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**HOW (NOT) TO IMPLEMENT EFFECTIVE INSOLVENCY RISK  
MANAGEMENT SYSTEMS: LESSONS FROM ASIA – AND ELSEWHERE**

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## INSTITUTIONAL LESSONS FROM INSOLVENCY REFORMS IN EAST ASIA<sup>1</sup>

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### Introduction

Changes in Asian insolvency systems since 1997 vary widely in their success. Our research indicates that effective implementation of an insolvency system relies on three sets of institutional factors:

*Formal design.* Knowledge is well advanced about the core features of an insolvency system. International organizations<sup>3</sup> have worked together with nations through UNCITRAL (UN Commission on International Trade Law) to produce a Legislative Guide of one hundred ninety-seven recommendations consensually developed norms for substantive corporate insolvency law.<sup>4</sup> The World Bank has articulated a set of principles for insolvency institutions.<sup>5</sup> Moreover, there are now many models of institutions that play a supporting role to insolvency regimes – informal restructuring mechanisms (e.g., INSOL’s workout principles), formal out-of-court workout processes, asset reconstruction companies, and asset management corporations, among others. Yet formal design accounts for probably no more than thirty percent of what needs to be done to manage risk through a solid insolvency system.

*Law-making in a national context.* The experiences of countries in Asia since 1997, and countries in the former Soviet Union and Soviet bloc, demonstrate that the politics of lawmaking are both critical yet poorly understood. This is not surprising since neither the lawyers nor economists who characteristically build insolvency systems are specialists in policy-making or what it takes to get a formal design implanted into the governance structure of a nation-state. As a result no codified protocols or lawmaking guides exist that present systematically the political processes and contingencies that will produce legitimate and effective insolvency systems. Perhaps another thirty percent of risk management resides in lawmaking.

*Implementation in a national context.* Since the law-in-action effectively *is* law for those it regulates, implementation is concomitantly the most important and the least understood aspect of institutionalizing an effective and fair insolvency system. Again, the professionals and sometimes civil servants who dominate this process are not specialists in institution-building, nor have international institutions gone very far in systematizing tacit knowledge about the conditions under which formal design and lawmaking will facilitate implementation. Indeed, lawmaking frequently incorporates within its recursive cycles a number of problems that make

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<sup>3</sup> E.g., IMF, World Bank, Asian Development Bank, INSOL, International Bar Association.

<sup>4</sup> UNCITRAL Legislative Guide on Insolvency Law (Final Provisional version, 6 August 2004 ). Approved by the UNCITRAL Commission, New York, June 2004.

<sup>5</sup> “Principles and Guidelines for Effective Insolvency and Creditor Rights Systems,” April 2001, World Bank.

implementation unpredictable and lawmaking unstable.<sup>6</sup> Arguably another thirty to forty percent of what makes an insolvency system successful resides in the implementation process.

Just as formal design of a system requires looking ahead to lawmaking and implementation, so difficulties in implementation require looking back to problems in design and law-making with a view towards prospective reforms that will correct earlier flaws.

This paper draws on two bodies of research to identify the fundamental challenges of building and implementing effective insolvency risk management systems. We have been directing an international research program on the globalization of insolvency regimes, with special attention to reforms from the mid-1990s to the present in China, Indonesia and Korea.<sup>7</sup> We are also informed by the findings of extensive research in economics, political science, finance and sociology that has accumulated over the past fifteen years on institution-building in all sectors of the economy and polity.<sup>8</sup> These provide a framework for interpreting current developments and for lawmakers who intend to embark on more ambitious reform programs.

We make three arguments. First, establishment of an effective IRM system depends on the successful interplay of three processes: design, lawmaking, and implementation. Without as much attention to the processes by which laws are made and the impediments to implementation, no matter how sophisticated the design it will not succeed. We illustrate from several recent experiments in Asian insolvency systems how risk management depends on getting the balance of effort right among design, lawmaking, and implementation. Second, cross-national research shows that insolvency risk management (IRM) systems comprise a large number of elements in common. Relationships among the elements also vary. No part of an insolvency system can be successfully implemented without adequate understanding of how it relies upon and contributes to the functioning of other elements in the system. Third, the attributes, importance and location of each element inside the state or market vary widely, because they must be adapted to each country's distinctive history, policies, and current domestic and international situation. Undiscriminating transplants of foreign models will almost certainly fail. This adaptation ultimately relies upon the government, because governments everywhere are the ultimate risk managers. Fourth, just as there is wide variation in the structure of insolvency systems in advanced countries, we should expect as much or more variation in developing countries. In part this variation occurs between because countries vary in their paths of development and relatedly because each country will configure differently the elements of its insolvency risk management system in order to be effective in its particular context.

In this paper we draw lessons from innovations in (1) courts, (2) professions, (3) state mediation agencies, and (4) monitoring and market workout mechanisms. However, the so-called *private* or market-based elements of an insolvency system depend not only on *public* institutions, most notably courts and often government agencies, but must be understood as options governments employ and often design for allocating risk in a society.

### **Elements of an Insolvency Risk Management System**

Conventionally, an insolvency system has five elements: substantive and procedural law; courts; government agencies to administer some types of bankruptcy and to regulate implementation; out-of-court mechanisms for liquidation or re-organization, but which exist in the shadow of the court; and professions, usually lawyers, accountants and insolvency practitioners.<sup>9</sup> In practice a total insolvency risk management system embraces much

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<sup>6</sup> Terence C. Halliday and Bruce G. Carruthers. 2004. "The Recursivity of Law: Global Norm-Making and National Law-Making in the Globalization of Corporate Insolvency Regimes." Working Paper, American Bar Foundation.

<sup>7</sup> This paper draws on four sets of empirical research: (1) Original research on insolvency reforms in China, Indonesia, Korea; and secondary research on other South and East Asian countries; (2) Original research on the development of global and regional norms by international organizations (World Bank, IMF, Asian Development, UNCITRAL, International Bar Association, INSOL); (3) Secondary research on Central and Eastern Europe and CIS countries; and (4) earlier research on insolvency lawmaking in the US and UK.

<sup>8</sup> For an excellent summary of this research, see John L. Campbell, 2004. *Institutional Change and Globalization*. Princeton: Princeton University Press.

<sup>9</sup> Most of the models promulgated by international organizations, such as the World Bank, the IMF, and UNCITRAL explicitly or implicitly refer to these five as the core of an insolvency system. See, for example, IMF, *Orderly and Effective*

more than these five elements for it must encompass risk to creditors, risk to the financial system, and the risk-taking of debtor corporations. For our purposes, elements of an insolvency risk management system include state institutions, market institutions, and those that overlap both, either because they may be independent state institutions or because they are private organizations but are heavily regulated by the state (Figure 1).

#### *IRM Elements inside the State*

All IRM (insolvency risk management) systems are centered on the state.<sup>10</sup> In Asia, as elsewhere, state initiatives are advanced through various configurations of legislatures, executives, and courts, although these are not well differentiated from each other in many countries. The *legislature* usually passes insolvency statutes and endows on them whatever legitimacy it derives from the quality and representativeness of the deliberative process. The *executive* manifests itself in two ways: through government ministries, usually Justice, Finance, Commerce or Trade, which have primary responsibility for designing, making, and administering insolvency law; and through special agencies which may be set up by the government permanently or temporarily to restructure companies or financial institutions.<sup>11</sup> The *courts* variously authorize actions by debtors, creditors, or insolvency representatives, adjudicate disputes, and often appoint or monitor trustees to oversee liquidation or restructuring.

Since the relative centrality of these institutions vary greatly in the power structure of a country, and their powers relative to each other similarly vary, we can expect that much of the negotiation over construction of an effective IRM system effectively turns into a problem of changing the balance of power within the state. It is for this reason that many insolvency reforms stall or collapse—they presuppose a shift in which part of the state wields power not only in the economy but in society more generally. In practice this means that reforms premised on major changes in powers of courts must be based on careful appraisals about the feasibility and political will necessary for executive agencies, legislatures, and market institutions to yield power to courts.

#### *IRM Organizations at the Intersection of the State and Market.*

In recent years organizations have been created that sit astride the state-market frontier. Situated more on the state side are independent short-term agencies such as the Jakarta Initiative Task Force which was set up by the Indonesian Government as a short-term corporate restructuring forum. Situated more on the market side are mechanisms for expedited proceedings, which have recently been adopted by UNCITRAL. In UNCITRAL's Legislative Guide, secured creditors can negotiate a debt restructuring amongst themselves and the debtor that would subsequently be confirmed by a court in order to make it binding.<sup>12</sup> Overlapping both state and market are varieties of the London Approach to informal workouts that rely on state structures or sanctions. A work-out mechanism coordinated by a Central Bank is a case in point.

