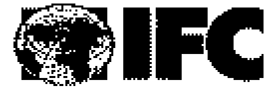

Organisation for Economic Co-operation and Development
In co-operation with the World Bank Group

The Third Meeting of the
Latin American Corporate Governance Roundtable

8-10 April, 2002
Bolsa Mexicana de Valores, Mexico City, Mexico

Insolvency systems and corporate governance: some general remarks

(Session 5)

by

Mr. Stilpon Nestor,
Senior Advisor to the OECD,
France

Corporate governance and insolvency arrangements are different parts of a continuum in the life of a corporate institution. This continuity can be gauged by looking at 3 key attributes of the insolvency system:

A. Its close relationship to corporate finance arrangements in specific countries.
B. Its function as a key benchmark for corporate attitudes towards risk.
C. Its function as a set of governance norms for insolvent going- concerns.

A. Assume for a moment that you have a country in which all companies have one shareholder and one banker as sources of finance—in addition to their own cash flows. This country would need but the most rudimentary of governance and insolvency systems. As regards corporate governance, there would be a limited agency problem and some monitoring mechanism for management would be needed; a few advisors/consultants could inform strategy, instead of a true board. On the insolvency side, there would be no need for collective proceedings. Outstanding loans would be secured by the corporation's assets and if these were not enough, by the sole shareholder's own assets. In fact there would be little reason for having a corporate institution at all as the limited liability "wall" between the corporation and its shareholder would be but a puny hedge that could be crossed both ways (i.e. by creditors of either the entity or its shareholder).

Thus, historically, insolvency arrangements have not been conceived to serve as a framework for the resolution of financial distress but rather as funeral services for dead companies. In fact, under the old German system, more than 90% of insolvent companies remained un-dead, as the estate did not even have money to cover the costs of bankruptcy procedures. In theory, the house bank would intervene early on the basis of their superior information and save the day without the need of insolvency. Insolvency arrangements in other continental jurisdictions-share the same "funeral service" aspect. On the other hand, experience with US Chapter 11 reorganisation suggests that only large companies succeed. In other words, re-organisation works better the further away we move from the single debtor/single shareholder model towards the wide diversity of finance providers of the modern corporation. Let me briefly suggest five reasons why this is so—and why we are indeed moving away from this model even in countries in which it was hitherto preponderant:

1. **Globalisation of financial markets**: Financial markets and the pricing of capital are globalised. The resulting competitive pressures are cracking open protected financial sectors. In turn, they are preventing lenders from being accommodating to corporate failure. The recent stories of Holzman and Kirch in Germany are good examples: German banks preferred to walk away from a "long-term, valued client" instead of continuing to carry dead wood in their balance sheets. The change of the German insolvency regime in the mid-90s was perhaps the first signal of a new attitude towards corporate debtors—and the need for an institutional mechanism to replace the vanishing paternalism of the banks. German companies were for the first time provided with a procedure that favours a negotiated settlement by protecting the insolvent entity from value-destroying opportunism of individual creditors.
2. **Financial sector capture becomes more difficult**: In contrast, Japanese banks have been unable to address the flow of bad loans, in spite of successive recapitalisations that periodically reduce the stock: pulling the plug on delinquent corporate borrowers is still considered a very unlikely option. Like their Thai and Korean kin—and unlike German banks, banks in Japan are captured by corporations. Capture may occur either directly, i.e. through same or interlocking ownership and control; or indirectly, via state ownership or "guidance" .Globalisation has also sounded the death knell of captive financial markets. The excessive leverage that capture entails (remember the 600% D/E ratios of Korean chaebol) is not sustainable anymore. Smaller economies discovered this truth at the expense of devastation in their financial systems— rich Japan is buying itself a slow death. As captivity becomes less tenable and the possibility of exit becomes real, corporate governance and insolvency arrangements are needed to reallocate assets and preserve value.

