measurement labelled *Distance to Frontier* score has to be taken into consideration as well. This measurement benchmarks economies with respect to regulatory best practice, showing the absolute distance to the best performance on each Doing Business indicator[21]. The score for *Distance to Frontier* for Georgia in the field of *Resolving Insolvency* is 40.24 % with Finland scoring 93.81 % as frontrunner

[14] http://www.worldbank.org/ifa/ipg_eng.pdf.
[15] http://www.imf.org/external/pubs/ft/orderly/index.htm
[16] https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf
[17] https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf
[18] https://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf
[19] See www.doingbusiness.org/methodology/methodology-note.
[20] See Annex 1.
[21] These scores are the simple average of the distance to frontier scores for the recovery rate and the strength of insolvency framework index.

worldwide[22]. Similar to the *Distance to Frontier* measurement of the World Bank is the *Compliance score for the general insolvency law* measured by EBRD in their 2009 Insolvency Law Assessment Project. Georgia reached in the EBRD Report a compliance score of 63 percent[23] which is characterized as low compliance and falls into the last but one category[24].

a) The Indicator Recovery Rate

The recovery rate is a function of the time, cost and outcome of insolvency proceedings involving domestic legal entities. It is assumed that the creditor is a secured creditor.

The recovery rate for Georgia is 39.9 (cents on the dollar). This is slightly better than the recovery rates reported for Armenia and Azerbaijan. The highest score worldwide (frontier) has been achieved by Japan with 92.9. It has to be taken into consideration, however, that these assessments are based on qualitative judgements of Georgian experts on a theoretical insolvency model case used for all countries worldwide[25]. Reality may deviate from such a model case result in Georgia and in any other country of the world.

b) The Indicator Strength of Insolvency Framework

The Strength of Insolvency Framework indicator analyses adequacy and integrity of the legal framework in place for liquidation or reorganization of legal entities. The four categories analysed are: Commencement of proceedings index (0-3 points), Management of debtor's assets index (0-6 points), Reorganization proceedings index (0-3 points) and Creditor participation index (0-3 points). The maximum score achievable for a country is 16 points. The result for Georgia is 6 points.

c) The major weaknesses of Georgian Insolvency Law leading to the low score of 6.0

The World Bank has based the low score of 6.0 concerning the *Strength of Insolvency Framework* in Georgia on the following findings:

- Commencement of proceedings index (maximum possible score: 3.0; Georgia score 1.5)
  - Debtor may file for liquidation only (score 0.5)

*In principle the debtor is entitled to file for insolvency (Art. 14). This application can be specified as filing for bankruptcy (Art. 17) which in legal terms is more a liquidation than an insolvency procedure (Art. 3 par.1 lit. s). Whether the debtor also can file for rehabilitation or whether rehabilitation procedure can only be initiated by creditor(s) after decision of Conciliation Council (Art. 43) is unclear.*

  - Can a creditor file for insolvency? (score 0.0)

*A single creditor or a group of creditors can file for insolvency only if certain additional requirements are met (Art. 14). These restrictions led to a N/A judgement which implies a score of 0.0.*

  - Basis for commencement of insolvency proceedings (score 1.0)

*Basis for commencement of the insolvency procedure is the inability to satisfy creditor's claim or the expected insolvency (Art. 14, Art. 3 par. 1 lit. a).*

- Management of debtor's assets index (maximum possible score: 6.0; Georgia score 3.5)

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[22] See Annex 1; Doing Business 2016, Measuring Regulatory Quality and Efficiency. Economic Profile 2016. Georgia, p. 85; Doing Business 2016, Distance to frontier and ease of doing business ranking, p. 163.

[23] http://www.ebrd.com/downloads/legal/insolvency/georg_ia.pdf

[24] See Annex 3. In another assessment of the insolvency framework's quality published in 2014 EBRD shows a slightly different result. Whereas 6 out of 11 Georgian respondents regard insolvency proceedings as not important, 8 out of 11 agree that they facilitate restructuring as a going concern and 6 out of 11 confirm that insolvency proceedings are mostly liquidation focused, see EBRD: Assessment of Insolvency Office Holders, p. 28

[25] For details see www.doingbusiness.org/methodology/resolving-insolvency.

