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

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Sustaining Firm Operations

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Session IV: Sustaining Firm Operations

Panel Contribution

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1. Efficiency of Insolvency Proceedings

What do we mean by „efficient insolvency proceedings“? Let us assume that there is given number of business failures -n - per year in a given jurisdiction. Is a system efficient when - n - cases are dealt with by insolvency courts, irrespective of the outcome? Clearly not. Court proceedings cause high social cost, and many cases may simply not warrant the cost of conducting formal proceedings.

In addition one important feature of efficient insolvency regimes is that they foster and facilitate out-of-court work-outs. But: Is insolvency law efficient when it scares as many sets of creditors and/or debtors into out-of-court settlements, i.a., when the percentage of cases reaching the court is as low as possible? Then possibly the conceivably worst bankruptcy system might be the most efficient. This would obviously be a rather preposterous proposition.

Is the percentage of rescues an indicator of efficiency? Many of us seem to think it is. I don't think so: breaking up unprofitable entities and reallocating their assets to more efficient users will clearly be more efficient than maintaining inefficient firms in business, impeding structural change, barring exit, and salvaging inefficient managements. Contrary to popular belief, bankruptcy liquidation is not generally an economic ill and a „destroyer“ of wealth.

Can the efficiency of insolvency proceedings be measured by the number of pennies creditors receive on their dollar, i.e., by the dividend distributed in proceedings? Then proceedings should be triggered well before insolvency – measured either under some balance sheet test or by a criterion of illiquidity. With present day debt/equity ratios many viable and solvent firms would have to undergo proceedings – clearly not an efficient proposition. In most systems we tend to consider as having reasonably effective economies creditor recoupment is generally very low (between zero and 10 ten percent, generally). Should one or two percent more or less be the yardstick for measuring efficiency?

I think from experience and from an accepted body of institutional economics we may conclude that an insolvency law is properly designed when it has the following features:

- a) Its advent is predictable for both debtors and creditors. There must be a clear cut and indisputable trigger which can be used in practice by creditors and debtors alike.
- b) It is value preserving. Rescues should be possible in appropriate cases. These cases cannot be identified by legal rules but only in a business driven search process which procedures can facilitate or obstruct. The legal framework should be so open and flexible as to implement such a search process. There should be no institutional and legal bias for

rehabilitation or for any other outcome of a proceeding.

- c) Quick and energetic liquidation – the enforcement of market exit - must be a real option at any time.
- d) It must discourage strategic behavior by creditors and debtors alike. In other words: Bankruptcy should not reshuffle and redistribute pre-bankruptcy negotiated entitlements.
- e) It must translate out-of-court practice into its legal framework, thus facilitating prepackaged solutions. In other words, bankruptcy should operate only the absolutely indispensable, minimal changes to the out-of-court interest structures and negotiating environments.
- f) It should use government and judicial resources sparingly, and draw essentially on the institutional and business resources available in a system at its given stage of development.

2. Two Types of Business Rescue

We have come to think that liquidation means breaking up the debtor's business, and rehabilitation means rescuing the debtor's business in its existing organizational form, typically with the previous owners. This dichotomy obscures the fact that a business may survive as a going concern in a liquidation: when all or substantially all the assets of the debtor are transferred to a new owner entity. In insolvency where equity generally will be depreciated, this type of rescue is paradigmatic. It separates the investive deployment of assets from uncertainties about the distribution of proceeds. When a business is sold on the market, the distribution of proceeds follows from the general distribution rules in liquidation and it automatically conforms to "absolute priority". Rehabilitation via a plan, on the other hand, involves a "sale" of the going concern not on the marketplace but to existing claimants of the debtor (Th. Jackson): The investment type decisions of asset deployment is then linked to the issue of distributing value to claimants. This may cause delay, high transaction and negotiating cost, and complex and uncertain non-market valuations. In many Common law and Civil law systems, the orderly liquidation type of rescue will be by far more frequent, quicker, and generally more efficient than rehabilitation via a plan.

The specific bankruptcy benefits of rehabilitation via a plan are essentially the following: the possibility of non-cash compensation to certain claimants, different treatment of classes having identical liquidation rank/priority, and a chance for the debtor to retain value or even control of the business without fresh investment. Non-bankruptcy laws create other differences, such as differing tax and labor law treatment of surviving debtor organizations as against the orderly sale of the going concern to a fresh entity. It is a challenge to general legal policies to level these differences which otherwise distort the choice between the two rescue techniques.