Copyright © OECD 2002 All rights reserved

3. **Development of market finance**: Not unrelated to the globalisation of financial markets is the growing prominence of market finance over the last 2 decades. Large companies are finding it cheaper to raise cash in commercial paper and bond markets. Innovations in structured finance are providing companies with opportunities to raise cash on the basis of future income streams. Banks, on the other hand, are more than happy to shift their balance sheets towards fee- based activities, away from traditional intermediation. This change has brought in a large number of disparate players—mostly, bond holders-- who are lending at arm's length and predicate their strategies on the existence of a credible and predictable bankruptcy system. In certain cases, lenders will devise sophisticated covenants that will set some governance constraints on corporate managements and produce some sort of discipline. But when financial distress sets in, these covenants may not be enforced, as lenders face a quandary: enforcement of the covenants will often drive the company into bankruptcy. As the number of creditors increases and their interests become more divergent credible bankruptcy proceedings become key in preserving value, in the face of an acute collective action problem.
4. **A moral hazard that is receding**: Most investors believed that the large corporations and banks to which they were lending enjoyed an implicit –or not- so-implicit-- government guarantee. But they failed to realise that the same liberalisation of capital accounts that allowed them to lend to these corporations also undermined the premise of the moral hazard: governments had no more the capacity to be overly generous to their corporate and financial sectors, as they were themselves subject to global financial market discipline. In the wake of the 97-98 crisis calls to upgrade insolvency systems came from all quarters. Slow progress in this front may be one of the reasons for the creditors' marked reluctance to return to emerging markets.
5. **A changing corporation**: The nature of the corporation is changing. This is lasting effect of the ITC revolution that will outlive the stock market bubble. Balance sheets are changing: the ascendancy of intangibles over fixed assets does not support a credit system fully based on secured credit. The nature of relationships with clients are changing: selling a product is often linked with the capacity of the seller to provide various services well into the future, which in turn amplifies reputational constraints on the seller—among which, her creditworthiness. The boundaries of firms are changing: firms are closer to Jensen's "nexus of contrast" paradigm than they have ever been. But this too is a precarious state of being, highly leveraged by reputation, as the ENRON and Andersen cases clearly demonstrate. Finally, large global corporations are often faced with enormous non-contractual claims emanating from product, environmental or other liabilities.

So should there be a single model for insolvency arrangements across the globe? Probably not—corporate finance arrangements are still sufficiently diverse, legal paths sufficiently distinct to require different approaches in each country. But in order to address a rapidly changing environment driven by globalisation in the financial markets, insolvency systems need to address certain issues in a consistent, coherent way:

1. **Value preservation,** which hinges on two elements:
   - Early access to the insolvency system: As the debtor approaches insolvency, value is destroyed more rapidly, due to reputational effects and the triggering of contractual covenants. Debtors should be allowed protection early in the process of value destruction. In the US, debtors that claim protection do not have to prove any sort of financial distress. They might be simply managing actual or contingent risks. In contrast, in the UK and many other Anglo jurisdictions, debtors are incentivised to file early with a stick: the law sanctions debtors who trade when insolvent. A cautionary note: while there are clear benefits to early access, countries with weak institutions should also be weary of setting the bar too low: In Russia, a low threshold for triggering insolvency procedures was widely abused by corporate insiders who faked insolvency in order to gain access to valuable company assets.

Copyright © OECD 2002 All rights reserved

- Moratorium on payments: Insolvency is first and foremost a collective action process. One of its main aims is to stop individual creditors impairing certain vital assets, which would cause the demise of the company even when the present value of the going concern is higher than the value of its constituent parts. A stay of execution for all individual claims during the insolvency period is key.

2. **Market conformity**: But a moratorium on execution should not mean a deviation from market arrangements. Market conformity means respecting absolute priority. Every functioning system in the world, including some of the most debtor- friendly ones-- such as US chapter 11 or the Japanese bankruptcy Code-- respect absolute priority when they redistribute claims in the post bankruptcy context. Any deviation from the absolute priority of claims in post-bankruptcy entitlements has to be approved by creditors or become an object of a "cram-down", a credible, court driven process which only allows such deviations when they are "fair and equitable".
3. Which brings me to the third element of an effective, modern insolvency system: credibility through effective **implementation**:
   - Courts and/or other public insolvency institutions are at the heart of effective implementation. In the wake of the Asian crisis, Thailand created a specialised insolvency court; while Korea established a specialised chamber within Seoul district Court. Other countries have opted for an administrative, quasi-court to drive implementation—maybe our Colombian and Mexican friends will share their approach during the discussion. One thing is sure: a court or a similar public institution plays a central role in collective proceedings. There is no shortcut around it. Institutional capacity has to be built, and multilateral institutions need to focus on this more than they have done in the past.
   - The design of the regulatory system has to correspond to infrastructure capacity in a given country. Transplanting the US Bankruptcy Code in a developing country that has few financially savvy lawyers, cannot afford investment bankers, has few financially sophisticated judges and very weak governance constraints on managers or major shareholders might not be a good idea. A more simplified system of going -concern auctions as suggested by some scholars (Balz) might be an alternative to traditional re-organisation systems predicated on negotiations between numerous claimants with divergent interests. A more detailed discussion of such proposals falls outside the scope of this presentation but should take place as policy makers review the effectiveness of insolvency arrangements. Let me just mention that one country's experience with an auction based system seems to very positive—caveat: the country in question, Sweden, has one of the most robust institutional infrastructures in the OECD area.

B. The next salient aspect that I would like to briefly discuss today is the impact of insolvency systems on the way the corporate governance mechanisms handle the risk of default.

1. On a general level, **weak insolvency mechanisms** that lack credibility have a profoundly negative effect on corporate governance. Excessive leverage in many Asian economies before 1998 was a direct result of the remoteness of the probability of bankruptcy. Controlling shareholders preferred to borrow cheaply from a captive financial sectors rather than issue equity, which allowed them to maintain control. The high levels of debt were maintained through a web of intricate cross- guarantees that masked the real level of risk by spreading it among a number of listed companies within the same group. The spreading of credit risk further enhanced expropriation of minority shareholders in individual listed companies, who were inadvertently assuming risks that they had not chosen to bear. Conversely, the blurring of boundaries between different listed firms through their treatment as a single firm (as regards risks) resulted in systemic insolvency within chaebols. In other words, the mispricing of debt capital because of weak insolvency mechanisms kept feeding already dysfunctional corporate governance arrangements which, in their turn, spread the risk of insolvency around the economy: a vicious circle.