- The continuation of contracts supplying essential goods and services to the debtor is not foreseen (score 0.0).

*The Insolvency Law contains no specific provisions on this subject. Supply contracts can be newly concluded (Art. 21 par. 2 lit. e) and are treated as second rank insolvency claims (Art. 40 par. 1 lit. b).*

- Rejection of overly burdensome contracts by the debtor is possible (score 1.0).

*If the transaction is characterized as "harmful," Art. 35 par. 1 applies.*

- Avoidance of preferential transactions is possible (score 1.0).

*Art. 35 par. 1 lit. a) is applicable.*

- Avoidance of undervalued transactions is not possible (score 0.0).

*The World Bank's assessment assumes that Art. 35 par. 1 lit a) is not applicable. This may be doubted.*

- Post commencement financing for the debtor available (score 1.0).

*This is not clearly stated in the law. Provisions on the bankruptcy manager (Art. 37 par. 1) and the rehabilitation manager (Art. 44 par. 4 and 4.1.) indicate however, that post commencement finance is possible. Such claims are, however, not ranked better than second rank insolvency claims (Art. 40 par. 1 lit. b).*

- Priority assigned to post commencement credit (score 0.5).

*There are no clear provisions on this topic in the Insolvency Law. According to Art. 40 par. 1 lit. b) such claims are ranked higher than secured and ordinary unsecured insolvency claims.*

- Reorganization proceedings index (maximum possible score: 3.0; Georgia score 0.0)
  - Creditors' vote on reorganization plan (score 0.0).

*The reorganization plan needs the approval of the Conciliation Council and is voted upon by secured creditors only (Art. 47).*

- Dissenting creditors' rights (score 0.0).

*The Insolvency Law does not stipulate that dissenting creditors in reorganization procedures receive no less than in liquidation.*

- Grouping of creditors into classes and equal treatment (score 0.0).

*Neither do all classes of creditors vote on the reorganization plan nor is equal treatment of all creditors of the same class guaranteed (Art. 47).*

- Creditor participation index (maximum possible score: 4.0; Georgia score 1.0).
  - Selection or appointment of insolvency representative with approval of creditors? (Score 1.0).

*Creditors approve bankruptcy and rehabilitation manager (Art. 37, 44).*

- Sale of substantial assets with approval of creditors? (Score 0.0).

*No approval of creditors required. Assets are sold via auction by NBE. Only if in two consecutive auctions the asset could not be sold it is given in kind to creditors (Art. 38).*

- Right of creditors to request information from the insolvency representative (Score 0.0).

*Creditors appoint bankruptcy or rehabilitation manager, but they have no clearly stated right to request information (Art. 37, 44).*

- Right to object to decisions accepting or rejecting creditor's claims (Score 0.0).

*Creditors cannot object to the court's decision on accepting or rejecting a creditor's claim (Art. 29).*

The World Bank's Doing Business Assessment of Georgia's insolvency framework is not a unilateral statement made by World Bank staff. The data used are derived from questionnaire responses by

local insolvency practitioners and verified through a study of legal acts and other publicly available information. Seven Georgian contributors have delivered their views for World Bank's assessment of the insolvency framework in the country[26], amongst them Law Firms, the NEB and others.

Summing up the Doing Business 2016 assessment one has to consider that the most severe weaknesses are seen by World Bank in the reorganization proceedings and in the creditor participation. It may be assumed that this is a consequence of Art. 1 of the Insolvency Law which stipulates that the "purpose of the law is to equally protect the rights of a debtor and of a creditor". Such equalization is internationally extremely unusual and needs to be reflected again. In recent years more and more attention is paid to the rescue of viable businesses. The conviction that financially distressed but economically viable companies deserve to be rehabilitated instead of being liquidated is universally shared. Georgian Insolvency Law has not (yet) followed this direction. The reorganization proceedings need to be strengthened and creditors' rights sharpened.

