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**INSOLVENCY SYSTEMS IN ASIA: AN
EFFICIENCY PERSPECTIVE**

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Insolvency Systems in Asia: An Efficiency Perspective

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***INSOLVENCY SYSTEMS IN ASIA :
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session v

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In the limited time available, I would like to make the following brief points.

1. An efficient insolvency system is in itself not enough.

Creditors and, in particular, debtors will not utilise an insolvency regime, regardless of how efficient it is or the number of insolvencies existing at that time, unless there is some incentive to utilise the insolvency system. This was certainly the experience in Thailand in 1998 where despite the introduction a new rehabilitation law in April 1998, a rescue package type law, there were only 15 rehabilitations in that year despite the fact that NPLs were over 40% of outstanding credits.

What is needed to ensure that the insolvency regime is utilised are clear incentives or triggers to entice debtors and creditors to utilise the system. In Australia, for example, the voluntary administration procedure introduced on 23 June 1993, following the General Insolvency Inquiry (commonly known as the Harmer Report), instituted very clear incentives for directors of insolvent companies to have prompt recourse to the voluntary administration system. At the same time as the voluntary administration procedure was implemented, a new regime imposing civil and criminal personal liability for directors of insolvent companies who continue to trade whilst insolvent was introduced. The new insolvent trading liability scheme allowed directors to avoid personal liability by providing them with a defence if they acted promptly to appoint a voluntary administrator. This defence represented an acknowledgment that in handing over an insolvent company to an independent administrator the

director was taking the most honourable of steps, acknowledging the position of the company and seeking to protect the interests of the true stakeholders of the company at that time, the creditors.

In addition, the taxation laws in Australian were amended in 1993 to provide for personal liability for directors for unpaid group taxes if the directors failed to appoint a voluntary administrator within a specified of period following receipt of a penalty notice from the taxation authorities. This procedure has, in Australia, been the trigger, in a practical sense, for many voluntary administrations, which have now become, by far, the most commonly used insolvency procedure.

2. Predictability is the priority, pricing the answer.

The importance of the question of the priority given to secured creditor claims and the utility of absolute priority as an essential aspect of maximising the volume of credit in the system is overstated.

The abundance of credit in the early 1990s in South East Asia is clear proof that credit levels will grow to, as the Asian crisis has shown, unsafe levels even in countries where secured lenders do not have absolute priority or efficient self help or other efficient enforcement remedies.

The predictability of the enforcement remedies available to creditors, even if inefficient or ineffective, and the predictability of the priority position of the lender are more influential to a lender's decision to provide credit than the ranking of the lender's priority.

The lender will simply factor into the pricing for the loan the priority position afforded to his claims. If the system is predictable, the absence of an absolute priority does not in practice discourage lending to a prohibitive level, whilst in theory it should reduce the level of demand if pricing is inflated by the lack of absolute priority.

However, in an insolvency scenario, it is crucial that priority be afforded to new money provided in order to preserve a viable business. Although, in order to protect creditor interests (i.e. the general body of creditors) and avoid unnecessary dilution of their claims, new priority should only be afforded to new money if an independent planner, administrator or trustee is in control of the business. Generally, this means the company must be in formal reorganisation.

3. Insolvency systems need to be dynamic.

The clear lesson from the recession in the late 80s in many countries and the Asian crisis in the late 90s is that deficiencies in insolvency systems materialise in times of crisis. To some extent, the economic and social purpose of insolvency law changes as the economy moves through its cycles. In times of crisis, it is clear that, from a macro and micro economic perspective, the goal of insolvency law needs to focus on saving viable businesses even if that requires a rehabilitation over a number of years. However, in times of economic prosperity, insolvency regimes probably offer more utility in providing quick and direct liquidation of insolvent entities, thereby freeing resources to be allocated to other prosperous businesses.

The stigma attached to insolvency can also play a crucial role in the suitability of an insolvency system to its users at a particular point in time. In times of crisis, it is crucial that directors do not feel that an admission of insolvency is an embarrassing situation and that bankruptcy should be avoided at all costs, whilst in good times the stigma of bankruptcy may well have a positive overall effect on the survival of businesses in trouble.

These matters are, of course, intangible.

4. Insolvency law inherently addresses political, social and economic concerns.

Intrinsically, insolvency law needs to be, and must by its nature be, directed at achieving a political, social and/or economic objective. Insolvency law's role

in the efficient operation of the economic market place is without question. Moreover, the nature of insolvency law means that it must, by recourse to its consideration and provision for varying stakeholder interests, set out to achieve a political or social agenda, or both. For example, it either favours debtors or creditors, or secured creditors, or provides priority to employees or to taxation authorities. One crucial and inescapable aspect of insolvency law is that it must deal with priority of stakeholder rights and the nature of its drafting often makes it either debtor or creditor friendly thereby implementing some social, economic or political agenda.

Further, in designing an insolvency system, international law and conventions need to be considered. For example, the International Labour Organisation Convention (No. 173) concerning the protection of worker's claims in the event of the insolvency of their employer cannot be avoided in designing insolvency systems for countries which have signed and ratified this convention. Under this convention, member countries can either accept obligations to provide protection to workers claims by means of a privilege (a priority) or by means of a guarantee institution.

