Asian Insolvency Systems

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Foreword

Asian countries are deeply integrated into the world economy so that it is increasingly important to keep their domestic insolvency policies in line with the expectations of international investors and lenders. Many Asian jurisdictions are thus continuing on the path of insolvency reforms, promulgating new laws, introducing new procedures and strengthening related institutions.

The *Forum for Asian Insolvency Reforms (FAIR*) convenes Asian and OECD policy makers together with private sector experts to share experiences. The last FAIR meeting, held in Beijing, China in 2006, examined progress with legal and institutional reforms in the region in the last decade. In considering the development of national systems, participants assessed the relevance of international standards and regional guidelines, developed by the Asian Development Bank, INSOL[1] International, OECD, UNCITRAL[2] and the World Bank.

Asian insolvency systems vary widely and differences have tended to grow with significant advances made by some countries and very modest reforms in others. Accelerating legal reforms, adaptation to changing circumstances and conformity with international best practice were singled out as important concerns for Asian law makers. However, it was agreed that the most urgent priority lies in the effective application of the law in order to close the so called "implementation gap". Court systems in particular, their independence and integrity, expertise and quality of service should remain a primary goal of Asian reformers and would benefit from additional resources. In this respect, Asian countries should also step up their efforts in supporting the development of the insolvency professionals, and in establishing the rules which govern their compensation, licensing, duties, responsibilities and ethics.

FAIR participants also reiterated their concern about the limited recourse to liquidation as an effective insolvency remedy to instill financial discipline and allow efficient reallocation of resources. Disappointment with progress in financial and operational restructuring was another recurring concern. Against this background, participants acknowledged the important role to be played by the private sector - creditors, investors in distressed assets, debt traders, restructuring specialists and others – in working hand in hand with the public sector towards innovative approaches in the development of Asian insolvency systems.

This publication contains the proceedings of the Beijing meeting and provides a regional and country perspective on progress in insolvency reform in Asia. The publication includes comparative reports on the insolvency systems of Hong Kong, China, Indonesia, Japan, Nepal, Thailand and Vietnam. It also provides insights into the

1. International Association of Restructuring, Insolvency and Bankruptcy Professionals.

2. United Nations Commission on International Trade Law.

role of courts and the priority of claims under the new Chinese bankruptcy law effective since June 1 2007.

The OECD is grateful to the Asian Development Bank, INSOL International, UNCITRAL and the World Bank for their contribution to the FAIR. Special thanks go to the Development Research Centre of the People's Republic of China for hosting the Forum in Beijing and to the Governments of Australia and Japan for their generous support.

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Executive Summary

1. Summary and objectives

The OECD, the World Bank (WB), the Australian Treasury and the Asian Development Bank (ADB) organised the 2006 meeting of the Forum on Asian Insolvency Reform (FAIR) on the subject *Legal and Institutional Reforms of Asian Insolvency Systems*. It was hosted in Beijing, by the Development Research Centre of the State Council of People's Republic of China. The FAIR benefited from the support of the Asia-Pacific Economic Co-operation (APEC), the United Nations Commission on International Trade Law (UNCITRAL), the International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL) and the Governments of Australia and Japan.

The meeting gathered an unprecedented number of participants, confirming the strong interest towards continuing the Asian policy dialogue on the subject. More specifically, the FAIR convened over 150 delegates from 24 jurisdictions (Australia; Bangladesh; Belgium; Canada; China; Chinese Taipei; Hong Kong, China; India; Indonesia; Japan; Korea; Malaysia; Mongolia; Myanmar; Nepal; the Netherlands; Pakistan; Philippines; Singapore; Sri Lanka; Thailand; United Kingdom; United States; Vietnam) and 6 international organisations (ADB, APEC, the International Monetary Fund, UNCITRAL, the WB and OECD).

The primary objective of the meeting was to summarise the lessons of a decade of insolvency reforms in Asia and to discuss directions for future work. In doing this, participants used as a reference international standards, such as the UNCITRAL *Legislative Guide on Insolvency Law*, the WB *Principles for Effective Insolvency and Creditor Rights Systems,* the OECD *Principles on Corporate Governance and Guidelines on Corporate Governance of State-Owned Enterprises,* as well as various documents and publications of INSOL. Regional guidance developed by the ADB was also discussed as it attempts to adapt internationally recognised approaches to the circumstances of Asian jurisdictions. In line with usual practice, FAIR participants examined recent institutional and legal initiatives. Special attention was paid to the main features of the draft Chinese bankruptcy law, which entered into force on 1 June 2007.