## 2. EBRD's assessment of Insolvency Office Holder (IOH) profession

The Insolvency Law knows various responsible functions for the carrying out of an orderly insolvency procedure. These are the Trustee (Art. 26), the Bankruptcy Manager (Art. 37) and the Rehabilitation Manager (Art. 44). The trustee always is the National Enforcement Bureau (NEB). The bankruptcy and rehabilitation managers shall be appointed by the creditors. If creditors do not appoint or fail to nominate a bankruptcy manager the NEB is appointed by court decision. The appointment of the rehabilitation manager needs court approval. In the language of EBRD trustee, bankruptcy and rehabilitation managers are qualified as Insolvency Office Holders (IOH).

EBRD has assessed the legal and professional framework for IOH's in 27 countries of the bank's operations during 2012 – 2014. The Scoring has been based on 7 Benchmarks with 1 – 6 key indicators respectively. A high score (theoretical maximum is 100 percent) is intended to signal the existence of a "comprehensive" regulatory and/or professional framework. It is not intended to imply that the framework functions perfectly or is perfectly regulated in practice[27]. The seven benchmarks analysed are:

Benchmark 1: A licensed or registered profession;
Benchmark 2: Effective continuing regulation, supervision and discipline;
Benchmark 3: Adequate qualification, training, standing;
Benchmark 4: An effective appointment process;
Benchmark 5: Compliance with codes of professional conduct;
Benchmark 6: Sufficient legal powers and duties;
Benchmark 7: Appropriate basis for remuneration.

Georgia's overall result was 48 % which placed the country on position 25 out of 27 countries leaving only Egypt and Morocco behind[28]. For further details see Annex 4.

[26] http://www.doingbusiness.org/contributors/doing-business/georgia.
[27] EBRD: Assessment of Insolvency Office Holders. Review of the profession in the EBRD region, 2014.
[28] EBRD: Assessment of Insolvency Office Holders. Review of the profession in the EBRD region, p. 18.

### 3. Generally accepted major features of best practice in insolvency law

Every country is unique and the insolvency law must fit to the specific situation of that country. Insolvency laws are, however, not exempt from general, sometimes global economic trends and legal or economic strategies. The frequency of changes of insolvency laws has enormously increased over the past decades[29]. Especially after the global financial crisis many countries have introduced new or significantly amended insolvency laws. A particular need emerged for more specific and detailed insolvency procedures for banks and other financial institutions. But also regular insolvency procedures needed new approaches in many countries.

Important strategic decisions have to be made by lawmakers. Most importantly the overarching objectives of an insolvency law need to be fixed. Various international organizations have done important work on defining objectives and key elements of modern insolvency laws. These papers can help to find a good approach for modernizing the insolvency law. In the first instance the work of UNCITRAL is to be mentioned here. UNCITRAL quotes the following basic objectives of a modern insolvency law[30]:

1. Provision of certainty in the market to promote economic stability and growth;
2. Maximization of value of assets;
3. Striking a balance between liquidation and reorganization;
4. Ensuring equitable treatment of similarly situated creditors;
5. Provision for timely, efficient and impartial resolution of insolvency;
6. Preservation of the insolvency estate to allow equitable distribution to creditors;
7. Ensuring a transparent and predictable insolvency law that contains incentives for gathering and dispensing information;
8. Recognition of existing creditor rights and establishment of clear rules for ranking of priority claims;
9. Establishment of a framework for cross-border insolvency.

Crystallized in nearly 200 recommendations UNCITRAL elaborates not only on key objectives but also on core provisions of an effective and efficient insolvency law. But the creativeness of lawmakers in many countries of the world has already gone beyond UNCITRAL's propositions. New types of insolvency procedures have been developed and play a growing role in the economic and legal management of insolvency cases in many countries. Self-managed insolvency procedures and procedures with reduced court involvement belong to these new approaches as well as consumer insolvency procedures with debt discharge after a certain period of demonstrated discipline.

