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By Simeon Djankov and Eva Zhang[1]

Abstract

Bankruptcies have fallen sharply in OECD economies during 2020 and the first half of 2021 because of an array of COVID-related support available to businesses, as well as imposed moratoria on bankruptcy filings. Keeping insolvent firms alive drains resources from the healthy parts of the economy. However, public financing for ailing firms will not last long, and a surge in corporate failures is likely in many countries. These failures may be attenuated if governments introduce restructuring plan features in their bankruptcy laws. So far, several OECD countries have reformed bankruptcy, while efforts at the EU level to spur insolvency reform remain weak.

1 Bankruptcy filings declined in most advanced economies during 2020 and the first half of 2021

The COVID-19 economic shock of 2020 cost millions of workers their jobs and shut down countless businesses. Companies suffering losses struggle to survive and many fail. A wave of bankruptcy filings was expected in the wake of COVID-19 (Bailey et al. 2021). Yet during 2020, the number of corporate bankruptcy filings in most advanced economies – members of the OECD – fell by 21% relative to 2019, and by even more relative to previous years (Chart 1). In 2021, bankruptcies fell further to less than 70% of their 2019 level.

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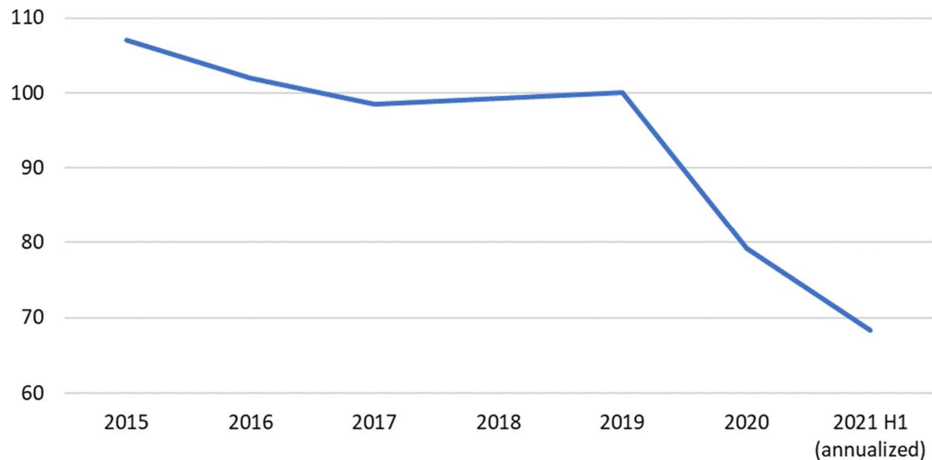
Chart 1
Annual Bankruptcy Filings in Advanced Economies

(Index, 2019 = 100)



Sources: Statistics Sweden for Sweden, Bank of France for France, ASIC for Australia, U.S. Courts for the US, and National Statistics retrieved from Macrobond (August 27, 2021) for all others.
Notes: The index is based on total number of bankruptcies in 24 advanced economies (Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Iceland, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Portugal, South Korea, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. For 12 economies (Australia, Belgium, Canada, Estonia, Finland, Germany, Norway, Spain, Sweden, Turkey and the United Kingdom), and the latest available data (most often from January to June 2021) are annualized to 2021 annual aggregates.

This decline in bankruptcy cases demonstrates the success of the initial COVID-19 response measures. On second glance, however, it brings worries too (Blanchard et al. 2020). There was significant financial distress during the pandemic—for example, by early June 2021, 40 percent of small businesses (that had credit card transaction data prior to March 2020) were temporarily or permanently closed in the United States (Chetty et al. 2020). An April 2021 survey of UK businesses finds that 17 percent were still closed. In Canada, over one-quarter of government-surveyed businesses expected their profitability to decrease in the last quarter of 2021, and one-fifth of businesses reported that they could not take on more debt.

Moreover, many businesses that escaped closure have survived because of downsizing or closing establishment(s) within the firm. The United States' Business Employment Dynamics (BED) data show, for example, that in the second quarter of 2020 gross job losses from closing and contracting private-sector establishments were 20.4 million.[2] With the economy starting to recover, the monthly losses declined to 6.7 million in the last quarter of 2020, but total employment for low-wage workers remain 20% below the pre-pandemic level in 2021 (Chetty et al. 2020).

Chart 1 uses bankruptcy filings from 24 sizable OECD economies and shows that the total number of corporate bankruptcy filed in 2020 fell by 21 percent in major industrial economies compared with 2019, and the filings dropped by another 10 percentage point in 2021. In the EU, Austria is experiencing the largest decline, with

[2] These statistics are discussed in historical context in Djankov and Zhang (2021).

bankruptcy cases dropping by 76% from 2019 to 2021. This is followed by Netherlands and France at around 50% decline by 2021.

The reasons for this decline are twofold. The COVID-19 pandemic has induced governments in advanced economies to finance job support programmes to assist workers and to temporarily halt bankruptcy procedures – providing lifelines to keep firms alive through the crisis, at a time when premature bankruptcy can worsen the recession. The job support programmes have been updated and expanded in most OECD countries to 2022 or further still.