Relevant Asian state institutions were very well represented. Participants from Ministries of finance and justice, the judiciary, Central banks, asset management companies, regulatory bodies of insolvency professionals, financial services regulators and academics attended the meeting. The presence of policy makers from a large number

of Asian jurisdictions constituted an important opportunity for the Forum to contribute to policy design in the region.

Participants acknowledged the needs for far greater regional cooperation, training and development on insolvency in Asia. A strong desire was expressed for a country-specific and sub-regional focus of the FAIR, in order to discuss emerging issues and formulate more concrete and innovative conclusions relevant to the needs, concerns and traditions of Asian jurisdictions.

In conclusion, FAIR partner organisations and participants expressed their support for an intensified information sharing and co-operation on capacity building. This was based on a proposal of the Australian Government to establish a Network of public and private sector experts for around-the-year dialogue on insolvency. The Network responds to a perception shared at FAIR meetings that on-going regional communication on reform issues would contribute to effective implementation of existing legal frameworks, and is likely to lead to project-focused cooperative work. Moreover, it was felt that the proposed regional Network is a key for ensuring sustainability of the outcomes of the FAIR meetings and the relevance of its future work.

2. Conclusions and recommendations

Participants discussed a wide range of issues which have been tackled by Asian policy makers in their efforts to improve the functioning of insolvency systems. On this basis, the following conclusions can be drawn:

Over the last decade, many Asian economies embarked on large-scale programmes aiming to reform their insolvency systems. These efforts focused on enacting sophisticated insolvency provisions and produced important positive results. However, a lot remains to be done in terms of implementation and institution building, as lawmaking alone cannot ensure that Asian insolvency systems function effectively.

Asian jurisdictions have taken inspiration from reforms and measures that have been successful in OECD and other emerging economies. Some of them have, in addition, used as a benchmark international guidance in their efforts to improve insolvency systems. Participants agreed that there is a need to adapt global norms to the particular circumstances of Asia in order to avoid risks of incomplete implementation. Moreover, a case was made for a greater attention to innovative approaches taking into consideration the constraints and characteristics of the domestic insolvency systems.

The UNCITRAL Legislative Guide and the World Bank Principles suggest a trend towards law reform intending to rescue businesses that might remain viable if they were financially or operationally restructured. The Legislative Guide, thus, calls for the establishment of insolvency systems in which liquidation proceedings are balanced with reorganisation.

In line with this trend, Asian policy makers have focused mostly on formal and informal rescue proceedings in their recent efforts. While rescue operations played an important role in dealing with large scale insolvencies, participants acknowledged that little attention was paid to the improvement of the liquidation process and there is an urgent need for policy makers to instil financial discipline by facilitating liquidation. In the absence of credible threat of liquidation, debtors and different classes of creditors have little incentive to agree on a rescue plan. An effective liquidation procedure

facilitates formal and informal mechanisms and serves as a benchmark in the negotiation of the value that unsecured creditors and debtors should get.

Notwithstanding the importance of other insolvency mechanisms, the fact that the preservation of wealth is best achieved by enterprise reorganisation was recognised in most presentations, reflecting the experience of Asian and non-Asian jurisdictions.

However, the new reorganisation laws in Asia have played a limited role, as they did not lead to the emergence of a reorganisation culture. What makes reorganisation work goes beyond the legal framework and requires the existence of an insolvency infrastructure including competent judiciary, insolvency professionals and other institutions, such as creditor or workers committees. In some states the policy options regarding reorganisation have been distorted for political reasons and consequently this has led to lack of transparency and credibility. Moreover, the fair and equitable treatment of foreign creditors can still be a problem in Asia, as there are frequent instances in which the latter are not treated the same way as domestic creditors.

The problem of reorganising and liquidating state-owned enterprises (SOEs) is a critical one for most countries represented at the meeting. It is clear that the task is challenging with procedural inefficiencies and unreformed laws obstructing their reorganisation. On the other hand, Asian policy makers need to acknowledge that a number of major industries are in global decline and require reorganisation. In such industries, simple financial restructuring without operational reorganisation will most likely lead to state subsidies and market distortion.

Participants also expressed concerns over the reorganisation of listed companies, which are often treated as "too big to fail". It was agreed that it is critical for the sound development of domestic capital markets to improve transparency and disclosure of listed companies, and ensure that they are reorganised in an orderly fashion with due respect to the rights of creditors and shareholders, including minority shareholders. Asset management companies or new investors, attracted for example by the issuance of new stock, could play a role in this respect.