The risk in insolvency systems providing priority to creditors likely to be owed significant amounts and who are not in a disadvantaged position, such as employees, for example, is that the creditors to whom priority is afforded may well allow unpaid debts to mount up whilst taking no action to recover the debts. This does not present any real risk to that creditor's position because of their priority, whilst it may ultimately disadvantage other creditors if the business subsequently goes into liquidation. This situation is particularly relevant to the priority often afforded to the taxation authorities for unpaid taxes. There seems to be a growing trend for taxation authorities to give up their priority and adopt other, more helpful, means of obtaining payment.

It is important that insolvency laws directly provide for any such priority that the national legislators wish to institute. If these concerns are addressed in separate legislation, conflicts and matters of interpretation will arise and therefore uncertainty and litigation is inevitably the consequence. In order to

ensure that insolvency laws operate in harmony it is often expedient to ensure that they deal with as many as possible of the concerns which will arise on insolvency. For example, the impact of the growth in environment liability for owners and occupiers (in addition to polluters) has in many jurisdictions had a profound effect on the way insolvency administrations are conducted and, indeed, whether they are resorted to at all. It would certainly be helpful in countries where these laws are in their infancy and where insolvency systems are being reworked to bear in mind the possible exposure of insolvency practitioners (receivers, liquidators etc.) and lender liability for environmental matters and address the scope of that liability in the insolvency laws; otherwise, the insolvency system may be rendered irrelevant in many cases.

5. Directors duty to creditors.

There can be little argument that directors of an insolvent company who continue to trade and incur debts they cannot pay should have direct responsibility to creditors. The concepts of the corporate veil and corporate limited liability rely on the directors performing their duties as directors. In many jurisdictions, these duties include statutory and fiduciary duties. A director who breaches his duties must be responsible to those to whom he causes damage. In an insolvency scenario, it is the creditors that suffer.

Laws which impose clear insolvent trading personal liability for directors and allow creditors a direct right to sue directors are, as discussed above, key aspects of any useful insolvency system.

Shareholders of insolvent companies have equity which by definition should have no value unless there is a clear expectation that the company will recover. The decision of shareholders to invest in the company is made understanding the level of control that they will have over the appointment of directors and management of the company. Generally, the shareholders appoint the directors. If the directors trade whilst insolvent there can be little justification, moral, economic or otherwise, for preferring shareholders over creditors whose debts were incurred by the directors whilst the company was

insolvent. There is an unavoidable deception involved in the director incurring debts whilst the company is insolvent.

However, the point at which the primary duty of the director must extend to the creditors is the point at which the director incurs a debt whilst the company is insolvent. Creditors whose debts were incurred while the company was solvent should not be entitled to the same direct rights offered by insolvent trading liability unless their claims are diluted by the subsequent incurring of debts whilst the company is insolvent (i.e. insolvent trading remains the trigger for direct liability of directors to creditors).

6. Use and misuse of debt for equity swaps.

Debt for equity swaps are being used in the following ways in many Asian restructurings at present.

(a) As a mechanism for creditors to avoid having to write off their lost investment. There is justification for this if there is perceived to be some possibility that the shares in the insolvent company will one day have value. However, in some restructurings, this is not the case; the debt for equity swap can be simply a mechanism to hide the lost investment for a few years as there is no real expectation that the company will be able to comply with its restructuring plan (particularly where the restructuring plan did not truly focus on the viability of the business; rather, it was simply a rescheduling of debts with no real expectation that the debtor would comply with the rescheduled debt reduction program).

(b) As a mechanism for creditors to provide incentive to management and shareholders to remain committed to the business. In this scenario, the creditors take most of the equity and grant the shareholders and/or management an ability to buy back (often at a discount) the equity if certain milestones in the restructuring are achieved or if certain performance criteria are achieved. This mechanism is aimed at providing an incentive to important players in the ongoing success of

the business (or in the ability of the business to raise new equity investment) to prevent them simply walking away from the company.

The requirement in Thailand that shares must be subscribed for in cash (which effectively prevents debt for equity swaps) has recently been removed if the company is in formal rehabilitation. This has provided a very clear justification for seeking formal rehabilitation of companies in order to implement the debt for equity swap.

7. Flexibility of rehabilitation packages.

Any rehabilitation package (rescue procedure) must be flexible in order to be successful. Endless possibilities for restructuring alternatives will be formulated by restructuring professional and interested stakeholders. In general, the more flexible the procedure the greater the likelihood of successfully saving a viable business and maximising the return to creditors and shareholders.

It is crucial that a rehabilitation law make clear what the objective of the law is.

Section 435A of Part 5.3A of the Australian Corporations Law is an excellent example. It states :

435A The object of this Part is to provide for the business, property and affairs of an insolvent company to be administered in a way that:

- (a) maximises the chances of the company, or as much as possible of its business, continuing in existence; or***
- (b) if it is not possible for the company or its business to continue in existence – results in a better return for the company's creditors and members than would result from an immediate winding up of the company.***

A flexible procedure which permits a business reorganisation and a corporate reorganisation is to be preferred. The law should make it clear that it permits the shareholding of a company to be adjusted. Conversely, the law should make it clear if it is possible to restructure the business and sell it to a purchaser (i.e. so that the business continues but not under the ownership of the original debtor company).

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