Copyright © OECD 2002 All rights reserved

2. **Discharge**, i.e. the possibility for the debtor to re-enter business on a clean slate basis following a business failure is a central incentive lever to encourage entrepreneurial risk taking. A debtor (or its directors) that will see filing as the end of their career will either not take enough risks or, as the possibility of insolvency looms, might become reckless. In some emerging markets, the absence of discharge has been compounded by a social stigma for the bankrupt. However, one should not overemphasise this "cultural" factor. In Korea, bankruptcy cases rose sharply following a revision of the law and the strengthening of implementation processes in 1998-99.
3. **Avoidance powers and related parties**. Most insolvency systems provide for avoidance powers for the insolvent debtor, i.e. they give her the power to claw back transfers, in cash or in kind, that have been made during a suspect period immediately preceding bankruptcy under certain conditions that imply less than full consideration. In countries characterised by large block holdings, avoidance powers are crucial. In their absence, blockholders are likely to tunnel away cash flows and assets from the enterprise on a degree far higher than during normal times. Strong avoidance powers should be combined with a standard of increased vigilance by the board as financial distress sets in. This could in turn lead to a higher level of prudence and more focused management of risks by management and the board.

C. The third area I would like to discuss is the effectiveness of corporate governance arrangements for the going concern of the insolvent debtor. i.e. after a firm enters into bankruptcy/re-organisation proceedings:

1. **Debtor in possession vs. external administration**: The first and foremost issue here is the possibility for the debtor's management to remain in possession and the effectiveness of debtor in possession arrangements. While US Chapter 11 is based on the debtor in possession (DIP) approach, most other systems (UK, France, Sweden) provide for a professional administrator or trustee to take over the management of the debtor. To make a very long story --and debate— very short, I submit to you that the choice might matter less than the fury of the debate suggests. It has been observed (Warren) that in more than 90% of the Chapter 11 cases filed, debtors changed CEOs within the period starting eighteen months before the filing and ending six month after the filing. Overall, 71% of debtor management lost their jobs within 2 years of the filing. So, debtor management changes anyway most of the time, even when the debtor remains in possession. The new German law has adopted a neutral stance toward the DIP issue. But DIP arrangements in emerging markets might be less advisable. Managements here are far more entrenched and far less vulnerable to market sanctions. Even if DIP becomes available, the appointment of an external agent even as a supervisor of management—as is the case in Australia—might be required in these circumstances in order to ensure that the assets of the debtor are not plundered.
2. **Insider dealing**: The single most important threat to the effectiveness of governance in insolvent enterprises is insider dealing. The legal system needs to be alert to the wide information asymmetries between insiders and outsiders. Any bids by insiders need to be carefully weighted against the possibility of expropriation of going concern value that belongs to the creditors. DIP systems might find it harder to avoid the pitfalls of insider dealing in the process of realising bankruptcy value, in the absence of an alert and sophisticated court. In a DIP context, valuations are produced largely by insiders. That might be especially problematic in markets where outside fairness opinions and audits are neither effective nor credible. It is another reason for some form of outside administration of the process. It also renders market based valuation through auctions processes a more attractive option.
3. **The role of the creditors**: In abstract, one would expect the creditors to play a leading governance role after insolvency is declared, through an active creditors committee. In practice this rarely happens, especially in emerging markets: creditor capture, lack of know- how or conflicting incentives make creditor committees unlikely drivers of collective proceedings, as a matter of course. Nevertheless, creditors might take the lead when other institutions in the

Copyright © OECD 2002 All rights reserved

process are incapable or unwilling to do so. In Indonesia, creditor committees have hired restructuring specialists who are then appointed in the boards of debtor companies.

4. **Recidivism**: while discharge provisions and early debtor filings positively affect entrepreneurial risk- taking by corporations, unrestricted access to subsequent re-organisations by the debtor enterprise has had perverse incentive effects on the behaviour of corporate debtors. In the US, the percentage of filings by debtors that have already gone through a chapter 11 plan is very high. That is partly due to the presence of skewed incentives on some creditors: for example, bankers may be eager to see outstanding debt re-classified as performing. Stricter rules for subsequent access to re-organisation might streamline incentives of creditors, managers and shareholders as they negotiate restructuring plans.

In conclusion, corporate governance patterns and insolvency procedures are very closely linked. In designing regulatory and legislative arrangements, policy makers need to always confront the incentive effects of one area into the other. A coherent corporate affairs view of policy is necessary in every economy whose wealth is largely generated by private corporations.

Copyright © OECD 2002 All rights reserved