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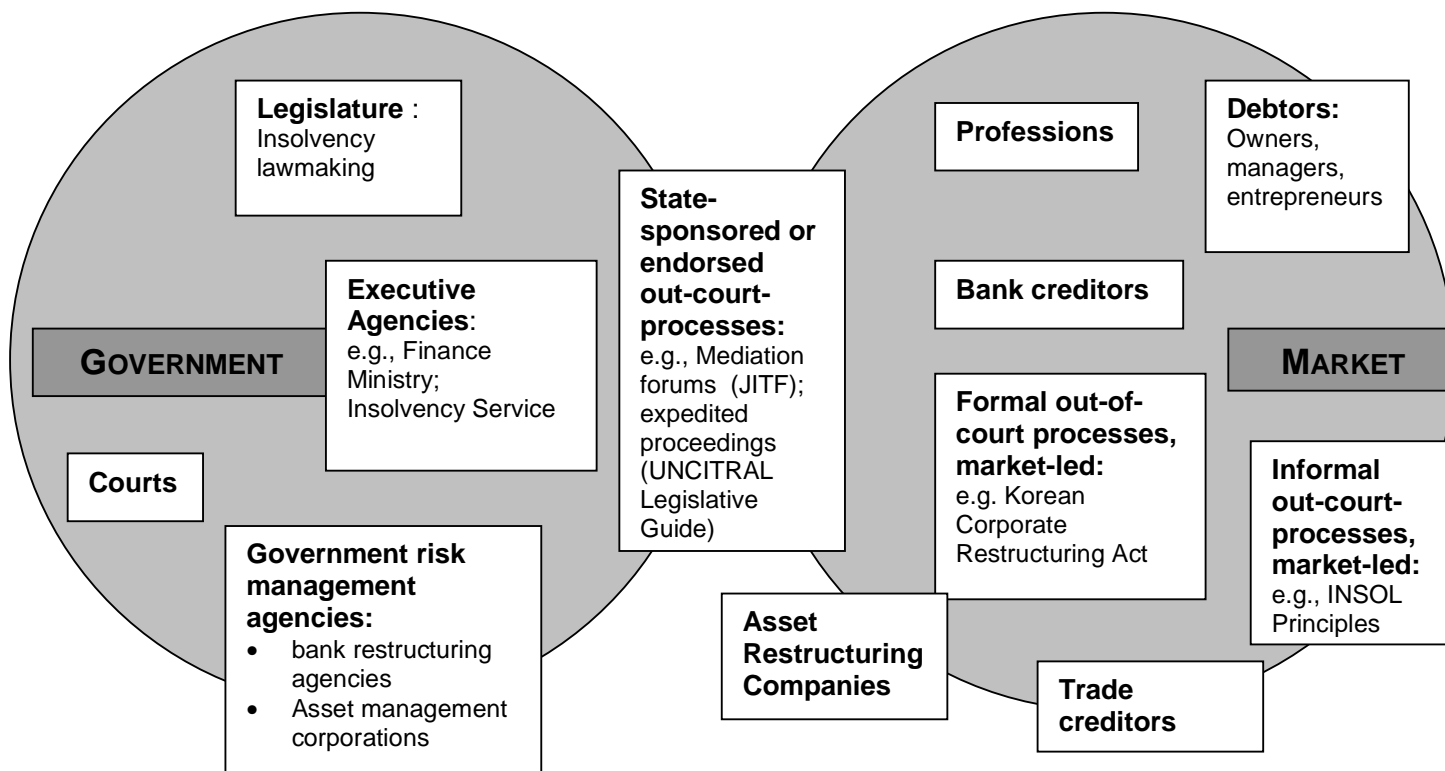
*Insolvency Procedures*, Legal Department, Washington, D.C., 1999; "Principles and Guidelines for Effective Insolvency and Creditor Rights Systems," April 2001, World Bank; Asian Development Bank, RETA (TA No. 5795-REG).

<sup>10</sup> It should be clear that we do not believe that all risk management emanates from the state, since a great deal of risk mitigation occurs within civil society, communities, tribes, and families. Part of the problem in designing risk management regimes is to identify these alternatives and to decide how to integrate or substitute for them in a government regulated system.

<sup>11</sup> If these agencies are housed within government ministries and staffed by career civil servants, then we locate them within the state. If they are given an independent status and are substantially staffed by private professionals who are seconded for a short period to the agency, we consider them to be at the intersection of the state and market.

<sup>12</sup> Op.cit., note 4, UNCITRAL Legislative Guide.

**Figure 1. Selected Elements of Insolvency Risk Management Systems**



*IRM Organizations in the Market.*

These fall into two categories: those directly regulated by the state; and those indirectly regulated by the state.

i. **Directly regulated.** The two most important are market-based IRM elements are banks and professions. While the banking industry is generally regulated to varying degrees by the central banks or bank regulatory commissions, occasionally governments may mandate that banks follow particular procedures that are designed to mitigate corporate failures and protect bank viability. As we shall see below in more detail, the Korean Government enacted in 2001 the Corporate Restructuring Promotion Act with the explicit purposes of compelling banks to monitor their corporate debtors more closely, to take collective action when corporate debtors began to slide into financial difficulty, and thereby to resolve in the market what might otherwise over-burden the courts. A London Approach that relies more on the leadership of private banks than guidance by a central bank offers another mechanism in this category.

Arguably, professional regulation is the most important element in the regulation of insolvency-related risk in the market. This is true in a very general sense that the expectations of professional performance that government maintains of accountants helps establish a threshold of corporate governance that enables risk to be monitored and controlled by professionals, particularly in their capacity as auditors. It is true in a quite specific sense that corporate restructuring in the market may be successful in direct proportion to the adequate supply and skill of the financial and restructuring experts available to the creditors and debtors. Yet many governments go a step further and obligate professionals to appraise the actions of company directors that may have led to insolvency and to report lapses in competence or honesty to government regulators (cf. England and obligations of insolvency practitioners). By this method, government multiplies its monitoring capacity and inserts its regulatory precepts directly into firm management on a case by case basis.

ii. Indirectly regulated. There are several other elements in a complete insolvency risk management system which are easily neglected or overlooked. Most visible are market-led out-of-court processes such as those conducted by workout departments of banks. They are influenced indirectly by banking regulations, such as those governing non-performing loans, and by the shadow cast by potential court involvement if the problems cannot be resolved internally. Asset reconstruction companies offer a market mechanism whereby assets of distressed state-owned enterprises or public conglomerates can be bundled and sold into a market, as often as not seeking real property opportunities for development. And then there are the plethora of risk management devices in the private market, ranging from rating agencies to informal workout mechanisms and asset restructuring companies, all of which actually or potentially are subject to regulation.

Trade creditors are also part of an IRM system for their level of credit is usually proportionally high, compared to other creditors, and they often have closer monitoring capacities and more flexibility to adjust to difficulties faced by debtors. Whether countries introduce laws to protect trade creditors through retention of title is part of the mix.

If the number of potential design elements in an IRM system were not complicated enough, the design of each element and their weighting in relation to each other varies widely across countries. If the number of potential design elements in an IRM system were not complicated enough, the design of each element and their weighting in relation to each other varies widely across countries. In advanced economies, for instance, the weightings differ considerably. In the United States, courts, professions (lawyers) and out-of-court practices are prominent, but government agencies are less so. In England, professions (accountants, insolvency practitioners), government agency, and out-of-court practices are prominent, but courts less so. In France, courts and professions are key. In Australia, professions and out-of-court practices are dominant and court involvement is limited. If this variation occurs in a relatively small number of countries with advanced economies that have strong trading relationships with each other, we should expect even more variation across countries that differ by history, culture, colonial heritage, religion, resources, race, and integration into the world economy.

What will we count as a successful insolvency risk management system? Effective insolvency systems arise from the process of institutional design and lawmaking as well as the outcomes from implementation. A successful *process* for institutional design is more likely to follow from legitimate bargaining amongst all stakeholders, usually through an open legislative process. This will produce stability, predictability, and certainty (i.e., change along predictable paths). Successful *outcomes* will include (a) stimulating capital flows (financial and human capital); (b) stimulating entrepreneurship (e.g., through encouragement of business development & business recovery through the second chances of company rehabilitation or fresh starts); (c) a shrinking of market uncertainty and its replacement by calculable risk-management mechanisms; (d) efficiently distinguishing between companies that should be liquidated versus those that have hope of rehabilitation; (e) early detection and prevention of economic crises; and (f) long-term economic growth without sacrificing social and political stability. The last criterion makes clear that an IRM system that produces widespread hardship, extreme inequality, and immiseration will ultimately produce more rather than less uncertainty.

### **Risk Management Experiments in East Asia**

Numerous institutional experiments since 1997 demonstrate that implementation of an effective insolvency institution depends on the interplay of initial design, lawmaking, and translation of the design into practice. Research shows that institution-building and implementation have failed because one or more of these elements has been ignored, taken for granted, or under-estimated.

#### **A. Courts**      *Heavy reliance on courts requires sustained political will to redistribute power in most nations*

Insolvency reforms in Asia commonly are caught in much more difficult political circumstances than many would-be reformers conventionally acknowledge. An effective insolvency system appears to require both certainty that failure of debtors to negotiate restructurings in good faith will lead to liquidation and that basic standards of fairness and the public interest are served in insolvency processes. In advanced countries these functions are usually satisfied by courts, or, if not, recourse to courts is possible for aggrieved parties. But historically many countries in Asia have given little prestige or power to legal institutions and courts are poorly equipped either to deliver competent law or to maintain independence when financial stakes are high, especially when political leaders often have financial interests in outcomes. While every insolvency system would therefore seem to be best

served with courts as its backstop, the implantation of a powerful, competent, and independent court system will vary radically in its success across countries.

Efforts to erect insolvency court systems in Asia have met widely variable fates. The results are directly related to the institutional contexts in which the new structures are implanted. Where legal education, lawyers and judges, a concept of the rule-of-law, and courts are highly respected, even in previously limited substantive areas, then a court-backed insolvency system can be erected effectively in a relatively short term. Where these conditions are missing, however, the effective establishment of what amounts to a new second or third force in politics (alongside executive and legislative power) remains fraught with difficulty.