A very recent document issued by the Commission of the European Union strongly reflects the new approaches for insolvency law making. In the Commission Recommendations of 12.03.2014 "On a new approach to business failure and insolvency"[31] the EU Commission states the following objective of their recommendations: "*The objective of this Recommendation is to ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure at an early stage with a view to preventing their*

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[29] Kühne, Reform und Transformation des Insolvenzrechts, p. 297.
[30] UNCITRAL: Legislative Guide on Insolvency Law, Part 1, 2005, p. 9.
[31] European Commission: Commission Recommendation of 12.03.2014 on a new approach to business failure and insolvency, C (2014) 1500 final.

*insolvency, and therefore maximize the total value to creditors, employees, owners and the economy as a whole. The Recommendation also aims at giving honest bankrupt entrepreneurs a second chance across the Union*". The major topics of the EU Commission recommendations are

1. Availability of a preventive Restructuring Framework;
2. Facilitating Negotiations on Restructuring Plans;
3. Restructuring Plans;
4. Protection for new financing.

Another important aspect for the EU Commission is a concept for a "second chance" for entrepreneurs. This concept has as decisive element the complete discharge of the entrepreneur of his debts after no more than three years[32].

When considering a new or amended insolvency law Georgia will have to assess these international best practices and new approaches and check their usefulness for Georgia.

## V. The Economic Impact of good/bad Insolvency Frameworks

The economic costs of the absence or ineffectiveness of an insolvency regime must not be underestimated. Firstly, an inadequate insolvency framework can lead to unnecessary loss of economic substance. If the legislative framework is weak or the insolvency procedures must be characterized as complex or unpredictable there is a high risk that liquidation is chosen as the easier way rather than reorganization. It should not be overlooked that in the case of a continuation of the business in the insolvency procedure the risk of domino effects on other companies is much lower than in the case of the debtor's liquidation. A non-transparent insolvency procedure also increases the risk of a significant asset stripping prior to the official commencement of the insolvency procedure.

Secondly, stability and quality of the legal environment are decisive factors for foreign investors when considering possible locations for their direct investments. Georgia is in competition with many other emerging markets as destination for foreign direct investments. The reliability of a court system and the possibility to realize claims and execute court decisions are key elements of the legal environment in any country. The discipline imposed on debtors by an effective insolvency law clearly increases the competitiveness of the enterprise sector in the country[33].

Finally, the insolvency regime also plays a role for the funding opportunities of companies. The risk margin as part of the interest rate must be higher in a country with an inefficient insolvency procedure compared to a country with an effective and predictable insolvency regime. Funding costs therefore should be lower for a company in a country with a well-functioning insolvency regime than for a company with same risk profile in a country without such a system[34]. The Asian Development

[32] European Commission: Commission Recommendation of 12.03.2014 on a new approach to business failure and insolvency, p. 9.

[33] International Monetary Fund: Orderly & Effective Insolvency Procedures, p. 7; Lee/Yamakawa/Peng/Barney, How do Bankruptcy Laws Affect Entrepreneurship Development around the World?, Journal of Business Venturing Vol. 26 (2011), p. 505, 506 even suggest for entrepreneurs starting up new firms to choose a jurisdiction that has entrepreneur-friendly bankruptcy laws; Similar: EU Commission: Commission recommendation of 12.03.2014 on a new approach to business failure and insolvency, p. 2 par. 4.

[34] Falke, Insolvency Law Reform in Transition Economies, p. 54.

Bank estimates this effect as not less than 50 percent and states an important impact on volume of available credits and length of repayment terms[35].

No doubt, insolvency law thus plays a pivotal role in commercial law of any country. Opaque structures before an insolvency procedure commences bear risks of asset stripping and transactions to the disadvantage of creditors. Weak and unpredictable insolvency proceedings may discourage would-be entrepreneurs. Investor confidence, availability of supplier credit and readiness of banks to grant credit as well as costs of such credit directly depend on the existence of a good insolvency framework. All this together puts the entry barrier for new businesses unduly high.