For our purposes, the important message is that sustaining business operation for some time is an issue not only for rehabilitation proceedings but also for properly designed liquidation proceedings.

3. The Link between Rehabilitation and Liquidation

The most important prerequisite for a functioning rescue system is the existence and permanent availability of an efficient liquidation proceeding. Only if liquidation – be it piecemeal or “orderly “ – is a pervasive option – or threat, if you will - throughout the course of proceedings , loss of time and money can properly be controlled. Systems, like the U.S. chapter 11 or Civil law systems which have a composition type rescue proceeding generally allow the insolvent debtor to delay the possibility of liquidation by filing for rehabilitation/composition. Introducing such a normative preference for debtor controlled rescue will generally distort the choice between the liquidation type and the rehabilitation type of rescues and, I submit, be suboptimal in terms of efficiency. Avoiding distortion of the choice between liquidation and rehabilitation also requires that the procedural rights and substantive entitlements of parties-in-interest should not differ according to which outcome is sought. In other words, rules on pending contracts, on avoidance etc. should be identical for both the liquidation and the rehabilitation “stages”. Another important consequence of leaving the liquidation open at any stage of proceedings is that dissenting claimants should not fare worse in a liquidation than in a rehabilitation and that – absent agreement among classes – absolute priority should be enforced, i.e., value obtained by rehabilitation should be allotted to claimants according to their liquidation priority.

4. Preserving the Going Concern Value in Appropriate Cases

Whenever the going concern value of a debtor entity is presumably higher than its liquidation value, the operations of the debtor should be sustained. This is a “unitary” problem, identical both in liquidation and in rehabilitation. It requires essentially four different things:

- Energetic management and clear governance from the outset,
 - a stay on all creditor action, including by secured creditors, avoiding dismemberment of the estate and disruption of operations,
 - reducing costs of operation, and
 - obtaining fresh money.
- a) The question whether debtor managements should remain “in possession” or whether appointment of a trustee should be the rule is, in my view, less important than the installation of some simple,

efficient, and vigorous governance,

- b) Staying all creditor action, including action by secured creditors, is quintessential if value maximizing collective action is to succeed. It may be possible to lift the stay whenever collateral is inconsequential for the estate, and this may often be the case in situations which lean toward straight liquidation. Note that the stay for secured creditors must not necessarily, and indeed should not be, cost free for the estate.
- c) In most systems, interest on unsecured claims stops accruing, and pre-bankruptcy debt is not serviced until distributions take place. The equally common principle that trustees should have the right to reject certain burdensome contracts further reduces costs of operation. This right will often be of particular importance in overstuffed firms, where speedy adjustment is often necessary. In Germany, e.g., the trustee may terminate employment contracts with the minimum legal notification period irrespective of collective labor contracts. It is useful to have some sort of insurance system in place to cover costs of labor which is no longer employed productively during the termination period.
- d) Providing sufficient working capital from the very first day of a proceeding is critical for leaving the rescue options intact. The standard rule in most systems that fresh lenders should enjoy administrative priority. In most systems, like my own, trustees also may (as any ordinary businessman might) offer lenders a lien in unencumbered collateral (which rarely is available) and a junior liens in already encumbered assets (which is often worthless). Many systems additionally make the trustee personally liable for debt contracted by him.

Those classical techniques of attracting fresh, high risk capital often do not suffice to attract new money. The U.S. Code (s. 364) therefore offers, under judicial control, an array of further devices, namely: a superpriority for fresh credit over other administrative expenses, and even the creation of senior liens in encumbered assets, provided the existing lien holder is adequately protected. Taken together these instruments apparently make lending to bankrupt debtors quite attractive; the U.S. have a vital credit market for debtors in possession (DIPs). It is possible to design DIP finance well before the advent of formal proceedings, and to start a chapter 11 with adequate cash resources.

5. Respecting Acquired Entitlements: Market Conformity

Bankruptcy should to the extent possible enforce pre bankruptcy contracts and entitlements and not redistribute value among claimants. This is important, of course, for the predictability of economic life in general. More

importantly, it forestalls the strategic misuse of bankruptcy by some groups against the interest of other groups. It follows that bankruptcy should respect and preserve the value of contracted entitlement, notably of security interests, in the course of proceedings.

