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**Trends and Developments in Insolvency Systems and Risk  
Management: The Experience of Taiwan**

by

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**Trends and developments in insolvency systems and risk management:  
The experience of Taiwan**

Dr. George C. H. Lin<sup>1</sup>

**1. TRENDS AND DEVELOPMENTS IN INSOLVENCY AND CREDITOR RIGHTS  
FRAMEWORK AND PRACTICES**

**(1) Legal Framework**

In Taiwan, currently there are three sets of laws that govern the corporation insolvency and reorganization proceedings. Those laws are the Company Law, the Bankruptcy Law, and the Banking Law.

Unlike United States and Japan, in Taiwan, the corporation reorganization proceeding has been incorporated as a part of the Company Law rather than been codified an independent set of law such as the Bankruptcy Law of United States and Japan. Our corporation reorganization proceeding only applies to public companies or the companies issuing the corporate bonds. The commercial companies sometimes would use the reorganization proceeding as bargaining chip to negotiate with their creditors for the purpose to lower the current interest rate or to reduce the amount of their outstanding debts. This trick works most of time because the reorganization proceeding under Taiwan law is very time-consuming process and most of the creditors do not wish their claim for payment being suspended for such a long period of time.

The courts in Taiwan, of course, do not wish to see the reorganization proceeding being misused by companies as a method to threat their creditors; therefore,, our Court would review the companies reorganization application with particular care before granting approval for reorganization in order to prevent the company from abusing or misusing the bankruptcy proceeding. In the past three years, from year 2001 to year 2003, more than one hundred companies in Taiwan filed reorganization applications to the courts; nevertheless, some of the applications are still pending, forty-six (46) of which have been dismissed, and only sixteen applications have been approved by the court.

According to our laws, both individuals and companies are eligible to apply for settlement and bankruptcy protection under the Bankruptcy Law. The bankruptcy protection our laws provide to the bankrupt is similar to that provided by Chapter 11 of U.S. Federal Bankruptcy Code. Nevertheless, individuals rarely apply for bankruptcy regardless it may discharge the payment liabilities after the declaration of bankruptcy, because, in Chinese society, people believe it would be very disgraceful to announce that they are bankrupted.

The insolvency of banks and insurance companies are subject to the regulations provided in the Banking Law and Insurance Law. In the recent years, the policy of Financial Supervisory Commission (“FSC”) adopted is to have other sound financial institutions take over or merge the failed financial institutions.. In addition, to facilitate the orderly exit of insolvent financial institutions from the market, the government established the Financial Restructuring Fund (“RTC”) and enacted the Statute for the Establishment and Administration of the Financial Restructuring Fund in July 2001 (hereinafter referred to as “RTC Act”). The function of the Fund is very similar to Resolution Trust Corporation in United States established in 1989 by Congress in accordance with the Financial Institutions Reform, Recovery and Enforcement Act (“FIRREA”).

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## **(2) Current Legal Developments**

The Company Law and the Banking Law have been newly amended by our government on November of 2001 and November of 2000. By this chance, I would to give you a brief introduction of the amendments of those two laws respectively and the proposed amendment of bankruptcy law as below:

### **1) The Amendment of Company Law**

The 2001 Company Law Amendment has been the most significant amendment to the Company Law since 1966 which includes the addition of 24 new articles, the deletion of fifty six articles, and modifications to one hundred and fifty six articles. To improve the reorganization proceeding is one of the main goal the amended Company Law plans to achieve. The important amendments in Company Law concerning the corporate reorganization include:

- a) the Court is mandated to dismiss the reorganization application if the insolvent company fails to meet the statutory requirements (Article 283-1);
- b) the company is not eligible to apply for reorganization if there is no possibility for the applying company to rehabilitate. (Article 282); and
- c) the creditors, before the commencement of the corporate reorganization proceeding may demand the court to issue provisional restraining order to secure the corporate assets; however, the period of such provisional restraining order can not exceed 90 days.(Article 287).

Nevertheless, albeit the Company Law has been substantially amended, the protection the Company Law provides for the creditors of company in company reorganization process is still insufficient. In situation where a company transfers the company assets to other third party within the reorganization proceeding with the purpose to defraud the creditors, nothing in the Company Law provides the creditors or the administrator/trustee with right to cancel the transaction and demand the third party to return the assets back to the recognition estate as the creditors and administrator can do in the bankruptcy proceeding. (Article 78 and 79 of Taiwan Bankruptcy law).

Ministry of Finance (“MOF”) has tried to add on provision into its proposed Company Law amendment which provides that the court may, upon the request of the company creditor or the administrator, dismiss the company’s reorganization application if the company entrusts or transfers its whole or substantial assets to third parties within six months before applying the reorganization proceeding.