There have been some attempts to analyse the economic cost related to a poor insolvency framework. Most of these research studies start with an analysis of the insolvency law(s) in place. Then they try to identify the negative consequences of the absence of certain parameters of what is deemed as a good insolvency framework. Nearly all of these studies focus on the existence and efficiency of rescue und rehabilitation systems. This is based on the underlying assumption that the rehabilitation of the insolvent or presumably becoming insolvent debtor serves all parties involved better than its liquidation: The debtor, the secured and unsecured creditors, the economy as a whole and the state in which the debtor is domiciled and commercially active.

Strong rescue and rehabilitation mechanisms can create a culture of giving failing firms a second chance[36]. Such a culture can stimulate entrepreneurial behaviour and avoid risk averseness. In total there should be a measurable positive impact on economic development of a country under such circumstances[37].

### 1. The Impact of the Insolvency Framework on self-employment and economic activity

John Armour and Douglas Cumming speak of an intuitive relationship and a seeming consensus amongst policymakers in many countries that an extremely “forgiving” bankruptcy regime would encourage many new would-be entrepreneurs[38]. Their hypothesis is that, all other things being equal, a more forgiving bankruptcy law will tend to stimulate entrepreneurship[39]. In their research paper they analyse 15 developed economies using data on bankruptcy law and self-employment over 16 years (1990-2005). Concentrating on self-entrepreneurship the authors primarily but not exclusively look on insolvency regimes applicable to individuals, the “personal bankruptcy laws”, and on liquidation insolvency procedures.

According to Armour and Cumming bankruptcy laws have both statistically and economically significant effects on levels of self-employment. These effects are so large that they matter more than other economic determinants like real GDP Growth and Stock Market returns[40]. Bankruptcy laws that are more entrepreneur-friendly give rise to statistically and economically significant increases in self-employment per population.

[35] Falke, Insolvency Law Reform in Transition Economies, p. 55.
[36] Chapter 11 of America’s bankruptcy code is an example for protection of firms from their creditors. This legislation is particularly friendly to companies facing liquidity problems and facilitates the debtors to borrow money for a new start and have the time necessary to work out the problems.
[37] International Monetary Fund: Orderly & Effective Insolvency Procedures, p. 12.
[38] Armour/Cumming, Bankruptcy Law and Entrepreneurship, American Law and Economic Review, Vol. 10 No. 2 (2008), p. 303, 304.
[39] Armour/Cumming, p. 310.
[40] Armour/Cumming, p. 337.

This analysis has been made in industrialized European and North American countries and in a time which lies more than 10 years behind. There is, however, no reason to be seen why these findings in principle should not be valid as reliable indicators for Georgia as well. An Insolvency Law which is more forgiving and making a *fresh start* possible should also produce an environment in Georgia which is more business friendly and supports self-employment.

The results of Armour and Cumming are broadly confirmed by other researchers. Lee, Yamakawa, Peng and Barney have chosen a slightly different approach and based their study on an even larger sample of 29 countries including emerging markets. Their research focuses on corporate bankruptcies and covers liquidation and rehabilitation procedures[41].

The results of Armour and Cumming are widely confirmed by a later European Commission Working paper of 2015[42] measuring the pre-insolvency efficiency of rescue and recovery frameworks in the 28 European Union countries.

**2. The Impact of the Insolvency Framework on Financial Sector Soundness**

Some research results indicate even an effect of rescue and rehabilitation procedures on soundness of financial institutions. The global financial crisis has shown a dramatic curtailing of credit supply by many banks. This deleveraging pressure on corporate debtors has led to payment problems of many private sector companies. A sharp increase of the non-performing loans (NPL) rate was the immediate consequence for financial institutions. Those banks in emerging markets, often primarily depending themselves on loan-based funding from banks in industrialized countries faced the same situation when wholesale funding loans were not over-rolled as usual but requested for payment. Funding difficulties together with value adjustments within the bank's loan book due to a deterioration of the credit quality and the increase of the NPL rate could easily lead to bank insolvencies and rehabilitation procedures[43].