The importance of recognising statutory priority claims, the power of creditors and insolvency professionals to make the critical reorganisation decisions was underlined, especially in light of the weaknesses of Asian courts. There was also a continuing reference to the option of using a "Chapter 11" type procedures, which implies however, the need for a robust and trained court and committee system to institute adequate controls.

In complementing their formal insolvency mechanisms, Asian governments have introduced out-of-court arrangements and need to encourage their use.

Participants recognised the importance of informal workouts in Asian insolvency systems, as they can provide cost-effective, efficient, and flexible solutions to corporate distress, which can be achieved outside the courts or other more formal systems. Well functioning informal workout regimes are dependent on the existence of formal insolvency procedures, which encourage debtors to cooperate in the design of informal workout plans.

The advantages of using principles in promoting sound out-of-court practices were also discussed. An important recommendation was made in favour of a pro-active role of the private sector in improving informal insolvency mechanisms. It resulted from the example of the Asian Bankers Association (ABA), who developed useful additions to the

INSOL Global Principles for out-of-court restructuring. The ABA has also formally adopted a model agreement serving as a template that can be adapted to suit a particular jurisdiction or individual workout. Participants noted that that the ABA and ADB work on informal work-outs needs to be used as an important reference point and especially in dealing with cross-border cases.

The shortage of relevant information and fresh capital was perceived as a serious obstacle to reorganisation in Asia. The changing parties of reorganisation, such as private equity, debt traders, hedge funds and the growing relevance of pension funds, were also mentioned as important emerging issues requiring further attention and discussion at FAIR meetings. The diverging interests of these new lenders need to be dealt with by developing adequate mechanisms for credible and effective resolution of distress.

Participants underlined the implementation gap between the design and enforcement of laws in most Asian jurisdictions. Substantive and procedural insolvency legislation does not exist in an institutional vacuum. The effective implementation of the existing laws in the region depends on the political resolve to support institution building, including with adequate financial resources.

Under nearly all systems, judges play a critical function in insolvency proceedings. Lack of experience and information systems enabling to share judicial experience are common characteristics of many Asian countries. The link between low levels of remuneration and rampant corruption was underlined as well.

In order to conduct insolvency adjudication effectively and efficiently, judges must be independent and have sufficient expertise in insolvency related matters. Judicial independence should be accompanied by accountability. Given the low level of confidence in the judiciary, creditors in Asia could benefit from additional mechanisms to enhance judicial accountability. These include increasing publicity of judicial reasoning, and putting in place mechanisms for monitoring judicial performance.

Moreover, in order to be competent in hearing insolvency cases, Asian judges should increase their expertise in relevant legal, economic and business issues. The complexity of collective proceedings, coupled with the need to independently assess issues of fairness and to supervise the process puts an additional premium on judicial expertise. Judges in the region should also benefit from special training programmes, which could be organised by the Supreme Court or specialised institutions. Another way to improve judicial expertise in insolvency issues is to appoint experienced professionals as judges for insolvency cases.

When the number of competent judges is limited and institutional capacity is low, participants suggested that the role of the judge in the insolvency system may be confined temporarily to dispute resolution and overall supervision of insolvency proceedings. Under such circumstances, a greater role could be attributed to creditors and insolvency professionals. The correlation between the quality of the judiciary and the practitioners was also underlined.

In this respect, it was agreed that the need for trained, licensed, regulated base of insolvency practitioners should be acknowledged as a policy priority in ensuring the efficient functioning of insolvency systems.

A modern insolvency system requires competent and ethical practitioners. They need to be skilled in the relevant law and/or accounting, as well as familiar with business

practice. They may benefit from specialisation in dealing with liquidations and reorganisation of small firms or in dealing with large enterprises with highly complex legal and financial structures, operating across borders. The contribution of practitioners to the effective functioning of insolvency systems is dependent on the existence of a professional regulatory body, ensuring and facilitating competent and ethical practice.

Many Asian jurisdictions confront significant difficulties with regard to the insolvency profession. There is a general deficit of skilled lawyers and accountants, lack of education and absence of regulatory oversight. These challenges should not be disregarded in reforming Aisan insolvency systems, as they undermine the implementation of the substantive laws.