*Korea* In 1997 Korea had in place a developed court system that attracted the best and brightest law students into judicial careers. The courts were supported by a sophisticated and prestigious—albeit tiny—legal profession. And because it had made a successful democratic transition some years earlier, the prospects of the rule of law, including judicial independence, were quite high. Most corruption had also been stamped out of the court system. In this context it made sense to design a system where large commercial insolvencies were moved away from direct government interventions and onto the courts, and to re-orient private workouts by banking institutions to the threat of liquidation in the courts. The Korean Government facilitated the process by creating a de facto specialized insolvency court within the Seoul District Court so it could ensure that experienced judges with commercial competency would preside over corporate liquidations and reorganizations. While it has confronted a number of difficulties in shifting commercial matters away from direct government control and into the courts, the institutional capacities of Korean courts and legal professions that were already in place enabled a shift in degree rather than in kind. All of these transitions towards a court-centered insolvency system have proceeded relatively smoothly. In other words, the design was well suited to prospects of implementation because the institutional fit was appropriate.

*Indonesia* By contrast, Indonesia in 1997 had a thoroughly institutionalized disrespect for law, a weak, barely competent, and corrupted court system, a dearth of research institutions that could inform policy-makers with reliable data, a corrupted state bureaucracy with limited institutional capacity, and an enormous problem of governing a vast, heterogeneous population spread over thousands of islands.<sup>13</sup> At the heart of Indonesia's economy lay an incipient conflict between the Chinese, who were disproportionately represented in the heights of the economy, and ethnic Indonesians, who far overwhelmed them in numbers and who controlled the heights of the state and the military. In this context, the prospect of successfully implanting an entire risk management system built around law was low at the outset. Nevertheless, international organizations sought to do so by the modernization of bankruptcy law, the reform of courts, the creation of bank restructuring (Indonesian Bank Restructuring Agency) and out-of-court restructuring agencies (Jakarta Initiative Task Force), and the creation of a new receivers' profession.

Establishment of the Commercial Court in 1998 illustrates the difficulties of implanting what was effectively an alien institution in unpropitious domestic soil.<sup>14</sup> There are positive aspects to its founding and functioning. The IMF and its Indonesian partners saw the court as a key element of a fairly comprehensive IRMS that would include out-of-court processes and a new profession. The publicity given its trials and tribulations has put the issue of corruption and the prospects for rule of law before wider publics. The IMF may well have been successful in its bold plan to drive a wedge for the rule of law into the whole court system via the Commercial Court, certainly as a symbolic gesture around which reform groups in society might rally.<sup>15</sup>

For practical purposes, however, the Commercial Court has been abandoned by foreign creditors because they have no ability to predict its outcomes. Perhaps less a matter of competence than of corruption, the court has made

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<sup>13</sup> Daniel Lev speaks of the challenge as enormous, “nothing less than re-creating an effective, responsive, accountable institutional base from the ground up.” The institutional problems, he says, are compounded by religious and ethnic incipient conflicts. (Talk given to the North-South Institute, Ottawa, 19020 June 1998.). However, Lev also notes that leading Indonesians did aspire to a rule-of-law state in the 1950s and advanced some distance towards it until Sukarno took the nation in a different direction.

<sup>14</sup> Daniel Lev maintains that a concept of rule of law did exist in Indonesia in the 1950s, but it has been effectively eroded in intervening decades.

<sup>15</sup> Interview 2305.

enough notable “puzzling” decisions to undermine legal certainty. Yet, given the problem of fit this might have been predicted, for the Court was expected to alter radically a path dependent trajectory of disrespect for law, of uncertain enforcement, and of corruption. In addition, the court was implicated in what could be construed as an effort to shift control of the conglomerates away from their Chinese owners to the state or foreign or ethnic Indonesian interests.<sup>16</sup>

In short, a concept that looked good in design was undermined by lawmaking and implementation. Parties critical to the success of the design—debtor corporations, Chinese business leaders—were marginalized in the lawmaking and not integrated into the design of a process they could accept as legitimate, fair, and feasible. Design occurred without fully appreciating the implementation hurdles of corruption, of placing a new court inside a compromised and ineffective existing court system, and of finding qualified judges. The actual practice of implementation required many compensatory measures to try and remedy each of these, but often it was a matter of too little too late.<sup>17</sup>

*China* The inertial power of path dependency makes a court-oriented risk management system in China even more problematic. The current version of the Draft Bankruptcy Law anticipates a key role for courts in each of the insolvency procedures it offers. In this respect it reflects the more optimistic prognoses of commentators on China’s legal development.<sup>18</sup> Yet the history of China’s legal and political institutions casts doubt on how sensible it is to expect such a radical change in course.<sup>19</sup> Historically, courts and law had much lower status in Chinese governance than public administration (Lubman 1999). Apart from punitive criminal law, law has not been a social ordering mechanism. Compounding this problem is the structure of a one-party state in which the Chinese Communist Party maintains its power over all significant policy decisions. A one-party state and a judiciary that offers legal certainty are incompatible, since any issue before the court can be trumped by Party interests or on grounds of state security or state secrets.<sup>20</sup> Moreover, in China a tight relationship of mutual patronage at local levels among political, law enforcement, and business leaders casts considerable doubt on Beijing’s ability to develop independent courts that can produce predictable decisions, even if it were so inclined.<sup>21</sup> Given this combination of an historically weak judiciary, the under-development of professions, the limited control of Beijing over the provinces, and above all, the dominant role of the CCP, it is very difficult to conceive of the implantation of a risk management system heavily reliant on courts in the near to intermediate term. Because of this, most foreign companies operating in China choose to contract around Chinese courts, since they seek to avoid them if at all possible.

In sum, an internationally approved design for an insolvency system contains internal flaws for it fails to address the deep institutional weaknesses of the courts as they presently exist. It skirts around the fundamental problem that the envisaged reforms, to be effective, would require a fundamental change in the power structure of Chinese politics. The ten-year long lawmaking process has consistently improved the design in matters of substantive law, but protracted struggles within the National People’s Congress and State Council reveal considerable rifts within the Chinese leadership.<sup>22</sup> And, as in Indonesia, key parties to insolvency risk management systems, most notable private business, have been largely absent from the design and lawmaking. As a result, implementation is likely to

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<sup>16</sup> Interviews 2267, 2032.

<sup>17</sup> Terence C. Halliday and Bruce G. Carruthers. “Conformity, Contestation and Culture in the Globalization of Insolvency Regimes: International Institutions and Law-Making in Indonesia and China,” by ABF Working Paper 2214.

<sup>18</sup> Cf. Randall Peerenboom. 2002. *China’s Long March toward Rule of Law*. New York: Cambridge University Press. Peerenboom argues that China is well advanced towards a “thin rule of law.”

<sup>19</sup> Cf. longtime China specialist, Stanley Lubman (Stanley Lubman. 1999. *Bird in a Cage: Legal Reform in China after Mao*. Stanford: Stanford University Press) who wonders if China has a legal system at all, in the technical sense of that word.

<sup>20</sup> A very few one-party states have managed over a long period to develop commercial courts that are relatively free of arbitrary executive intervention, the most notable being Singapore. However, the circumstances of a tiny island nation, or of Korea or Taiwan, are so radically different from China that any extrapolation is implausible on its face.

<sup>21</sup> Central government officials in major government agencies complain about their ability to control their provincial and municipal counterparts which are often beholden to local political and commercial interests.

<sup>22</sup> Terence C. Halliday and Bruce Carruthers. “Legal Certainty, Market Uncertainty, and Social Instability: The Confounding Case of Stalled Bankruptcy Law in China.” Paper read at the annual meeting of the Law and Society Association, Chicago, May 2004.

be more symbolic than real, and, if the government can exercise sustained political will around a consensus within the Party-state, it will require many recursive cycles of reforms over a long period to institutionalize an effective system.

Insolvency reforms that aim to enhance significantly the powers of courts thereby are likely to create political controversy that far exceeds issues of corporate reorganization. The shifting of powers to courts demands that states shed power, usually from executives historically unaccustomed to be checked by an institution that is seen to be subservient to the power of the executive.

**B. Private Insolvency Professions: *Institutionalizing insolvency professions requires as much focus as reforming substantive law***

Designers of IRMS too often place most emphasis on substantive and procedural law at the expense of building professional capacity. Yet we are not aware of any effective insolvency and risk management system that operates without competent and honest professionals. It is conceivable for an insolvency system to function with minimal interventions by courts or government agencies. It is not conceivable for such a system to function effectively without specialists, especially for reorganization. “The probability of effective reorganization increases when agents of reorganization have the capacity to (a) decide whether rescuing business is feasible and to advise on alternative courses of action (liquidation, reorganization, creative combinations of these); and (b) to reorganize the company itself . . . .”<sup>23</sup> Such capacities depend on a sufficient supply of expert labor. Public policy must therefore (a) find means to bring the best and brightest into the debt restructuring area, (b) regulate competition to constrain costs and reduce conflicts of interest, (c) remove financial and reputational barriers to insolvency professions, and (d) develop a regulatory system that delivers competency and integrity.<sup>24</sup>

There is historical precedence in advanced economies for the centrality of professions. The opportunities for corporate reorganization that were built into the 1978 U.S. Bankruptcy Code were only possible because the new law built a critical compensation provision into it. Rather than being paid by the hour, lawyers could be compensated proportionally by the size of the estate they could cobble together to effect reorganization. The combination of a new intellectual challenge opened up by the law plus significant economic incentives produced one of the most radical instances of upward mobility of any professional sub-specialty. In a very short period, bankruptcy practice went from a marginal, low-status field that was of interest only to small boutique law firms to a highly compensated, highly prestigious field in which every major law firm established a specialized practice. As a result, many of the best and brightest in law made corporate reorganization a dynamic and creative field. In Britain, too, the Insolvency Act 1986 fully professionalized insolvency practitioners. Once again a relatively marginal field became an important department in every major accounting firm, thus bringing broad expertise into company risk management in the shadow of insolvency. However, the government cleverly included a capacity to intervene in the regulation of the profession if it used its self-regulatory power to consolidate its monopoly at the expense of clients. In other words, the viability of the entire rehabilitative enterprise depended on the quality of private practitioners that could be drawn into the field.