For many businesses, the government programmes have worked. Businesses have reacted by keeping employees on board or hiring new ones when restrictions on business operations became less onerous. In turn, the support keeps businesses open, until the economy turns around.

A question arises: Is the observed reduction in bankruptcies a good thing—due to maintaining company value—likely to contribute to future productivity or a bad thing—due to zombification—likely to be a drag on productivity? Our previous research on the effects of bankruptcy regimes around the world (Djankov et al 2008) suggests that on balance keeping companies alive during a downturn is a good thing for the economy. This assistance is particularly valuable for the economy in the case of industries with global or regional business linkages, where firm exit means destruction of relational/human capital. Becker and Ivashina (2021) show that better insolvency systems are also associated with more cyclical use, and high development of private debt markets which rely heavily on private resolution of insolvency.

A large number of firms will need debt restructuring once government support programmes run out. Gourinchas et al. (2021) estimate with European data that the withdrawal of fiscal support and thus the contraction of credit to the corporate sector could have led to a surge in small business failure rates by 8.44 percentage points relative to normal times in 2021. Extensive reorganisation or liquidation procedures, which may work in normal times, will prove insufficient to service a large wave of insolvencies. Changes to existing regimes should be done now, before the wave on bankruptcies comes.

2 Worries about Zombie Firms

Some economists are concerned that keeping insolvent firms alive will drain resources from the healthy parts of the economy (Acharya 2020). Zombie credit—that is, lending to otherwise insolvent firms—has been shown to slow economic growth through the misallocation of credit and the suppression of normal competitive forces (Becker and Ivashina 2021). The prevailing view of what drives zombie lending puts banks and government assistance administered through banks at the heart of the problem (some recent references include McGowan, Andrews, and Millot (2018), Acharya, Eisert, and Hirsch (2019), and Blattner, Farhino and Rebello (2018).

These fears are misguided on balance. Policies to force businesses to shut down permanently risk slowing down the COVID recovery (Laeven et al. 2020). As businesses shut down, they break a supply chain that affects other businesses, including in healthier sectors. Such breakage should be avoided as much as possible.

The changes in bankruptcy law in some OECD economies are one part of a larger package of recovery measures taken by governments in response to the pandemic. Previous experience, for example, during the East Asian financial crisis, shows that such legal changes take time to percolate to distressed firms. The likely longer delay in the wave of bankruptcy filings is of assistance to these distressed firms.

In crisis as well as normal times, the possibility for firms to propose a restructuring plan outside of the formal judicial process is beneficial for the economy. This is because as much as 30 percent of the company value is lost in bankruptcy procedures in high-income countries when the business is liquidated or sold piecemeal (Djankov et al. 2008). This loss may be avoided altogether or at least attenuated when governments introduce restructuring plan features in their laws. Research by Becker and Ivashina (2021), using an updated dataset following on Djankov et al. (2008), demonstrates that formal restructuring is likely to fulfil an important cyclical role in the economic recovery.

3 Reforms in several advanced economies

In the aftermath of the pandemic, bankruptcy laws have been revised in seven OECD economies (Australia, Belgium, Germany, Hungary, the Netherlands, Singapore, and the United Kingdom). Three such changes have been common during the pandemic. The first enabled an illiquid company to reach an agreement with its creditors with no involvement from courts. Second, distressed companies are given greater latitude to force a restructuring agreement on every creditor if the majority of creditors agree. And third, suppliers are prevented from stopping deliveries on the ground when the debtor is having trouble paying creditors, as long as the debtor firm pays for its supplies on time—even ahead of bank creditors.

In June 2020, the United Kingdom added three features to its insolvency law. These included introducing a two-month moratorium, allowing a rescue plan to be forced on creditors, and preventing suppliers from stopping deliveries.

Germany also revised its bankruptcy law to enable restructurings. A new insolvency feature is the introduction of a restructuring plan prior to filing for liquidation. Second, it is possible for a company to reach an agreement with its creditors without court involvement. Third, the company in financial distress has the right to a preliminary court meeting to discuss with the competent judge the requirements for a self-administration plan, the composition of the creditors' committee, and protective orders.

Other governments still have time to consider legal reform to make it easier for distressed companies to restructure. Typically, there is a lag between the onset of an

economic crisis and a surge in corporate bankruptcy filings. In the Great Recession, for example, it took two years—to 2009—for bankruptcy cases to peak in the United States. The rise was significant, from 19,695 bankruptcy filings in 2006, the last year before the recession, to over triple this number (60,837) in 2009. The lag in bankruptcy filings following the COVID-19 pandemic may be longer still, partly because of the large fiscal lifelines.

In addition, government moratoria on bankruptcy filings have been extended several times. Nearly two-thirds (23 out of 38) of OECD economies introduced temporary debt payment moratoria in response to the pandemic. For example, France enacted temporary moratorium to the bankruptcy law in May 2020 in response to the pandemic. The decree brought several temporary amendments to French bankruptcy law, including the suspension of insolvency filing duty, extension of conciliation procedure's duration, and the possibility for management to adopt safeguard and restructuring plans. Some of the measures from the May 2020 decree, such as protections for debtors in conciliation, were extended to the end of 2021.