### **2) The Amendment of Banking Law:**

Merger, winding-up, together with receivership constitute the entire safety net of the banking system in the event of the financial institution failure. Due to its significant influence on public interests, the latest amendment emphasizes governmental involvement in the event a bank fails in operation via providing more supervision power to the competent authority and requiring more cooperation of the failed bank at issue.

Furthermore, in order to avoid systematic risk, the Taiwanese government enacted RTC Act in July 2001 to provide assistance to failed financial institutions. The RTC Act supersedes all banking related laws and regulations if any conflicts exist between those banking related laws and regulations and this RTC Act. I will provide you with a summery report of the important provisions of the RTC Act in the following section.

### **3) The Amendment of Bankruptcy Law**

The Bankruptcy Law has not been amended since 1993. Judicial Yuan, endorsed by Executive Yuan, has proposed its version of Banking Law amendment on May 6, 2004 for public comments. The Judicial Yuan's version of Bankruptcy Law contains total 132 articles whereas the currently applicable Bankruptcy Law has 160 articles. The Judicial Yuan's vision adds one hundred and six newly enacted articles to and deleted ten articles from the currently Bankruptcy Law, which makes the Judicial Yuan's version as the most substantial amendment of past five decades. The major points addressed in the Judicial Yuan's version of Bankruptcy Law are:

- a) the court may directly order to liquidate the debtor's assets to repay the debts owed without going through the whole bankruptcy process if the total amount of the debts claimed by the creditors is under 3 million NT dollars, which is approximately 90,000 US dollars (Article 59 to 61);
- b) the court, upon the application of the bankruptcy administrator, may limit the bankrupt's spending if the bankrupt's living standard is substantially higher than ordinary people in their general life (Article 82);
- c) the law holds the certified public accountants jointly and severally liable with their clients, i.e. the bankrupt, if the accountants didn't faithfully fulfill their duties while auditing or certifying their clients' financial statements (Article 100);
- d) the bankruptcy estate does not include the assets obtained by the bankrupt after the declaration of bankruptcy, unless those assets were obtained by the bankrupt by succession, gift or by other gratuitous methods (Article 101);
- e) the claim of bankrupt's employees with respect to the salaries payable within six months shall have priority right to the bankruptcy estate (Article 118); and
- f) the bankruptcy settlement and judgment made by foreign courts may be enforced against the bankrupt's assets in Taiwan if such foreign settlement or judgment has been recognized by Taiwanese Court (Article 208).

## **(2) Institutional Developments**

### **(1) Asset Management Companies ("AMC")**

The first AMC in Taiwan, under the avocation and support of our government, was found in accordance with the Law Governing Merger of Financial Institutions enacted on December 2000. The founding members include thirty banks and three bill finance companies. The official name for the first AMC in Taiwan is Taiwan Asset Management Corporation; ("TAMCO"). When TAMCO was established on May 22nd, 2001, it has registered capital of 2.5 billion NT dollars (NT\$ 2,500,000,000) and paid-in capital of 1.76 billion NT dollars (NT\$1,762,000,000).

The main purpose to establish the TAMCO is to provide assistance to Taiwanese banks and financial institutions to reduce their NPL ratio. To encourage the establishment of such asset management companies, the government provides many tax incentives, including amortizing the loss generated from the disposing of the NPL for five years, and enjoying the lower value added tax rate (2%) applicable to the financial institutions. Following the establishment of the TAMCO, many foreign financial institutions, such as Lone Star, Cerberus, GE Capital, Lehman Brothers and Morgan Stanley, joint with some domestic banks, have also established assets management companies to handle their own NPL.

AMCs have been functioned pretty well in Taiwan. By the end of May 2003, the amount of NPL sold by the local financial institutions to AMC has reached NT two hundred thirty billion dollars (NT\$23,000,000,000)<sup>2</sup>.

### **2) Financial Restructuring Fund ("RTC")**

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<sup>2</sup> The total NPL of local banks and credit cooperatives by the end of June 2003 is approximately nine thousand five hundred fifty one billion(9,551,000,000), source from FSC..

In addition, as stated above, our government has enacted the RTC Act in July 2001. RTC was set up on June 2001 with the initial capital of approximately NT 13.8 billion dollars (NT\$1,380,000,000). According to the RTC Act, the term of the RTC would be three years from its establishment, in other word, the RTC found on June 2001 will cease it operation on July 2005. The term of the RTC may, upon the approval of Legislative Yuan, may be extended for another year. According to Article 10 of RTC Act, CDIC may utilize the RTC fund to assist the failed financial institutions by (1) paying off the outstanding debts of financial institutions, or (2) liquidating the failed institution's assets in order to satisfy the company's unpaid debts; (3) investing the failed institution by purchasing its preferred shares. By the end of August 2004<sup>3</sup>, via exercising RTC, CDIC has successfully held the public bids for forty six financial institutions.