But the development of the private market for professional services in developing or transitional economies can be fraught with problems. The bundle of reforms in Indonesia included establishment of a receivers’ profession that would represent parties to insolvency and act as trustees upon court appointment. This course of action made eminent sense because the scope of restructuring envisaged in Indonesia required an expert profession whose credentials matched the magnitude and complexity of the challenge.

But the experiment has fallen on hard times. While the IMF hoped that foreign experts would be eligible to expand the pool of experts available in the renovated insolvency system, Government regulations restricted certification to those that could pass an Indonesian language test. While the original fees were to be set on a proportion basis to size of estates, this was later changed to a receiver’s regular hourly rate outside insolvency. Judges increased uncertainty for receivers by making a determination of their fees at the end of the case with the result that receivers

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<sup>23</sup> Bruce G. Carruthers and Terence C. Halliday. 1998. *Rescuing Business: The Making of Bankruptcy Law in Britain and the United States*. Oxford: Oxford University Press, 1998. P374.

<sup>24</sup> *Id.*, pp. 373-377, chapters 8, 9, and 10.

could not predict the value of a case when they took it on. Receivers have little cooperation from banks. Most receivers have difficulty obtaining information from debtors. Moreover, an appearance of collusion appears to exist where judges expect kickbacks from receivers they appoint.<sup>25</sup> Of the original 116 certified receivers, only 32 have been appointed, and many of these several times. The lawyer-receivers come from small firms and the accountant-receivers come from only one Big Four firm. Furthermore the professional association is very weak, exercising little regulatory control, offering no continuing education, and providing no communications among members or protection of members.<sup>26 27</sup>

The limited success of the Indonesian receivers' profession demonstrates how a good design can be subverted through problematic lawmaking and implementation. Lawmaking through regulation permitted the Ministry of Justice to institute a receivers' profession that excluded all foreign expertise, even in the short term. That in turn limited the impact of the reforms severely, although it was not so surprising since professional protectionism exists in many countries. In its implementation, the regulatory structure set up to organize the local profession received little external support and failed to exercise any of the conventional functions of a self-regulatory body in advanced countries. In this respect the regulation of insolvency practitioners reflected some of the inadequacies of professional regulation in other fields, such as law.

This is not only a problem for Indonesia. The Chinese government has been working steadily to upgrade professions, including law and accounting, and appears fundamentally committed to develop what it calls intermediary organizations, a policy intended to devolve some administrative functions from the state to the market. But it is not clear that the level of deep planning for professional institution-building has occurred at anything like the level of sophistication that has gone into drafting of a new bankruptcy law. Here the design of an insolvency profession remains primitive and it can be expected that lawmaking will be messy as disparate professions of lawyers and accountants compete for potential work. The impediments to implementation do not appear to have been confronted forthrightly.

Similarly, while Korea has undertaken many insolvency reforms through to the present, the nature of the professional monopoly, which many observers believe benefits lawyers more than a fully functioning IRMS, has not been confronted adequately.<sup>28</sup> In lawmaking the government has been heavily influenced by the professional lobby which has sought to maintain a strict monopoly, certainly over the entry of foreign professionals into the Korean market for professional services. The monopoly has allowed a greater influx of new Korean lawyers into the profession. However, to some foreign corporations and creditors, implementation still appears to allow more conflicts of interest which can be avoided in larger, more competitive professional markets

Without an expert, independent profession that can handle demand, a IRMS will be on shaky ground. The design of the private professional part of the system must therefore be as central as the substantive provisions, for the latter will not function without the former. In fact, it can be argued that even if substantive law is wanting, skilled and creative professionals can fill in the gaps and craft solutions that fit the problems not adequately treated by the law. It is for this reason that the IMF and World Bank standards both emphasize this institutional foundation of an insolvency system. Nation-states reforming their IRMS should treat professions not as a necessary afterthought, but as integral parts of an interdependent system that will fail without strong professional services.

Relatedly, it should be recognized that in some jurisdictions insolvency professions affect risk-taking by companies through regulatory responsibilities they must undertake as a condition of their license to practice.

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<sup>25</sup> This pattern is quite similar to the so-called "bankruptcy ring" which operated between judges and lawyers appointed as trustees in the US before the 1978 reforms.

<sup>26</sup> "Survey of Receivers: Final Report." Interviews 2265, 2276.

<sup>27</sup> Tomasic (2001) maintains that "it is vital that private insolvency practitioners are in a position to influence decision-making processes of the Commercial Court." Roman Tomasic, "Some Challenges for Insolvency System Reform in Indonesia." Paper presented at FAIR II, Insolvency Reform in Asia: An Assessment of the Recent Developments and Role of Judiciary. Bali, 7-8 February 2001.

<sup>28</sup> Korea is slowly expanding the size of the legal profession by admitting a higher proportion of applicants to bar into practice. See Yoon Dae-Kyu, "The Paralysis of Legal Education." In *Legal Reform in Korea*, Tom Ginsburg (Ed). New York: RoutledgeCurzon Press. Table 3.3. Pp. 41.

In the United Kingdom the Insolvency Act 1986 included provisions to motivate directors to limit risk to creditors by monitoring closely their financial affairs, by seeking professional advice earlier rather than too late, and by activating insolvency proceedings before most assets were dissipated. Provisions on wrongful trading (directors could be held personally liable for the loss of assets if they continued trading when they knew or should have known that they were technically insolvent) and disqualification of directors worked together to compel directors to limit the risk they were taking with creditors' money. These threats against directors energized business associations, such as the Institute of Directors, and accounting firms, to offer educational campaigns to inform directors of their potential personal risk if they failed to follow prudent practices.<sup>29</sup>

**C. State mediation agencies: *effective implementation requires a systemic approach with close attention to the lawmaking process***

The lines of demarcation between state- and market-dominated risk management systems (Figure 1) reflect the historical development of particular institutions and credit culture. As Vassiliou (2003) has pointed out, in the economic development of advanced countries, liquidation measures long preceded rehabilitation.<sup>30</sup> Efforts to save companies could all take for granted a threshold condition—that a strict liquidation law provided a predictable alternative. The same can be said for out-of-court processes. For private restructurings to work a powerful negative sanction needs to cast a shadow over proceedings: in the case of failure, secured creditors can seize assets and dismember the business, or courts can order the liquidation of a firm's assets or sale of the firm as a going concern. If there is any uncertainty about this terminal outcome, then leverage over debtors to bring them to the bargaining table is largely lost.<sup>31</sup>

In Asia since 1997 reform programs have instituted both reorganization provisions within insolvency law and restructurings through out-of-court processes without the assurance that creditors will enforce their security or courts will act decisively to liquidate a firm.

The adverse effects of a weak court combined with limited negative sanctions for non-cooperation can be observed in the Jakarta Initiative Task Force which was set up as an independent governmental agency in September 1998 to restructure debt outside of the Commercial Court.<sup>32</sup> The logic of this out-of-court process made good sense: it conformed with Indonesian modes of dispute settlement; it enabled companies to save face in private rather than public proceedings; and it took pressure off newly established courts. Companies with assets in excess of \$US10 million could negotiate restructuring agreements with creditors under the guidance of experienced mediators, many of them from overseas.

However, what was intended as a voluntary scheme that would relieve pressure on the courts fell far short of expectations because debtors had few incentives to come to the table. The Government removed various impediments by eliminating various tax or regulatory impediments to restructuring and it provided substantial tax concessions for parties which negotiated in good faith.<sup>33</sup> But the government was reluctant to institute negative sanctions against debtors that refused either to come to the table or negotiate in good faith.<sup>34</sup> In the absence of a

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<sup>29</sup> Terence C. Halliday and Bruce G. Carruthers. 1996. "The Moral Regulation of Markets: Professions, Privatization and the English Insolvency Act 1986," *Accounting, Organizations and Society*, Vol 21, No. 4, 1996, pp.371-413.

<sup>30</sup> Lampros Vassiliou. 2003. "The Asian Recovery: Progress and Pitfalls." Global Forum on Insolvency Risk Management, Washington, D.C., Jan 28-29.

<sup>31</sup> This view is widely shared by international financial institutions. Cf. the IMF Report on Indonesia, November, 2000, that identifies, as the most important obstacle to corporate restructuring, the failure of the legal system "to pose a credible threat to debtors that refuse to restructure." (p53). See also William P. Mako. 2003. "Uses and Limitations of Out-of-Court Workouts: Lessons from East Asia." Paper read at Global Forum on Insolvency Risk Management, World Bank, Washington D.C. January 29, 2003. p19.

<sup>32</sup> Magdi Iskander, Gerald Meyerman, Dale F. Gray, and Sean Hagan. 1999. "Corporate Structuring and Governance in East Asia."

<sup>33</sup> These included punitive tax burdens, regulations governing creditors; obligations to sell equity after debt-equity swaps, and deferral of value-added taxes on debt/asset swaps (Mako 2003:18-19).

<sup>34</sup> Regulations were amended in April 2000 to shift JITF from a purely voluntary to a more regulated process that gave mediators some powers to facilitate mediation on a time-bound schedule with the threat that recalcitrant debtors would be referred to the Attorney-General for initiation of bankruptcy proceedings or civil suit, but this was not a credible threat since

“hammer” to get debtors into negotiations, or any real threat of liquidation if negotiations foundered, creditors and conciliators could rely on little more than persuasion. Debtors also knew that court-driven liquidation was not a viable threat since the court often showed itself to be more sympathetic to debtors than creditors. As a result, while the official records show the “restructuring” of enormous amounts of debt, in fact, creditors were compelled to take huge haircuts and to conclude fictive long-term agreements for postponement of debt repayment that they never expected to see.<sup>35 36</sup>

In short, reorganization without effective liquidation in Asia creates perverse insolvency systems. If liquidation provisions are not credible, then bankruptcy law doesn’t do its work; if reorganization provisions are not practicable, then companies are liquidated unnecessarily. Uncertainty results in either case.