This is not to deny the necessity of staying individual secured creditor action which is indispensable for most value maximizing solutions. But it means that secured creditors should be fully compensated for the delay inflicted on them by a stay ordered essentially in the interest of unsecured creditors and equity holders. The necessary minimum protection is that collateral should be protected by regular payments against depreciation and wear and tear. The more appropriate rule is to pay regular contractual interest on the secured portion of a secured creditors claim (the German solution, rejected by the U.S. Supreme Court in a landmark decision¹). This, of course, requires an early valuation of collateral, and it drains cash from the estate - but it creates very beneficial incentives for trustees to lift the stay in appropriate cases, and it sanctions unnecessary delay very efficiently. It keeps unsecured creditors and equity holders from “playing with other people’s money” (Th. Jackson).

6. Flexibility versus Rigidity

¹ United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365.

Many legal systems separate the rehabilitation stage from the liquidation stage, and they make conversion from rehabilitation to liquidation practically irreversible. Often a rescue attempt is generally, or at the request of the debtor, a mandatory opening stage of insolvency proceedings. Many systems clearly prefer rehabilitation of the debtor structure to the liquidation type rescue described before, and they do not exploit the full rescue potential inherent in properly designed liquidation proceedings. In a concern for avoiding delay, some jurisdictions set fix deadlines for a rescue attempt and/or for subsequent liquidation. A more sophisticated control of delay can, however, be achieved, by making junior claimants (unsecured general creditors, subordinated creditors, and equity holders), represented by the trustee, pay the fair (market) price in the way of interest to secured creditors, and to place the course and duration of proceedings generally under creditor control. If secured creditors are fully compensated by contractual interest for delay and experimentation, it is alright to grant unsecured creditors the most influential voice in proceedings.

7. Institutional implications

Installing as large a measure of creditor rule, or creditor self-organization and autonomy, as possible also addresses the most important institutional issue in countries with scarce judicial and professional resources. May those whose money is at stake bear responsibility for the course and outcome of a proceedings.

8. The Link between Out-of-Court and Court Proceedings

Bankruptcy should take an out-of-court perspective to the extent possible. Leaving creditors in control as much as possible, fully respecting and enforcing pre-bankruptcy entitlements, and allowing for utmost flexibility and openness of negotiations in formal proceedings are such elements of an out-of-court perspective. They allow out-of-court negotiations to transit smoothly into court proceedings, and they facilitate prepackaged solutions where the court is needed only for minimal purposes such as breaking the resistance of a few holdout creditors. In out-of-court negotiations interest patterns follow a) priority in a potential liquidation and b) certain typical economic interests. Reflecting the real life diversity of claimants with their different cash preferences, risk inclination, and various mixes of monetary and non-monetary interests in the debtor's destiny in formal proceedings

via flexible classification of claims and intersects who may receive different treatment under a plan is another element that facilitates the transition from out-of-court to formal court proceedings, and helps to prepackage viable solutions largely out-of-court.

9. Unitary proceedings – the Best Plausible Choice?

My country, Germany, felt that a unitary proceeding with a very large measure of creditor control over key issues in the course of proceedings would provide the most flexible and economically sensible legal framework for insolvencies. The basic structure is one of a classical liquidation including all financial claimants -from secured creditors to subordinate creditors and equity holders - where key issues, especially the costly and even more so the irreversible ones, are entrusted to creditor decision making (creditor rule, or autonomy).

Unitary proceedings entail, i.a.:

- Unitary triggers and access,
- a unitary legal framework without inherent preference for liquidation or for rescue, or for rescue via a plan or rescue via liquidation
- the creation of an estate with a unitary scope both for liquidations and rehabilitations,
- unitary rules on trustee liability and on administrative priority, including for fresh credit,
- the greatest possible freedom to explore alternative value maximizing solutions,
- unitary rules on pending contracts and on avoidance,
- unitary governance by an independent trustee but with the right for creditors to leave the debtor (or its existing management) in possession under certain circumstances,
- unitary creditor control over the suspension of the debtor's business operations,
- unitary rules on the compensation for secured creditors of time value by regular payment of contractual interest,
- unitary rules on the availability of a plan both for liquidations (of any type) and for debtor rehabilitation,

- in the case of a plan: minority protection of dissenting claimants amounting to the liquidation value of their entitlements (the hypothetical best case liquidation dividend),
- the enforcement of absolute priority vis-a-vis dissenting classes of creditors,
- the possibility to classify claimants not only according to their respective liquidation priority but also according to similar or substantially similar economic interests,
- a unitary discharge rule from which a plan can only depart with the consent of the debtor, and overall
- a unitary, quite modest involvement of the court in issues of an economic nature.