Sustainable development often hinges on the extent to which a country's people can be employed on a sustainable basis. If troubled companies are to return to profitability and grow their workforce again, they need to be able to lay off redundant workers. It was agreed that employees are a major corporate asset in Asia; however the size of the workforce may be a significant challenge in restructuring. The issue of treating employees and their claims requires special attention in Asia.

The problem of workers versus secured creditors was at the centre of the attention, due to the large amounts at stake. It was felt that it was important in addressing this issue to ensure that existing labour laws and social safety nets function effectively.

Participants stressed the need for a policy decision to be made on the priority of claims and the way employees and various classes of creditors will be treated. Such a decision should acknowledge the potential consequences for social and political stability on the one hand. Conversely, policy makers should ensure that the insolvency system provides adequate incentives and protections for creditors in order to facilitate access to credit for the development and growth of corporations. It was also acknowledged that this issue is particularly important in SOEs, which employ large numbers of people in many countries of the region.

There was a general perception of insufficient attention paid to the role and rights of creditors in Asian insolvency proceedings. The discussion focused on the changing profile of creditors in Asia and on their participation in reorganisations. Participants felt that creditor apathy in some countries, together with weak courts have been detrimental to the effectiveness of insolvency proceedings in the region. Insufficient creditor co-operation and co-ordination have resulted in many secured creditors deciding not to participate in the insolvency process, as they find it inefficient. On many occasions, the problem has been exacerbated by the absence of competent insolvency professionals, available to provide the necessary support and advice.

They also noted the increasing role of private equity investors, hedge funds and debt traders, which change the types of risks creditors need to take into consideration in their credit policies. One such risk lies in the difficulty to have an accurate understanding of the true ownership profile of a debtor company, which often leads Asian creditors to low or no risk acceptance and / or to imposing greater security cover. Creditors are also often targets of fraud or abuse, which is another reason for the cost of lending to increase. While public sector action on these issues is important in order to ensure access to capital at optimal cost, private sector responses can also be designed. One participant noted the possibility for creditors to establish a fund to fight fraudulent practices and support investigation.

On the other hand, the emergence of hedge funds and debt traders as restructuring activists is another major development in the region. They bring new financing, and a capacity to effectively take restructuring decisions. In contrast with previous practice of fictional restructuring and debt rescheduling in the region, hedge funds have been instrumental in organising real financial and operational reorganisation. It is important to analyse the impact of this development on work-out proceedings and observe if banks and other creditors would follow the example of hedge funds and engage more actively in reorganisation as a profitable opportunity. Further research would be useful to help understand if hedge funds participate in multi-stakeholder committees established in the framework of insolvency proceedings and the related implications.

A special session was devoted to cross-border insolvency issues. Asian examples showed that dealing with multi-national companies without an international insolvency framework may lead to a standstill, while the debtor remains in possession of the group's assets. Such situations generate considerable uncertainty and undermine the effective application of insolvency proceedings. Moreover, the financial consequences for all stakeholders, debtors, shareholders, creditors, employees, suppliers and others are far from being negligible and may signal increased credit risk, deterring investors from the region.

In line with discussions at previous FAIR meetings, participants examined the following options for reforms and recommended that they are given serious attention by Asian policy makers: (i) cross-border insolvency convention or treaty involving as many countries in the region as possible and providing an inclusive framework facilitating and encouraging adherence; (ii) bi-lateral arrangements; (iii) unilateral cross border legislation enacted by as many countries as possible.

Notwithstanding the above considerations in favour of cross border insolvency reforms, inadequate domestic law and practice are harmful for the possible development of such initiatives. Ideally shortcomings of the national framework of insolvency should be addressed before adding the overlay of cross border arrangements. However, experience in Japan suggests that establishing international insolvency proceedings takes time and therefore, there is a case to be made in favour of immediate initial action in this respect.

The discussion further examined cases in which the debtor is part of a corporate group spread across a number of jurisdictions, as the related conflicting jurisdictional priorities and rights. Most cases of cross-border insolvency in Asia can be expected to involve corporate group issues and problems. Therefore, group companies presenting an additional layer of difficulty require further attention, both on the domestic, regional and international fronts.

The UNCITRAL Model Law on Cross Border Insolvency presented at FAIR III in Seoul, as well as the INSOL Guide to Recognition and Enforcement of Cross Border Insolvency need to be explored by Asian policy makers in finding solutions to insolvency in the context of groups of companies.