Here the moral is clear: while private elements of an IRMS may be integral to an effective holistic approach to financial risk, they may function effectively only when the formal law is designed with great care to modulate the relations among elements of the risk management system. If those elements are not well balanced—courts without predictable liquidation standards or out-of-court processes that lack positive or negative sanctions—then the system as a whole is deformed. But to design a system where all the parts are implemented in harmony depends on institutional conditions mentioned earlier. Institutional design is therefore a very contingent enterprise—easy enough in theory, but extremely difficult unless attributes of nation-states are conducive to all elements of the system.

There are other lessons that demonstrate the dangers in lawmaking and implementation. Lawmaking of the Jakarta Initiative was taken without consulting and integrating corporations into the decision-making process. Put another way, one of the key parties to effective implementation—the debtors—were given no opportunity to express their views or to help forge a process that might satisfy some of their concerns.<sup>37</sup> Moreover, what could be seen as a technical problem in fact had far-reaching political and social implications. Some commentators observe that the Jakarta Initiative could be seen as another way to transfer control of Indonesian corporations to foreign interests, or to take the reins of many prominent businesses away from Chinese owners and hand them to non-Chinese ethnic Indonesians. For all these reasons the Jakarta Initiative generated passive and active resistance by debtors, some of which could plausibly have been reduced if the Jakarta Initiative had been designed in collaboration with industry and obtained at the outset some legitimation from industry groups. Exclusion of debtors is common in insolvency lawmaking, but it frequently results in the subversion of risk management institutions by an interested class of actors that were never given a role or the respect to assist in their design.<sup>38</sup> It should be hardly surprising that

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neither the Financial Sector Policy Committee or Attorney General were prepared to act decisively. In principle, government agencies could also revoke licenses or concessions. EKUIN Decree No. 10/2000 also permitted the Financial Sector Policy Committee to publish names of non-cooperative parties, but this threat also rang hollow. See the Letter of Intent from the Government of Indonesia and Bank Indonesia to the IMF, May 17, 2000 (Accessed at [www.thejakartapost.com/special/imf\\_loi2.asp](http://www.thejakartapost.com/special/imf_loi2.asp); last accessed 10/19/2004).

<sup>35</sup> At the time of its closure in December, 2003, the Chairman of the Jakarta Initiative reported that it had successfully restructured financially 96 companies with debts that totaled \$US20.5 billion. Companies reduced their debt by approximately 50 percent. (JITF Press Release, 18 December 2003). As of May, 2000, about 57 percent of the debt was rescheduled, 28 percent was converted into equity, and the rest was converted into convertible bonds, or otherwise dealt with as cash payments, debt buy-backs, debt/asset swaps or debt cancellation. (JITF Quarterly Report, June 2001). The success of JITF may be read as a glass half empty or a glass half full. In the latter interpretation it might be celebrated that despite the obvious limitations in what were accomplished, it was no small achievement—in the absence of effective sanctions—to bring creditors and debtors into an unfamiliar mediation forum and restructure halve the debt load of major companies. Or in the words of one old hand at crisis management by international financial institutions, any step forward should be counted as a success (Interview 3002).

<sup>36</sup> Interview 2251.

<sup>37</sup> It is the case that debtors or industry groups are usually absent from the politics of insolvency lawmaking. In the United States reforms of 1978 this was less of a problem because US legal culture is already sympathetic to debtors. Some of provisions of the U.S. Bankruptcy Code that are most debtor friendly were intended to help small debtors. In the 1980s UK insolvency reforms, industry eventually did get actively involved in reforms after it became plain that they would place new obligations on directors for wrongful trading that could lead to director disqualification and personal liability for company debts. Carruthers and Halliday, 1998, op.cit.

<sup>38</sup> It should be observed that exclusion occurs often because parties do not recognize their interests or are unable to mobilize effectively.

implementation then becomes the site for rearguard struggles by debtors to resist provisions in which they had no hand in designing. The problems faced by the Commercial Court in Indonesia resulted not only from a failure in institution-building and resources, but by the choice of debtors who had been excluded from the political process to use the courts as a rearguard battleground to subvert the intent of lawmakers.

**D. Monitoring and Market Workout Mechanisms: *Multi-directional monitoring of all risk management institutions keeps them accountable to key constituencies***

Without close monitoring of changes, and the ways law comes to operate in practice, perverse and deviant patterns may quickly take hold and be all the more difficult to extinguish. Laws often are passed and ignored, especially when they are passed under the duress of external influence or in response to a public outcry that requires at least a symbolic response. The attention span of politicians is often fleeting. For all these reasons, monitoring of actual implementation by interested parties can ensure that the law-on-the-books is taken seriously in practice.

Monitoring can reside in several places in an insolvency risk management system.

Monitoring can be institutionalized within firms through accounting regulations and corporate transparency provisions. Although monitoring can be left to firms themselves, monitoring of clients by banks can be mandated by banking regulators or by explicit statutory charges. Monitoring may be instituted in all elements of the insolvency system – debtor corporations, creditors, and the institutions of mediation, restructuring and liquidation.

*Korea:* In 2001 the Ministry of Finance and Economy (MOFE) pushed through the National Assembly a law intended to facilitate bank-led out-of-court restructurings, the Corporate Restructuring Promotion Act (CRPA or Act). The market in Korea lacked a voluntary mechanism to coordinate conflicting interests among creditors and debtors in order to restructure companies in financial difficulty. Banks in Korea had long been accustomed to act as agents for their political principal—the Government of Korea. Government-led banking ensured that commercial criteria for lending were subservient to policy guidance, whatever the financial merits of a given borrower. Banks did not have effective credit risk evaluation mechanisms since credit risk was not a primary basis for lending. The deficiencies in banking practice extended to inadequate methods for early detection of financial difficulties, in part because the lack of accounting transparency of borrowers made risk evaluations and monitoring difficult. If companies were in distress, no prompt mechanisms existed for action. And under existing mechanisms, workouts were not binding on foreign creditors which created a problem of free riders and holdouts.<sup>39</sup>

Rather than set up a government agency, the Act created a set of mechanisms and responsibilities for creditor institutions over firms with debts of more than 50 billion won (934 companies). The Act took aim at accounting procedures in firms and monitoring procedures by banks. It legalized a set of internal accounting procedures in companies to improve their transparency to banks. It mandated that banks institute Corporate Credit Risk Evaluation Programs in which they undertook quarterly reviews of key financial data of their corporate clients. If corporate clients failed prescribed tests, a lead bank was charged with convening a council of major creditors to produce under time constraints a restructuring plan that could be imposed on all creditors by vote of creditors carrying more than 75% of a company's debt. Troubled companies were compelled to submit to the restructuring plan, subject to certain protections.<sup>40</sup>

The Act built in several negative sanctions. If a Memorandum of Understanding were not concluded within the grace period, then bankruptcy procedures would be invoked (and by this time courts were liquidating even very large companies). Credit institutions would be subject to compensatory liability if they failed to act on resolutions they had voted for. And failed creditors were required to compensate other creditors for the damages they inflicted upon them. Monitoring provisions for quarterly evaluations of compliance with the MOU were built into the Act.

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<sup>39</sup> Presentation slides, "Law for Promotion of Corporate Restructuring," Ministry of Finance and Economy, August 9, 2001. Soogeun Oh, 2002, "Government Intervention in Corporate Exit Mechanisms: The Corporate Restructuring Promotion Act of Korea," presentation to Hong Kong University Faculty of Law, April 18-19, 2002.

<sup>40</sup> Mako 2003, op.cit. Soogeun Oh, 2003, "Setting Insolvency Rules: A Course of Understanding and Persuasion," presentation to OECD FAIR III, Seoul Korea 10-11 November 2003.

Various arbitration and conflict resolution procedures in the market were built in for all parties. If the private market solution failed, then normal bankruptcy procedures would apply.<sup>41</sup>

It will be too soon to evaluate how well the new risk management provisions will work in the longer term and how effectively the Act will promote restructurings. Initial steps were faltering. In the first six months only twenty firms went into formal workouts under the Act and it appeared that the quiet hand of government technocrats continued to be informally guiding some proceedings, especially in those banks where the government was a majority stockholder. Legal critics argue that by removing restructurings from a court-driven process the Act effectively diminishes the rule of law in the economy and reduces the rights of creditors. And since banks are vulnerable to continuing bureaucratic “guidance” the market itself is deformed by arbitrary political interventions.<sup>42</sup>

Monitoring by professions offers another option. In insolvency this can involve professional monitoring of firms and professional monitoring of insolvency institutions for procedure and outcomes.<sup>43</sup> The former can be mandated by law or regulation or follow from normal professional practices. The latter represents one way that professions can exercise a civic professionalism that holds institutions accountable in which professions have an expert interest, technical authority, and privileged access. Yet another source of monitoring can come from civil society groups, such as the Center for Law and Policy in Indonesia, which has been monitoring court decisions<sup>44</sup> or the Korean Development Institute, whose economists track quantitative indicators with close attention and much sophistication.<sup>45</sup> Monitoring can be mandated by government or international organizations and contracted out to law or accounting firms or thinktanks. This is the approach taken by the Team 7 who were charged with analyzing every insolvency decision of the Commercial judges. As a prelude to Team 7, the IMF also funded an internal report by a leading Jakarta law firm on all cases in the Commercial Court to date, but it was never released to the public.<sup>46</sup> In exceptional circumstances, monitoring may be mandated by international financial institutions, such as the statistical reports to the IMF from the JITF.