The EU discussion paper "The economic Impact of Rescue and Recovery Frameworks in the EU" shows the result that better ex ante and ex post possibilities to restructure debtors' liabilities appear to improve the reactivity of the NPL rate to changes in economic conditions and its subsequent normalization[44]. The IMF additionally highlights that an insolvency framework with sufficient predictability can help develop a secondary market in debt instruments. This would enable banks to transfer loans to entities specialized in the workout process[45] and thereby contracting the balance sheet and improving the capital ratio.

**3. The impact of the Insolvency Framework on corporate deleveraging and economic activity**

In times of easy and cheap credit corporates usually tend to increase their indebtedness without simultaneous strengthening of the capital base. Highly leveraged balance sheets become dangerous when the liquid supply of cheap money dries up. Particularly after economic shocks but also in situations of below average, stagnating or even negative economic growth a general pressure to

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[41] The very long time span of 19 years of this research has, however, been criticized since legislative changes during this period of time allegedly have not been taken into consideration enough, see Cumming, Measurement the Effect of Bankruptcy Laws on Entrepreneurship Across Countries, The Journal of Entrepreneurial Finance, 2012, Vol. 16, Issue 1, Article 4.

[42] Carpus Carcea/Ciriaci/Cuerpo, Lorenzani/Pontuch, The Economic Impact of Rescue and Recovery Frameworks in the EU, European Commission, Discussion Paper 004/September 2015 p. 11, 12.

[43] This has been especially strong in Kazakhstan and Ukraine.

[44] Carpus Carcea/Ciriaci/Cuerpo/Lorenzani/Pontuch, p. 16.

[45] International Monetary Fund: Orderly & Effective Insolvency Procedures, p. 8.

corporate deleveraging emerges which negatively impacts the domestic demand of companies and therefore bears the risk of aggravated reduction of economic activity.

It has been analysed whether a direct correlation exists between the availability of an efficient rescue and recovery framework and the level of negative relationship between corporate deleveraging and GDP growth. For the EU member states the result has been that this negative effect for economic growth is significantly lower in countries characterized by higher efficiency of the rescue and recovery frameworks[46].

## VI. International Insolvency Law and Georgia's Accession to the EU

Cross border transactions and multinational corporations make it necessary to analyse and regulate the international dimension of insolvency procedures. In principle two questions become relevant. First, whether domestic Insolvency Law can require any legal applicability or other relevance in another country and, second, whether vice versa a foreign insolvency procedure has any legal effects domestically. There is no common answer on this question. Very different approaches prevail on this in different countries. In International Law this question is known as the rule of either the principle of universality or the principle of territoriality.

The Insolvency Law acknowledges foreign insolvency proceedings if property in Georgia is involved or creditors in Georgia (Art. 54 par. 1), unless there is a contradiction with Georgian law or with Georgian 'ordre public'. In the case of a foreign insolvency proceeding a separate insolvency procedure in Georgia concerning the branch in Georgia of the foreign debtor (secondary insolvency proceeding) is not precluded (Art. 55).

The Association Agreement concluded between Georgia and the European Union[47] contains no specific requirements concerning the insolvency law framework. Nevertheless an orientation at the legal system of the European Union is one of the objectives of the Agreement (Art. 1 par. 2 lit. g). Currently the insolvency laws of EU countries are still national and quite different. A comprehensive harmonization has not yet taken place. The EU's own setting of legal provisions in the area of insolvency law is limited to international insolvency proceedings and is directly applicable law in the EU member states[48]. This legal act regulates insolvency cases involving two or more countries of the European Union. Some European countries, e.g. Germany, have changed their national insolvency laws after coming into force of the EU Regulation in order to regulate insolvency proceedings with countries outside EU.