Finally, participants reiterated their interest in promoting regional co-operation on insolvency policies and practices. Now that global norms have been clearly articulated by UNCITRAL and the World Bank, there is a pressing need to examine ways for adapting them to the variety of national circumstances in Asia. These variations can be systematised by scholars and technical assistance experts, so that Asian policy makers are

in a position to chose the most appropriate and innovative set of measures among a menu of policy options, adapted to the singularity of national situations.

On the other hand, the policy significance of bankruptcy reforms, led to the conclusion that policy makers in Asia require a political will to engage in massive institution building. Co-operation with their counterparts from other regions, as well as with experts from the private sector and relevant international bodies can play an important role in supporting such efforts.

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Part I

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS IN ASIA

LAWMAKING AND INSTITUTION BUILDING IN ASIAN INSOLVENCY REFORMS: BETWEEN GLOBAL NORMS AND NATIONAL CIRCUMSTANCES

by
Terence C. Halliday*

"The key to the impact of the legislation will lie in its implementation."
OECD Economic Survey–China, 2005 [1]

It is now a truism to affirm that in all lawmaking a gap opens up between law on the books and law in action. This gap is a central focus of research for empirical socio-legal scholars of law worldwide.[2] It is also increasingly recognised by law and finance scholars who assert that law inherently is "incomplete," that its effectiveness relies heavily on the institutions of implementation.[3] It is precisely this gap that has led the EBRD, in its surveys of Central and Eastern Europe, to measure separately the enactment and implementation (or effectiveness) of insolvency.[4] Effectiveness in implementation becomes the ultimate criterion for appraisal of legal change and law reform.

There are three principal decision points that occur in the design and implementation of national insolvency regimes. Each centres on a determinative question.

First, what shall be the relationship of local insolvency regimes to global norms? This raises policy considerations about the value to be obtained from conformity to global standards as that value is balanced against a distinctive national path that reflects the peculiarities of national culture, institutions and development. The trade-offs in this choice determine not only the degree of harmonisation or convergence with insolvency regimes in other countries, including major trading partners and sources of investment, but also the probability of effective implementation in a particular domestic situation.

Second, what is the relationship between a technical notion of insolvency law and policy factors that are presumed within or entailed by that law? Frequently, international organisations properly seek to confine themselves to "technical" matters and avoid contentious policy issues, either because political matters lie outside their mandates, or because policy conflicts would lead international norm making into contentious stalemate.[5] Yet technical matters invariably involve policy choices that must be confronted by national policy makers. For national reformers it is imperative that the policy implications of apparently technical recommendations be clearly identified, their

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implications understood, and choices around those implications made deliberately in the context of state and party ideologies, and related policies.

Third, what is the relationship of formal law to law in practice? By formal law we refer to statutes, bureaucratic regulations and court cases. Reducing the "implementation gap" becomes a critical practical problem for national reformers. Even as they negotiate a satisfactory resolution of tensions between global and national standards, they must also anticipate the difficulties that arise from their own institutional capacities, political systems, legal culture and legal institutions. The more that national lawmakers draw on international norms or foreign experiences, the more susceptible they are to legal transplants that do not work–the so-called "transplant effect."[6]

This paper addresses these questions as they relate to key areas of policy choice in the implementation of bankruptcy law. It begins by arguing that there is a hierarchy of policy choices for a government. The paper then turns to seven policy issues in the construction of effective and equitable insolvency regimes. On each issue the paper considers the policy hurdles, provides examples from developing and developed countries of efforts to surmount this hurdle (some successful, some not), and reflects on their implications for policy and implementation in Asia with special reference to China.

This analysis is based on three bodies of empirical research. The first relies on empirical studies of lawmaking and implementation in Indonesia, Korea and China over the past fifteen years.[7] The second relies upon empirical research on global and regional international organisations that have driven the global reform movement in corporate insolvency law. The third draws on historical research that has been undertaken on the two most important sets of bankruptcy reforms in advanced economies–the US Bankruptcy Code of 1978 and the English Insolvency Act 1986–which stimulated in substantial part the worldwide movement for insolvency reforms. The paper selects specific instances of reform in these four countries to exemplify prospects and problems in key policy issues.[8]

1) Hierarchy of policy issues

Policy issues around reforms of insolvency law and institutions can be ordered in a hierarchy from higher to lower levels of generality. While in most lawmaking such a hierarchy exists, it is especially apparent in insolvency lawmaking since bankruptcy reaches to some of the most fundamental policy debates on substantive values in a society, its political system and economy. We can distinguish three levels of policy: 1) meta-policy issues; 2) master policy issues for insolvency; and 3) insolvency-specific and collateral policy issues.