### **3) Ratio of Non-Performing Loan:**

Through operation of AMC and RTC, NPL ratio has been substantially reduced from its highest point of, 8.04% in March 2002 to 4.33% by the end of 2003. The MOF's goal to lower the NPL ratio under 5% within only two years has been achieved<sup>4</sup>. Based on the latest data published on official website of the FSC, the NPL ratio is 4.03% in August 2004. Further, according to the latest public release of FSC on October 5, 2004, the NPL ratio has even reduced to 3.54 % in August 2004.

### **4) Professionals' Liability**

#### **a) Liability of Certified Public Accountants and/or External Auditors**

To cope with the ever-changing financial environment, the demand of increasing accountants and/or external auditors' liability arises. Especially after the enactment of the Sarbanes-Oxley Act of 2002 in United States, many countries have followed the United State's footsteps by adopting the principals set forth in Sarbanes-Oxley Act to impose stringent new rules to regulate the accountants as well as the company's external auditors.. In Taiwan, several major laws have been or about to be amended for the same objective as it of Sarbanes-Oxley Act, that is, "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws". The important amendments of those laws are as follows:

- i) Securities and Exchange Amendment of April 2004: The licensed public accountant would be subject to imprisonment, criminal fine of up to 15 million NT dollars (NT\$15,000,000),and/or suspension of practice license if the public accountant (1) intentionally issues audit report or opinion that contains false or untruthful material information; (2) issues the audit report/opinion contains false or untruthful material because of his failure to perform the auditing work with due care; or (3) fails to perform the auditing work in accordance with the applicable laws, regulations and public recognized auditing guidelines. (Article 174);
- ii) The proposed amendment of Certified Public Accountant Law: According to the proposed amendment, the official authority may suspend the practice license of the accountant and /or cancel or revoke business registration of the accounting firm if the accountant or the accounting firm practices business in violation of this law (Article 38). The accounting firm will also be held jointly and severally liable with the misbehaved accountant for the client or other interested person of damages caused by their breach of legal duty (Article 42).
- iii) The proposed amendment of Bankruptcy Law: The amendment holds the public accountant jointly and severally liable with a debtor if the accountant includes false information or fail to include the material information in the debtor's financial statement.

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<sup>3</sup> The total number of local financial institutions, including banks and credit cooperatives, are three hundred sixty three(363) by the end of July 2004.

<sup>4</sup> It is so called "2-5-8 Financial Reform Plan" to strengthen the financial status of financial institutions executed by MOF. This meant that in two years, the NPL ratio of these institutions would be reduced to below 5% and their capital adequacy ratio would be maintained at a minimum 8% as required by the Bank for International Settlements.

**b) Lawyers' Liabilities**

In addition to accountants, the latest amendment of the Securities and Exchange Act also imposes sanctions, imprisonment, or criminal fine up to fifteen million NT, against lawyers who issues false or untruthful opinion to any contract, report, or document concerning the trading, offering or sales of company securities (Article 174).

**2. CURRENT RISK ASSESSMENT AND MANEGAMENT SYSTEMS AND POLICIES**

**(1) Credit Information Systems**

The Joint Credit Information Center ("JCIC") and Financial Data Information, Ministry of Finance ("FDI") play a very important role in our risk assessment and management system. Those two institutions are responsible for in the collection of the information concerning financial and tax related information of individuals as well as companies. The members of JCIC and FDI are allowed to access the information retained by those two institutions for necessary credit checking and reference.

**1) Joint Credit Information Center ("JCIC")**

It is a non-profit foundation established on March 20, 1975. As of May 14, 2003, JCIC has member group comprised only by institutional members- three hundred twenty nine financial institutions, including fifty-one local banks and nineteen foreign banks. JCIC's data basis contains a large volume of information concerning the checking, loan and credit cards transactions within and among the financial institutions. The operation model of JCIC is very successful. Encouraged by this experience, an institution with similar function has been established in 1999 in Shanghai by the support of PRC government. The official name of the institution is Credit Information Services Co., Ltd.

**2) Financial Information ("FDI")**

It is established in 1960 and later being renamed in 1987. It is a governmental organization under the supervision of the MOF. The creditor obtains the final court judgment or the entitlement of enforcement is allowed to access FDI's data basis to check the debtor's financial record after filing the application with MOF.

The information kept by FDI includes: In general practice, the FDC will update the information kept in its data basis annually based on the tax records it collected from the individuals or companies each year.