A new approach towards harmonization of national insolvency laws of EU Member States has been made by the EU Commission in 2014[49]. The primary objective of these recommendations is the introduction of insolvency preventing early restructuring procedures, during which the debtor remains in control over the regular business operations, a temporary stay of individual enforcement

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[46] Carpus Carcea/Ciriaci/Cuerpo/Lorenzani/Pontuch, p. 19, 21.

[47] Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part, Official Journal of the European Union, 30.08.2014, L 261/4.

[48] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (OJ L 141, 05.06.2015, p. 19),replacing the Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (OJ L 160, 30.6.2000, p. 1). See also Directive 2008/94/EC of the European Parliament and of the Council of 22 October 2008 on the protection of employees in the event of the insolvency of their employer (OJ L 283, 28.10.2008, p. 36).

[49] European Commission: Commission Recommendation of 12.03.2014 on a new approach to business failure and insolvency.

actions may be requested, a restructuring plan can be adopted by the majority of creditors and be confirmed by the court and new financing is given certain priority/protection. The negative effects of bankruptcy, in particular the social stigma connected to it shall be dealt with by institutionalization of a "second chance" for entrepreneurs. Therefore a complete discharge of the entrepreneur's debt after no more than three years is recommended[50].

The policy of the European Union is and will be clearly directed towards a further convergence of insolvency frameworks in the Member States. A new legislative initiative on business insolvency, addressing the most important barriers to the free flow of capital is announced for the 4th quarter of 2016[51].

Any new or amended Georgian insolvency law will have to reflect the European legislation on international insolvency proceedings and the Commission's recommendations for future development of national insolvency frameworks.

## VII. Reform and Recommendations

Developing a new or amended insolvency law is a very complex matter. The details must be carefully and thoroughly analysed. From the position of an external analyst and based on own assessment and legal and economic research findings concerning Georgia's Insolvency Law the following aspects should be dealt with in a reform project:

- More differentiation for treatment of pre-insolvency "harmful" actions;
- Establishment of a pre-insolvency preventive restructuring framework;
- Establishment of the function of a Mediator or Supervisor, approved by the court, for a pre-insolvency restructuring plan procedure;
- New definition for the overarching aim/objective of the insolvency procedure putting protection of creditors' rights and rescue of viable businesses in the centre;
- Re-defining the role and responsibilities of Insolvency Office Holders (IOH);
- Setting educational and professional minimum standards for IOH;
- Questioning of NEB's monopole role as Trustee and Auction service provider, perhaps transforming NEB's insolvency department into a supervisory body for private sector IOHs[52];
- Making rehabilitation the preferred option for corporates which have a potential to survive;
- Replacing the Conciliation Council by more and better structured responsibilities of the courts, IOH and creditors;
- Improving pre- and post-commencement finance availability;
- Establishing complete debt-discharge for entrepreneurs after a defined period of time;
- Introduction of a personal (consumer) insolvency procedure including final debt discharge;

[50] For details see European Commission: Commission Recommendation of 12.03.2014 on a new approach to business failure and insolvency, p. 6,9.

[51] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Action Plan on Building a Capital Markets Union, 30.9.2015 COM (2015) 468 final, p 30.

[52] See also USAID Report "Assessment of the insolvency System in Georgia". Governing for Growth (G4G) in Georgia, p. 36.

Difficult decisions will have to be made by Georgian law makers.  But doing nothing or doing not enough increases the risk to fall further behind other countries since more and more countries follow the best practice experience and modernize their insolvency laws respectively.