Monitoring is not simply a matter of diagnosis through the gathering of firm evidence of changes, problems or progress. Monitoring is a powerful stimulus to institutions which find themselves accountable and transparent to public review and critique.<sup>47</sup> The analysis of court decisions, for instance, that actually names judges whose cases seem deviant, or seem systematically to favor a particular category of parties, (see Suyudi’s findings)<sup>48</sup> is a very powerful sanctioning mechanism. When the monitors can ally with the media, then a strong coalition enables the activation of public opinion which in turn adds further pressure on new institutions.

An insolvency risk management system that builds cross-cutting or reciprocal monitoring into the relations among its elements builds a strong foundation of accountability, particularly when economic or ideological interests give monitors strong encouragement to exercise vigilance. More attention is needed to the structure and dynamics of such a comprehensive design. At the present time designers give priority to monitoring in one place or another (e.g., bank regulators of banks, banks of lenders) but do not envisage a broader pattern where many elements of the system can be observing systematically the behavior of other elements, whether it be civil society groups or the media monitoring the judiciary, or professionals managing directors. There is no reason why industry groups should also not monitor creditors, courts, and mediation agencies.

Nevertheless lawmaking over monitoring may be divisive—no party likes a spotlight to be shone publicly on its activities—and dilute the potency of monitoring responsibilities, sometimes because powerful lobbies resist either exercising or being accountable to monitoring efforts. In practice, implementation requires more than a metric of

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<sup>41</sup> Presentation slides, “Law for Promotion of Corporate Restructuring,” Ministry of Finance and Economy, August 9, 2001.

<sup>42</sup> Oh 2002, *op.cit.*

<sup>44</sup> See Aria Suyudi’s jurimetric analysis of the Commercial Court in these proceedings.

<sup>45</sup> Korea Development Institute Conference, November 13, 2003 .

<sup>46</sup> Interview 2250.

<sup>47</sup> A leading Indonesian reformer maintains that the strength of a legal profession relates directly to limits on court misuse and abuse. M. Reksodiputro, 2000, “Bankruptcy Reform: Lessons from the First Nine Months.” In Lindsey 2000, *op.cit.*, p50.

<sup>48</sup> These proceedings.

evaluation and regular reports. It requires informed scrutiny to be sure that reports are meaningful. Objects of monitoring frequently use the well-attested technique of symbolic compliance to offer apparently impressive results which are hollow upon more careful inspection. Whether these be false or incomplete sets of accounts, or artificially boosted statistics of restructuring success, or impressive-sounding statistics on memorandums of understanding—only informed and vigilant monitors will be able to distinguish the symbolic from the real.

### **Conclusions and Caveats**

International organizations ritually repeat the maxim that “one size does not fit all” in international transplants of laws and legal institutions. The maxim is entirely correct, but in practice it is heeded less consistently because there are many pressures on international organizations and developed countries to export legal models without due awareness of their fit in particular national situations. On the one side there are pressures for harmonization in the belief that it will produce certainty and investment. Strict harmonization, at least of rules and institutions, abrogates the principle of different sizes for different contexts. On the other side, international institutions and often nation-states do not know what conditions will support laws and institutions that are imported from other countries or based on models promulgated by international organizations. For symbolic or well-intentioned reasons they may mistakenly import models poorly suited to local situations. This problem is compounded because the experts on which international organizations and nation-states usually rely do not have expertise in the behavior of institutions and the conditions under which they will take root and grow.<sup>49</sup> Our conclusions and warnings therefore reinforce the maxim that “one size does not fit all” with its corollary that *variability* of insolvency systems is not only inevitable but desirable.<sup>50</sup>

#### **1. Poorly adapted legal transplants will likely fail.**

Design of an effective IRMS faces several difficulties all of which turn on the puzzle of how to combine the general with the particular, the universal with the local, the foreign with the domestic situation. By accident or design, nations often import foreign or global models that are entirely inappropriate, given their history, institutional capacities, and economic and legal development, with the result that they produce more rather than less uncertainty. The success of models in other situations can be beguiling. Even if adequate research establishes that ostensible success is both real and lasting, success elsewhere depends on a specific set of circumstances in that country. Without identifying the salient conditions of success, nations risk bad transplants and resulting uncertainty in the law and market. Failures of transplants abound when “best practices” are carried from one country to another without full awareness of the conditions under which they succeeded or failed. Imports must come with a conditional account of the circumstances that were conducive to their success. And that is no easy matter.

For instance, the London Approach, championed initially by the Bank of England, seems to offer a clean, quick, effective way of restructuring debt out of court and thus appears to introduce welcome efficiencies into private or quasi-private risk management. What were the circumstances of its origin and the conditions of its success?<sup>51</sup> England boasted in an independent Central Bank of enormous authority. Most secured lending to corporations flowed from a handful of the UK’s domestic clearingbanks whose head offices were within walking distance of the Bank of England. The Bank of England had little difficulty “inviting” major credit institutions to sit around a conference table and forge a “gentlemen’s agreement” to restructure a failing company’s debt with every expectation that the power of informal sanctions in the tight English world of private banking would make agreements effectively binding on all parties.

It is entirely plausible to extrapolate from the UK experience and develop principles that might be applied to all countries, as INSOL has effectively done. But that extrapolation only works when it is known which of the conditions of the London Approach<sup>52</sup> were critical to its success or it is known what conditions are most propitious

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<sup>49</sup> For a social science analysis of the complexities of institutional change, see Campbell (2004), *op.cit.*

<sup>50</sup> One way to solve the incipient tension between global norms and national variability is to formulate global norms as binding principles with the expectation that their application will take the form of locally-adapted non-binding rules. Braithwaite, John Bradford 2002. Rules and Principles: A Theory of Legal Certainty. Australian Journal of Legal Philosophy, Vol. 27, pp. 47-82, 2002

<sup>51</sup> There is a need for independent research that establishes the degree of its success in a scientific manner.

<sup>52</sup> In practice it seems that the label “London Approach” is used as a rhetorical short-hand for any more or less voluntary out-of-court workout process, even if the details of the process differ radically from those that made the original

for the application of the INSOL workout principles. What if a country's central bank is neither independent nor authoritative? What if the role of coordination is given to a lead commercial bank? What if the number of financial creditors is very large? If some are domestic and many are foreign? If some are long-term lenders and others are bond-holders who sell into secondary markets? If non-financial creditors want a seat at the negotiating table? If debtors demand to be part of the restructuring negotiations? If no mechanism exists for making agreements binding? At least one experienced World Bank official has argued that the conditions that would make a London Approach work do not usually pertain in East Asia and thus it must be creatively adapted to local circumstances.<sup>53</sup>

This argument is not to dismiss the potential value of out-of-court mechanisms for risk management. It is to maintain that a global model or foreign import is not sufficient in itself to warrant adoption. Global models and foreign imports must always be accompanied by the contingencies under which they are likely to work. So far that knowledge seems to exist, perhaps, only in the tacit understandings of some international institutions which are experienced in the cross-fertilization of models from one national context to another.

## **2. Government is the Ultimate Risk Manager**

This paper rests on the premise that government is the ultimate risk manager. In his brilliant recent book, David Moss of Harvard Business School has shown that government manages risk by either reducing or allocating risk to different segments of the government, market and society.<sup>54</sup> In the economic development of the United States, for instance, Moss shows that the first phase of development involved the extensive involvement of government in creating a secure business environment. This did not necessarily imply direct government intervention or an increase in the size of government, though it always had a regulatory component. From 1789 to 1900 the government introduced protections for property rights, established a common internal currency, required deposit insurance, passed limited liability law for corporations and later fixed exchange rates. In so doing the government mobilized its generic powers of compulsion to solve recurring problems in private markets.<sup>55</sup> The passage of successive bankruptcy laws was an integral part of the government's efforts to create a risk management system, in this case that stimulated entrepreneurial risk-taking by company owners, managers and directors.<sup>56</sup>

The configurations of an insolvency risk management system are a public policy decision on how and where risk will be reduced or allocated. Of course, to say that government is the ultimate risk manager does not determine which institutions will be given what kinds of responsibility for reducing or managing or stimulating risk.<sup>57</sup> It is to say that economic development may benefit when government takes a macroscopic and long-term view of the risk management problem and acts holistically to design a comprehensive, integrated system to solve that problem.

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Bank of England interventions distinctive. This is not unlike the idiomatic use of "Chapter Eleven" by lawmakers as a form of legitimating any reorganization provisions in bankruptcy law, no matter how much they deviate from the actual provisions of Chapter 11 in the U.S. Bankruptcy Code.

<sup>53</sup> IFI officials involved in the design of the Jakarta Initiative quickly realized that a pure London Approach could not work in Indonesia, since most of an English infrastructure was missing. The JITF needed to be tailored in ways that compensated for the lack of institutional supports (Interview 3002). See also Gerald E. Meyerman, 2000. "The London Approach and Corporate Debt Restructuring in East Asia." Paper read at a conference on Emerging Markets in the New Financial System: Managing Financial and Corporate Stress, New Jersey, March 30-April 1, 2000.

<sup>54</sup> David A. Moss. 2002. *When All Else Fails: Government as the Ultimate Risk Manager*. Cambridge, MA.: Harvard University Press.