a) Meta-policy issues

These issues reach to fundamental ways in which societies define their values and their institutions. A notable current example is the set of principles discussed in China's State Council White Paper on Political Democracy.[9] Meta-policy issues relate to insolvency law through three institutions.

i) Meta-policy issues for the market, politics and society

The first concerns the functions and limits of *markets*. Policy makers must decide what functions markets will be permitted to perform. What values will markets serve? For example, will a distinctive kind of capitalism or market economy prevail in China–a

market with "Chinese characteristics"? Scholars point to varieties of capitalism in Europe and North America.[10] It is conceivable that other forms of capitalism will continue to emerge in different regions of the world where circumstances are qualitatively different from those in Europe and North America. In China this policy issue might be posed as a tension between a *socialist* market economy, where the dominant principle is "socialist," or a socialist *market* economy, where the dominant principle is "market."[11] Their balance affects the substantive and procedural provisions within bankruptcy law and constrains the scope of options in the other two levels in the policy hierarchy.

A second meta-policy issue centres on the structure of *political power* in a society. For any country it must be determined: Where will the locus of state power reside? How will holders of power be held accountable by other centres of power, by society, by citizens? Will rule *by* law or rule *of* law prevail? These questions relate to bankruptcy regimes insofar as all bankruptcy regimes assume a certain configuration of power in a society. If it is a primary condition of a bankruptcy regime to deliver competent, fair, neutral outcomes,[12] then courts will be integral to a bankruptcy regime. This in turn assumes their autonomy from any of three sources of corruption–the market, the state, or the public. If courts are to treat all creditors equally irrespective of location, then this presumes that local political authorities in jurisdictions where bankruptcy filings are made will restrain themselves from interference in proceedings on behalf of local actors to the disadvantage of non-local parties.

A third meta-policy issue concerns the values that will order *society*. Will a government stimulate creativity and reward entrepreneurship among its citizens? How much will government permit civil society to hold accountable government institutions? How much inequality will a government tolerate in civil, economic, political and social rights, opportunities and outcomes? How much responsibility does a government take upon itself for social protections of citizens, including those that are unemployed or thrown out of employment? Decisions on these issues affect not only substantive decisions in bankruptcy law (*e.g.* whether SOEs which have economic and social functions should be subsumed under bankruptcy law, what kinds of priorities workers should have in liquidation proceedings), but influence the shape of institutions within which bankruptcy regimes are embedded (*e.g.* various sorts of social safety nets).

Each government makes a meta-policy decision where to draw the lines between these three institutions–the market, the political system, society. A *socialist* market economy arguably will draw those lines differently from a socialist *market* economy.

ii) Institutional assumptions in constructing insolvency systems

To build an insolvency system with the attributes recommended by global norm-making institutions proceeds on sets of assumptions that are not always expressly stated. These assumptions, with special reference to China, include the following:

1. On markets

Markets require social infrastructure–a means of organising economic activity (*e.g.* firms, contracts), [13] a regulatory framework that regularises and enforces norms of market activity, and ultimately some management by government.[14] Markets require some measure of predictability and certainty.[15] That can be accomplished by several methods: informal relations, such as family and ethnic ties;[16] government control, such as state-led models of development;[17] and a rule-of-law open market approach. As China's rapid economic growth has demonstrated, a great deal of market activity can be sustained

without effective formal law and its accompanying institutions. Yet China's extraordinary efforts in the past decade to create commercial law regimes[18] indicate it is on a course to shift emphasis from the first and second towards the third mode of obtaining certainty in market transactions, particularly for outsiders.[19] Insofar as the third is chosen, this implies that laws will be implemented with reference to universal standards (at least within China) and not particularistic criteria (*e.g.* local political, legal interests).

2. The political system

Political actors in all countries often find it difficult to restrain themselves from intervening in commercial transactions or court-led proceedings, both of which undermine the capacity of a bankruptcy system to deliver certainty and predictability and to allow investors to price risk accurately. This is particularly so for countries with state-led economic development. The effectiveness of a bankruptcy system is highly correlated with the ability of government authorities to exercise restraint. For example, for a market-led rule-of-law bankruptcy regime to work in China assumes that China's leaders have made a policy decision to restructure the distribution of power within the political system. This requires, at the very least, that the Party will be self-restrained both at the centre and locally in the functioning of the bankruptcy system,[20] that courts will be given independence from executive control or arbitrary government interventions, and that local municipalities, counties and provinces will change their orientations from defence of local enterprises, creditors and stakeholders at the expense of stakeholders from outside localities.