4 Efforts at the EU level

Following the Eurozone crisis of 2008-2012, the European Commission jumpstarted a number of initiatives to update insolvency regimes and be better prepared for coming financial crises (ECB 2021). However, many of these initiatives have not yet been embraced by EU member states. In particular, the Restructuring and Insolvency Directive; the Directive on secondary markets for NPLs; the Directive on harmonised rules for accelerated extrajudicial collateral enforcement have remained in the periphery of national legislative efforts. A future proposal foreseen in the CMU Action Plan 2020, for minimum harmonisation in targeted areas of the insolvency framework, has likewise not been met with much initial enthusiasm.

This lackluster attitude is hard to square with the usefulness of the proposed legislation. For example, the Restructuring and Insolvency Directive, adopted in 2019 just before the pandemic struck, requires EU governments to put in place measures to insert restructuring features in bankruptcy legislation. The directive provides a frame, it does not attempt to harmonise reorganization after a business becomes insolvent, nor does it try to prescribe the conditions for opening insolvency proceedings; the ranking of insolvency claims; and avoidance actions. In 85 percent of the EU the Directive has not yet been transposed. By the original deadline of July 2021 23 out of 27 European governments notified the European Commission that they would meet the extended deadline of July 2022.

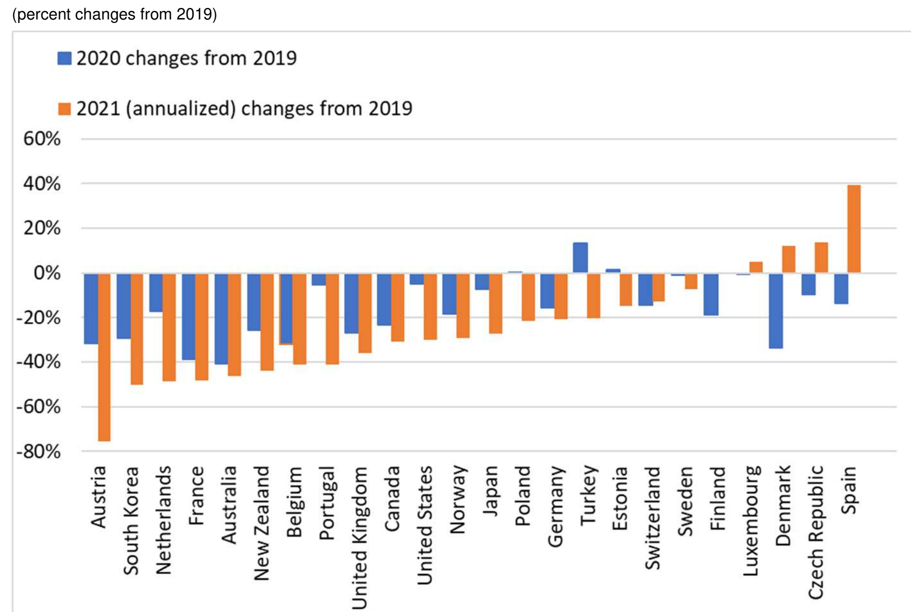
This example illustrates that a lot more needs to be done at the European level to ensure preparedness for future crises. Individual national reform efforts can be studied in detail to understand which features of insolvency legislation most directly relate to better economic recovery. Chart 2, based on the fall in bankruptcy filings at the national level, suggests which countries urgently need reform action. In most countries, the fall in bankruptcy fillings continued to 2021, particularly in Austria,

Netherlands, and France, The larger the fall, the more likely it is that the insolvency system may experience a surge in filings in the coming years.

Chart 2

Annual Bankruptcy Filings, by Economy

(percent changes from 2019)



Sources: Statistics Sweden for Sweden, Bank of France for France, ASIC for Australia, U.S. Courts for the US, and National Statistics retrieved from Macrobond (August 27, 2021) for all others.
Notes: 2021 annual aggregates are annualized from latest available data (most often to June 2021).

5 Final Discussion

The global recession following the 2020 pandemic raised long-forgotten alarms of severe corporate distress due to complexity of many insolvency regimes to handle restructuring (Claessens et al. 2001). This is the departure point of new research by Becker and Ivashina (2021), building on recent work by Greenwood, Iverson and Thesmar and Ellias, Iverson and Roe (2021). These studies provide new evidence consistent with the previous findings in Djankov et al. (2008) that insolvency regimes play an important role in economic recovery after crisis.

In jurisdictions with already-available reorganization options in the bankruptcy law, or in jurisdictions like Germany and the Netherlands that have used the pandemic as an opportunity to update their insolvency regimes, the fear of unproductive firms ("zombies") dragging down the economic recovery seems unfounded. Rather, recovery may take the form of cross-sectoral shifts in employment and productivity, as consumer preferences have evolved due to the pandemic; and as global supply chains have become more local in nature, providing opportunities for new growth in Europe.

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