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## Abbreviations

| | |
|---|---|
| ADB | Asian Development Bank |
| BGBl | Bundesgesetzblatt |
| EBRD | European Bank for Reconstruction and Development |
| EU | European Union |
| GDP | Gross Domestic Product |
| GIZ | Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) GmbH |
| IMF | International Monetary Fund |
| IOH | Insolvency Office Holder |
| NEB | National Enforcement Bureau |
| NPL | Non-Performing Loan |
| OJ | Official Journal |
| UNCITRAL | United Nations Commission on International Trade Law |
| USAID | United States Agency for International Development |
| WiRO | Wirtschaft und Recht in Osteuropa |

**Annex 1: World Bank: Doing Business 2016. Measuring Regulatory Quality and Efficiency**

| Country | Doing Business Ranking 2016 | Resolving Insolvency Ranking | Recovery Rate (cent per dollar) | Time (Years) | Cost (% of estate) | Strength of Insol-vency Framework | Distance to Frontier Index |
|---|---|---|---|---|---|---|---|
| Armenia | 35 | 71 | 36.9 | 1.9 | 11 | 9 | 48.00 |
| Azerbaijan | 63 | 84 | 39.5 | 1.5 | 12 | 7.5 | 44.68 |
| Georgia | 24 | 101 | 39.9 | 2.0 | 10 | 6 | 40.24 |
| Kazakhstan | 41 | 47 | 42.8 | 1.5 | 15 | 11.5 | 58.97 |
| Russia | 51 | 51 | 41.7 | 2.0 | 9 | 11.5 | 58.39 |
| Turkey | 55 | 124 | 18.7 | 4.5 | 15 | 8 | 35.09 |

**Annex 2: World Bank: Doing Business 2016. Strength of Insolvency Framework**

| Country | Total Score Max: 16 | Commencement of Proceedings 0-3 points | Management of Debtor's Assets 0-6 points | Reorganization Proceedings 0-3 points | Creditor Participation 0-4 points |
|---|---|---|---|---|---|
| Armenia | 9.0 | 3.0 | 2.0 | 3.0 | 1.0 |
| Azerbaijan | 7.5 | 2.5 | 3.0 | 1.0 | 1.0 |
| Georgia | 6.0 | 1.5 | 3.5 | 0.0 | 1.0 |
| Kazakhstan | 11.5 | 3.0 | 6.0 | 0.5 | 2.0 |
| Russia | 11.5 | 2.5 | 5.0 | 1.0 | 3.0 |
| Turkey | 8.0 | 3.0 | 2.0 | 1.0 | 2.0 |

**Annex 3: EBRD: Insolvency Law Assessment Project - 2009**

| Country | General Insolvency Law Assessment Score | Compliance Rating | Insolvency Office Holder Assessment Score | Compliance Rating |
|---|---|---|---|---|
| Armenia | 77 % | Medium Compliance | 60 % | Low Compliance |
| Azerbaijan | 67 % | Low Compliance | 47 % | Very Low Compliance |
| Georgia | 63 % | Low Compliance | 27 % | Very Low Compliance |
| Kazakhstan | 61 % | Low Compliance | 52 % | Very Low Compliance |
| Russia | 78 % | Medium Compliance | 76 % | Medium Compliance |
| Turkey | 72 % | Medium Compliance | 27 % | Very Low Compliance |

**Annex 4: EBRD: Insolvency Office Holder Assessment (2012-2014)**

| Country | Licensing and Registration | Regulation, Supervision and Discipline | Qualification and Training | Appointment | Work Standards and Ethics | Legal Powers and Duties | Remuneration | Overall Result |
|---|---|---|---|---|---|---|---|---|
| Armenia | | | | | | | | |
| Azerbaijan | | | | | | | | |
| Georgia | 25 | 50 | 25 | 83 | 31 | 58 | 69 | 48 |
| Kazakhstan | 100 | 69 | 85 | 75 | 38 | 75 | 75 | 72 |
| Russia | 75 | 63 | 85 | 75 | 75 | 75 | 75 | 75 |
| Turkey | 25 | 50 | 40 | 75 | 31 | 67 | 69 | 51 |

*Note: EBRD has done an evaluation of the insolvency office holder profession (IOH) in 27 out of 35 countries in which the bank operates in 2012-2014. Armenia and Azerbaijan have not been analyzed. Georgia was ranked on position 25 out of 27 followed only by Egypt and Morocco. The values shown in this table are the percentage of the maximum score of 100. The overall result of 100 per cent is intended to signal the existence of a comprehensive regulatory and/or professional framework.*

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