3. Lawmaking

The rationalisation of lawmaking significantly affects market certainty. China has taken major strides towards rationalising and developing its lawmaking system, most notably in the Legislation Law (*lifa fa*) passed by the National Peoples' Congress (NPC) in March 2000.[21] This has important consequences in two directions. One is to clarify the lawmaking relationship of the NPC to sub-national peoples' congresses. Another is to clarify the lawmaking authority of the NPC in relation to State Council agencies and their rulemaking and powers of interpretation. Since struggles between the NPC and State Council agencies, and among agencies themselves, has led to much ambiguity in implementation of law, the resolution of these issues in bankruptcy lawmaking will affect substantially its effective implementation.[22]

b) Master insolvency policy issues

All countries confront three principal policy issues about insolvency regimes–two substantive, the other institutional:

i) Liquidation versus reorganisation

For most countries until recently bankruptcy law has functioned principally to provide an orderly set of mechanisms for firms to be liquidated. In most cases of corporate failure, secured creditors were able to seize assets outside of bankruptcy proceedings no matter what the cost to the continuation of the business or other creditors, including workers. As a result of this bankruptcy policy, many potentially viable businesses were destroyed, many creditors were needlessly harmed, and many workers were summarily dismissed.

The UNCITRAL Legislative Guide and World Bank Principles signal a global movement of law reform that is intended to save businesses that might remain viable if

they were financially and operationally restructured. The Legislative Guide calls for bankruptcy law that balances provisions on liquidation with those on reorganisation. States the guide:

> *An insolvency law needs to balance the advantages of near-term debt collection through liquidation (often the preference of secured creditors) against preserving the value of the debtor's business through reorganization (often the preference of unsecured creditors and the debtor). Achieving that balance may have implications for other social policy considerations, such as encouraging the development of an entrepreneurial class and protecting employment.*[23]

It is precisely such a shift that we observe in the latest drafts of China's Bankruptcy Law.

ii) Universalism versus protectionism

The more business transactions cross jurisdictional frontiers of law and courts, the more critical it is that law expand to encompass the scope of market transactions.[24] Liquidation regimes are unfair and reorganisation regimes are impossible when creditors in each jurisdiction seize whatever assets are available to them thereby dismembering the business. The modern movement of bankruptcy law has sought to solve this problem by adopting universal principles of jurisdiction. Once a centre of main interests of the enterprise has been designated,[25] then the bankruptcy proceedings are co-ordinated across jurisdictions and their subsidiary proceedings so they proceed as a unified whole. In this way the value of the assets is maximised and the probability of a business surviving is increased. The UNCITRAL Model Law on Cross-Border Insolvency offers a global solution to this problem.[26]

However, the policy issue of universalism versus protectionism also occurs within countries. Local authorities in municipalities, counties, provinces or states may use their powers to favour local creditors and businesses over those outside the jurisdiction. Empirical researchers on China identify this as a widespread issue. As Cai Dingjian writes,[27] local political leaders pressure judges to follow the maxim, "do not let any runoff water flow to the fields of outsiders (feishui buliu wairentian)". Local judges discriminate against non-local parties. Unless this problem of local protectionism can be solved, the entire prospect of saving businesses and saving jobs of workers is lost.

iii) State versus market

Every nation-state must decide where it will locate the institutional machinery that regulates bankruptcy of enterprises.[28] There are many options. Some states, such as Australia, prefer the private market of professionals to carry much of the burden of liquidation and restructuring in the shadow of courts with government agencies playing a minimal role. Other states, such as France, prefer the courts to be centrally involved in all principal decisions about a company's fate, and to watch over the public interest, although the court may rely heavily on the expertise of private professionals. The evolution of bankruptcy law in many countries can be observed as a shift from government bureaucratic control to a more diversified institutional arrangement in which private professionals, courts and government agencies distribute responsibilities among themselves.

The decisions on where to locate bankruptcy regulation depends partly on political ideology about states, markets, and the relations between them. It also depends on the capacity of institutions to "provide certainty in the market to promote economic stability

and growth; …ensure equitable treatment of similarly situated creditors; …and to provide for timely, efficient and impartial resolution of insolvency."[29]

These three master policy issues for insolvency regimes will determine the broad policy context for specific policy determinations that affect implementation.