<sup>55</sup> These were (a) information problems, where government solved the adverse selection problem by forcing everyone into the pool, and the moral hazard problem, by extending its investigatory and enforcement capacities; (b) perception problems, where government engaged in public information campaigns; (c) commitment problems, where government used its taxing powers to spread risk; and (d) externalization problems, where government internalized externalities through liability measures. Moss, *op.cit.*, chapter 2.

<sup>56</sup> These were followed in a second phase of reforms between 1900-1960 with measures to create a secure environment for workers, through workplace safety regulation, workers' compensation, old age insurance, unemployment insurance, and the like.

<sup>57</sup> It must be emphasized that government's role as a risk manager is quite independent of whether a country has a laissez-faire economy or a welfare state. It is only to say that government (e.g., Mrs. Thatcher's Conservative Party) designs as a matter of public policy what risk will be reduced and in how risk will be allocated.

Neither is the U.S. experience normative for other countries. Global and contextual conditions have changed radically from American nineteenth century economic development. The U.S, economy, legal system, and polity have long been acknowledged by scholars for their exceptionalism rather than their normalcy among the worlds nation-states. For symbolic or pragmatic reasons, other nations often borrow from the U.S. or claim their reforms resemble U.S. institutions. It is common in developing countries to be told that insolvency reforms are following Chapter 11 of the U.S. Bankruptcy Code on reorganization of companies. Most often this means only that countries are incorporating into their law provisions for the rehabilitation of companies. To follow Chapter 11 closely, with its institutional assumptions of powerful and competent courts, huge and prestigious pools of professional expertise in law and accounting, and a legal culture that favors debtors, would doom the rehabilitation experiments of most countries to failure. Government can be the ultimate risk manager without either mimicking America's own economic development or patterning a developing country's nascent legal institutions on those in the United States where circumstances, history and legal culture are radically different.

### **3. National circumstances must determine where each country places the boundary between state or market responsibility for insolvency risk management**

We have argued that the design of insolvency risk management systems must be holistic. The extensive experiences of advanced nations and experimentation in developing and transitional countries show that a fully-defined system comprises many elements that extend all the way from pure state entities through the market and out into civil society (cf. Figure 1). If governments are the ultimate risk managers, they are more likely to meet with success in lawmaking and implementation when their design of the systems views all parts in relation to the whole.

Perhaps the most fundamental institutional issue is the policy decision about the appropriate line of demarcation between risk management processes located within the state and those located primarily within the market. Every government locates this line in a different place and often the policy debates are fierce for they can be tantamount to decisions over whether civil servants or private parties will have jurisdiction over areas of work. There can be no a priori decision about where this line should be drawn. Research on several transitional and developing economies casts doubt on how much can be handled by state agencies and courts where these are deformed, corrupted, or undeveloped. Research indicates that establishment of independent competent courts is a rare achievement.<sup>58</sup> If countries have deformed state institutions, then it may make more sense to push a larger burden of the risk management responsibility onto the market, albeit regulated by the state. On the other hand, where governments have respected courts and/or substantial administrative capacities, then bureaucratic solutions might also work. In several developmental states, however, part of the larger move towards an open political and economic society may require a wresting of power away from powerful state agencies and the allocation of those powers to strengthened courts or private sector institutions, as has been the case in South Korea.<sup>59</sup>

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<sup>58</sup> Bryant Garth. 2002. "Building Strong and Independent Judiciaries through the New Law and Development: Behind the Paradox of Consensus Programs and Perpetually Disappointing Results." *52 DePaul Law Review* 383-400.

<sup>59</sup> Terence C. Halliday and Bruce G. Carruthers. 2004. "Epistemological Conflicts and Institutional Impediments: The Rocky Road to Corporate Bankruptcy Reforms in Korea." *Legal Reform in Korea*, Tom Ginsburg (Ed). New York: RoutledgeCurzon Press. Pp. 114-133.

Figure 2a. State-Centered Insolvency Risk Management System

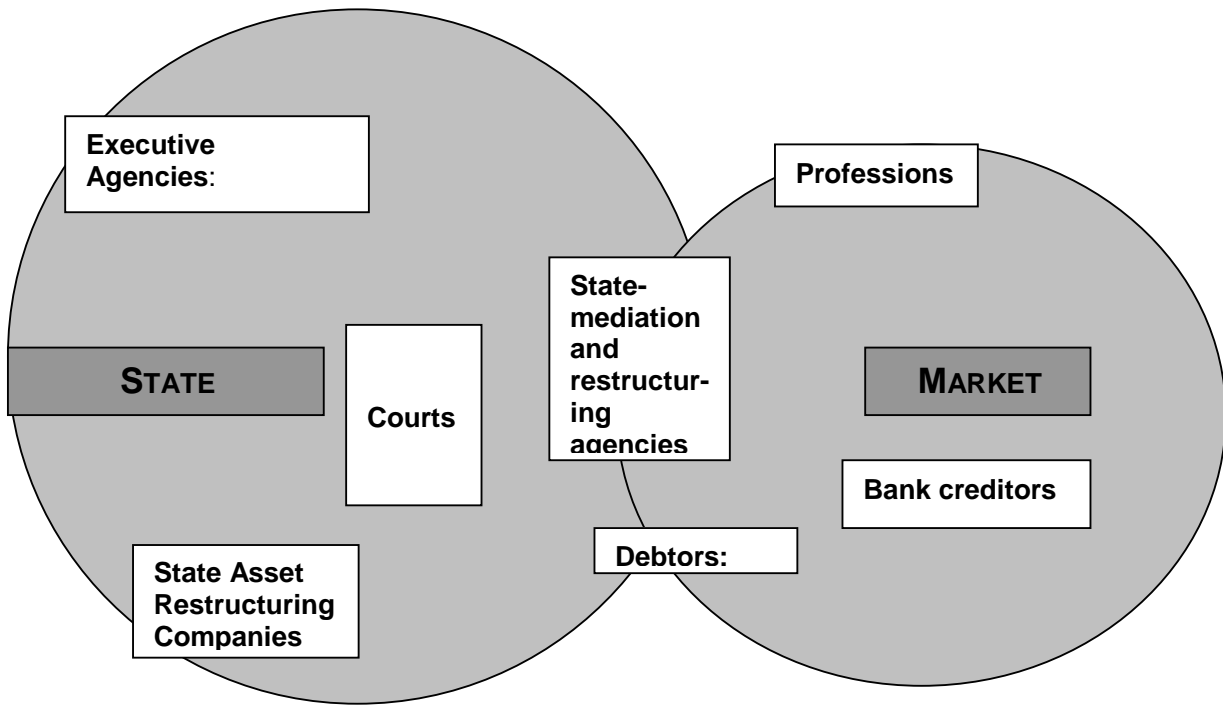


Figure 2b. Market-Centered Insolvency Risk Management System

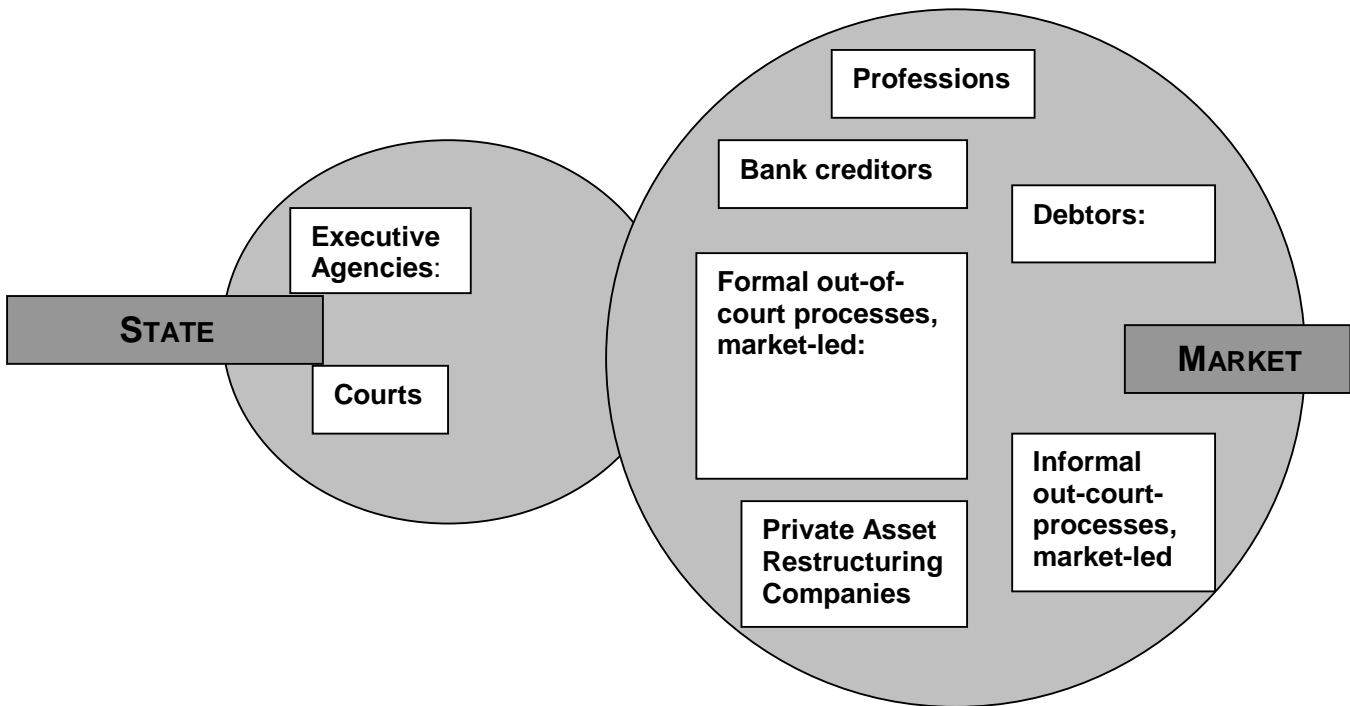


Figure 1 can therefore look quite different—and should look quite different—in countries where the state has competently driven economic development, or where the market is vibrant but the state is ossified and corrupt, or where law is a principal ordering mechanism in social relations versus where law historically has been marginal to social and economic control. We represent diagrammatically variants in Figure 2a and 2b. In Figure 2a it is the state that dominates because historically it has done so (cf. France) and because markets or civil society may be institutionally under-developed. The reform trajectory of such nations will likely follow a progressive devolution of state functions to the market and civil society through a down-sizing or retraction of the state. This will strengthen other institutions and spread the options for allocating risk across institutions but is unlikely to remove the dominance of the state as risk manager overall.