**(2) New Financial Instruments**

With an aim to meet the needs of rapid economic transformation and development, to create a more favorable banking investment environment, and to establish a more inviting capital market, MOF has newly recognized the legality of a number of new financial products, including securitization of financial assets and securitization of real estates.

**1) Securitization of Financial Assets**

In order to increase the liquidity of the financial assets, Financial Asset Securitization Act was enacted in July 2002, aiming at providing a flexible capital allocation, more effective reduction of their funding cost, and better risk management. Authorized by the Act, MOF has promulgated eight sets of regulations to facilitate the implementation of the Act. Two types of securitization have been provided in the Art: Special Purpose Corporation ("SPC") and Special Purpose Trust ("SPT"). In addition, the Act is silent as to whether the originators can also act as service agents that manages the trust property. The Act provides significant tax incentives for the participating companies, which, for example, the interest payments distributed to investors is subject to a lower withholding tax rate and the interest payment will be taxed separately from the personal or corporate income. As of 21 September, 2004, total eleven applications have been approved by authority. Those approved securitization products include: corporate loan, residential mortgage loan, cash advance card receivables, receivables of vehicle loan, and corporate account receivables. Among those approved applications, five of which

have been issued via public offering while the rests are sold by private placements. Two out of eleven approved products have been issued abroad. The latest securitization product application, approved by FSC on September 16, 2004, is Asset Backed Commercial Paper (“ABCP”) secured by the corporate account receivables. The ABCP is the first securitization product of corporate account receivables that has ever been issued in Taiwan. The value of outstanding securitization shares is approximately 5.7 billion NT dollars (NT\$5,708,000,000) in total<sup>5</sup>.

## **2) Securitization of Real Estates**

Real Estate Securitization Act was enacted in July 2003. The Act provides only one structure of securitization, that is, SPT. The framework of the real estate securitization is substantially similar to the SPT of financial asset securitization. Authorized by the Act, seven regulations has been promulgated to facilitate the implementation of the Act. Two types of the securitization incorporated in the Act are Commercial Mortgage Backed Security (“CMBS”) and Real Estate Investment Trust (“REIT”). As of 21 September 2004, two applications for CMBS have been approved by the authority but no application has been filed for REIT. The value of one of the approved CMBS application was approximately 4.4 billion NT dollars the shares were sold in form of financing via public offering. The value of the other CMBS project was approximately 0.6 billion NT dollars, the shares were sold in forfeiting form by private placement. As far as I know, an application for REIT is about to filed by some leading real estate group corporations.

## **3) Conclusions and Perspectives**

Within the past three years, Taiwan government has made a lot of efforts to encourage merger of financial institutions by providing tax incentives and more flexible merger models available in the Financial Holding Company Act (enacted in November 2001). As a result of government’s efforts, fourteen financial holding companies have been successfully established by the end of August 2004. Notwithstanding the establishment of the financial holding companies, as of the end of August 2004, fifty local banks and three hundred thirteen cooperatives are still in operation to provide bank services to only twenty three million populations. According to the record, none of the bank acquires more than 9.5% market share at that moment of time.

Over banking is a serious problem that needs to be resolved in the foreseeable future by our government. In this regard, our government expressly state that the targets of our second financial reform would be 1) by the end of year 2005, there shall be at least three financial institutions the market share of 10% in minimum.; 2) by the end of year 2006, there shall exist only 7 financial holding companies in the market; 3) by the end of year 2006, at least one of the local financial institutions shall either be operated by foreign financial institutions or offer its capital shares overseas.

Furthermore, our government plans to put the New Basel Capital Accord, Basel II, in force in 2006 because the New Basel Capital Accord Basel II mandates the banks to achieve the international settlement ratio (“BIS Ratio”) sets forth in the Basel Capital Accord of 1988, that is, 8%. To satisfy this requirement, in year 2001, Taiwan government has amended Statutes of Capital Adequacy Ratio of Bank to require banks to maintain at least 8% in their BIS Ratio. Additionally, “258 Financial Reform Plan” mentioned above was also executed in September 2002 by MOF, with an aim to reach 8% BIS Ratio by the end of 2003. Moreover, to cope with the further requirements set forth in the Basel II, FSC is preparing to amendment proposal for the Statutes of Capital Adequacy Ratio of Bank and is expecting the amendment to be approved by legislative branch in year 2005.

Regardless, the efforts above, as of the end of 2003 there are still, six local banks still failed to reach the BIS Ratio mandated by MOF. In this respect, we believe more efforts would be required to implement this policy.

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<sup>5</sup> By the end of August 2004, the total value of all financial asset, is NT\$ three hundred forty two thousand three hundred thirty five billion (NT\$ 34,233,500,000,000)