In Figure 2b it is the market that dominates because the state may be deformed (e.g., corrupt, incompetent, lacking legitimacy) whereas the market is more dynamic, more open to experimentation, more successful in recruiting personnel skilled in corporate rehabilitation, and the like. Markets always require regulation and state monitoring. The government remains the ultimate risk manager, but it may allocate most risk management to market institutions that it creates or confirms and regulates. The reform trajectory of such nations will likely require a progressive strengthening of state regulatory capacities and its judicial functions, but the center of restructuring and risk management will remain in the market (cf. Britain).

In short, design must fit each system uniquely to its double context: national path dependency and global norms. This strongly implies an incremental rather than radical strategy of reform.<sup>60</sup> Since it is very difficult to move a nation too radically away from paradigms that have governed it for decades or generations, or from established institutional trajectories, any reforms must take the time to reflect on the vexing issues of how to fit an innovation within governing paradigms and taken-for-granted meanings about states and markets, obligations and rights, relations and agreements, that pervade every society. This is not only a matter of design but of implementation, for changes require acceptance by their primary constituencies and acceptance comes only when the framing of change is meaningful within a cultural context.<sup>61</sup>

The strategy of the Chinese government to follow an incremental path with its insolvency reforms well illustrates this approach. For a decade China's State Council has preferred to deal with the liquidation and reorganization of its formerly pervasive state-owned enterprises through incremental steps of small, local experiments that were modified and expanded geographically as successes or failures demanded. Only in 2004, ten years after drafting began on a new, comprehensive bankruptcy law, does it envisage placing all companies under the umbrella of a law-driven rather than bureaucratic-driven risk management process. But, even now, the draft law currently being reviewed by the National Peoples Congress has excluded between 1000-2000 significant state-owned enterprises and all partnerships and many small enterprises because the State Council is doubtful that a law-governed, court-based system can manage some of the potential dislocations that might better be treated through administrative discretion.

#### **4. Insolvency risk management systems fail when institutional designers do not give proper recognition to lawmaking processes and conditions of implementation**

Disproportionate attention is given to design by most institution-builders. Yet lawmaking and implementation can subvert the best conceived plans. As a result, it is impossible for builders of effective risk management systems to avoid the politics of lawmaking or the pragmatics of implementation.

Effective reforms must be legitimate. Arguably the more legitimate the process, the more likely reforms will be accepted by all parties. Legitimation of legal systems even in underdeveloped systems of political representation depend on participation in the political process. If major parties to reforms are excluded from deliberation over the design of reforms, then they are likely to perceive reforms as potentially hostile or at least alien. In insolvency reforms it is a mistake to exclude, as frequently happens, debtor corporations, business elites, workers and trade creditors, among others. Their exclusion may not be a matter of conscious rejection. Excluded parties may not have recognized their own interests in reforms, or they may have recognized their interests but have been unable to

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<sup>60</sup> Occasionally there are historical moments when a radical break seems possible and can be sustained, but these are rare. See Campbell (2004), pp.33-35.

<sup>61</sup> John Campbell (2004), chap. 4.

mobilize during the lawmaking process. And it can be more than a matter of interests: good lawmaking benefits from extensive information on the conditions under which the law will work. Broader participation by affected parties is likely to generate this information. Whatever the reason for exclusion from participation, however, the most admirable design is likely to be undermined if lawmaking is perceived to be “crammed down” on one set of actors in the credit network by another set of actors; or by one profession (e.g., economists) on another (e.g., lawyers); or by one government department upon another. This problem is intensified the more well-placed the ‘losing’ party is to stall or frustrate implementation

Effective reforms also require that reformers anticipate and analyze the factors and actors that will facilitate or inhibit implementation. At the very least it requires that lawmakers consider what interested parties are in a position to frustrate successful implementation. These will certainly include practitioners, creditors or debtors, and courts. If their experiences, cultural orientations, and interests are not integrated into the design and lawmaking, then they are likely to turn into active or passive resisters of reform. The internal politics of implementing actors also cannot be ignored. In China, professionalization is still in its infancy. Much fragmentation, conflict, and jurisdictional contestation takes place among poorly regulated, not very autonomous professions. System design and institution-building may be subverted incidentally by competition among professions—between elites and non-elites, between well-institutionalized and newly formed professions, between accountants and lawyers. A similar fragmentation and competition has bedeviled Indonesian systemic reforms.

Furthermore, implementation is the “location” where external organizations (e.g., international financial institutions, overseas aid institutions) and even national government agencies have least impact. It is the place where the weak can retreat and resist. It is the location for guerilla warfare in law reform. As a vast scholarly literature on regulation demonstrates, without a culturally-adapted, cooperatively-designed framework of regulation, its practitioners can effectively nullify reforms. Thus it is a matter of pragmatism to elevate considerations of implementation and its primary actors into the front rank of lawmaking for insolvency systems. This requires sophistication in the design of other-monitoring and self-monitoring systems. It also requires a system adapted to a particular national context so that all elements of the system are balanced within the state, within the market, and between them. Each country will respond to problems of design and implementation by drawing the line between state and market regulation in a different place.

##### **5. Best Practices are Never Best Everywhere.**

Transnational and global institutions, international organizations and professions, now offer an array of norms, ranging from the global consensus of UNCITRAL and the global consultations of the World Bank to the practices of professions and other countries. We have argued there are many pragmatic reasons to situate an IRMS inside the parameters of global norms, not least that they represent a distillation of expertise and experience from many situations. The universality of the global, however, must be converted into the particularity of the local. Without understanding what will be legitimate and meaningful and practical in the unique circumstances of a particular country, will lead system designers into a morass which breeds uncertainty and confusion. It must be emphasized emphatically that “best practices” are never best everywhere; they are “best” only in specifiable circumstances. Unless those contingencies accompany a best practice model then it requires a great deal of skill and luck to adapt it successfully in local circumstances.

##### **Varieties of Capitalism, Varieties of Insolvency Systems**

These conclusions lead to modest expectations about what is possible, particularly in the short term. They lead to a more contingent expectation of what happens when the transnational is brought to the national, or the global to the local situation. They also point to major gaps that still exist in the global movements towards effective IRMS. Arguably the most important gap is that no systematic comparative framework exists as yet on varieties of capitalism, varieties of insolvency risk management systems, and the matching of one to the other. In brief, we need to get to the point where we know what kind of insolvency risk management system has an adaptive affinity with the particular variety of capitalism practiced by this particular nation-state. Just as advanced economies divide between *coordinated market economies*, which emphasize a strong coordinative role for the state and usually a social welfare function, versus those that are *liberal market economies*, which allow firms principally to coordinate

their activities through hierarchies and markets,<sup>62</sup> so we can expect that there will be considerable variation across Asia in the amount of coordination of risk that will be centered in the state or market respectively. As yet, however, little is written of these varieties of capitalism and even less about how they might affect insolvency systems.

Finally, just as insolvency systems are as much policy domains as technocratic constructions, so too it is a mistake to divorce the efficiency and effectiveness of an insolvency system from issues of equitability. Since policy approaches to insolvency regimes vary substantially across advanced countries because of differences in distributive concerns about secured and unsecured creditors, workers, tax authorities, and other stakeholders, such as single-company towns, it can be expected that even more variation will occur in Asia and other regions. Many of the implementation problems that we have observed in Asia arise from unacknowledged or veiled conflicts over equity—between workers and owners, between local creditors and foreigner investors, between national sovereignty and global hegemony, between rust-belt regions and fast-growth regions.<sup>63</sup> While insolvency reformers are most comfortable dealing with the technical aspects of risk management, policy-makers and parties-in-practice know that every design decision carries distributive consequences. Confronting inequities and distributive consequences makes not only good policy sense, but good practical sense, for manifestly inequitable decisions, however conceived, will undermine certainty in the market, sooner or later.

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<sup>62</sup> Peter A. Hall and David Soskice, “An Introduction to Varieties of Capitalism,” in Peter A. Hall and David Soskice (eds), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford University Press, 2001), pp. 1-68.

<sup>63</sup> Note Linnan’s (2000) comments on Indonesia: “There are technical problems with Indonesian bankruptcy law, but the over-riding issue is whether Indonesian society believes that functioning bankruptcy law serves Indonesia’s interests rather than solely those of foreign creditors . . . .” David Linnan, 2000. “Bankruptcy Policy and Reform: Reconciling Efficiency and Economic Nationalism.” In T Lindsey (ed). *Indonesia: Bankruptcy, Law Reform and the Commercial Court*. Sydney: Desert Pea Press., p.94. See Linnan 1999:132-3 on the conflict between economic liberalism and national sovereignty. Oddly enough, after showing how bankruptcy law involves major issues of public policy, he can then conclude that “bankruptcy law is not a moral matter, but rather one of allocative efficiency,” as if the latter were not a moral claim in itself.