2) Insolvency policy hurdles to effective implementation

Substantive and procedural bankruptcy law does not exist in an institutional vacuum. Research on institution building[30] and on insolvency reforms has shown that there are several key policy choices that influence the probability of effective implementation, both substantive and institutional.

a) The recruitment and regulation of competent practitioners

A modern insolvency system requires competent and ethical practitioners.[31] These function primarily within the private market for professional services although most countries also regulate and administer aspects of the insolvency system through government officials who must also be highly qualified.[32] Global norms (see Table 1) point to three sets of attributes critical to the effective professionalisation of bankruptcy practice.

First, professionals must display a level of competency comparable to the demand of practice. That competency requires both technical sophistication in the relevant law and/or accounting, and familiarity with business practice. Competency may be calibrated to the level of complexity of the task. Liquidations and reorganisations of small firms with a simple legal and financial structure, which transact business in a single jurisdiction will require very different skills from enormous enterprises with highly complex legal and financial structures, which transact business across national and international jurisdictions.[33]

Second, because bankruptcy professionals handle moneys and are exposed to opportunities for self-enrichment, they must be socialised in values of integrity and probity, and be embedded in regulatory structures that reinforce honest behaviour and sanction deviance.

Third, both the first and second attributes depend on the effective functioning of regulatory apparatuses. Regulation of professionals in a particular case comes from parties to the case (*e.g.* creditors) and, more important, a court. Most important, bankruptcy professionals require a professional regulatory body that simultaneously enables them to collectively express their interests and expertise, and to facilitate qualified, competent and ethical practice.

Many governments in Asia confront significant policy hurdles in the implementation of a bankruptcy profession. There may be a general deficit of skilled lawyers or accountants, a deficit of bankruptcy specialists, a derogation or marginalisation of bankruptcy work, a pattern of corruption around bankruptcy work, a lack of education in bankruptcy law and practice, and the absence or ineffectiveness of regulatory bodies for credentialing and ethical oversight. Moreover, most countries already have an established division of labour. This can produce an institutional inertia that resists adaptation to changes in the market. Professionals may be socialised in a form of practice (*e.g.* liquidation) that is inimical to changes in insolvency or wider public policy (*e.g.* a preference for reorganisation). Together these elements may be sufficient to destroy a bankruptcy regime, no matter how well crafted the substantive law.

Table 1. Global norms on the Professionalisation of Insolvency Practice

UNCITRAL Legislative Guide
Qualifications (paragraphs 36-41) 115. The insolvency law should specify the qualifications and qualities required for appointment as an insolvency representative, including integrity, independence, impartiality, requisite knowledge of relevant commercial law and experience in commercial and business matters. The insolvency law should also specify the grounds upon which a proposed insolvency representative may be disqualified from appointment. 118. The insolvency law should establish a mechanism for selection and appointment of an insolvency representative. Different approaches may be taken, including appointment by the court; by an independent appointing authority; on the basis of a recommendation by creditors or the creditor committee; by the debtor; or by operation of insolvency law, where the insolvency representative is a government or administrative agency or official.
World Bank Principles
D8 Competence and Integrity of Insolvency Representatives The system should ensure that: - Criteria as to who may be an insolvency representative should be objective, clearly established and publicly available; - Insolvency representatives be competent to undertake the work to which they are appointed and to exercise the powers given to them; - Insolvency representatives act with integrity, impartiality and independence; and - Insolvency representatives, where acting as managers, be held to director and officer standards of accountability, and be subject to removal for incompetence, negligence, fraud or other wrongful conduct.

These policy hurdles are not confined to developing countries. It is instructive to consider the case of England, which successfully solved its problems with practitioners by creating a new hybrid insolvency practitioners' profession. In the first major insolvency legislation for almost a century, Mrs. Thatcher's government sought to stimulate public confidence and investment in the market. To do so required "cleaning up" the market. Both demanded a radical reform of insolvency practice.[34]

The Cork Committee Report (1980) and the media criticised insolvency practice on the grounds that: 1) there were no formal qualifications for practice; 2) many practitioners and small insolvency firms were not regulated by themselves or the government; and 3) there were widely publicised cases of unethical practitioners conspiring with company directors to defraud creditors through bankruptcy proceedings.[35] The Insolvency Act and its implementing regulations: 1) created a new insolvency profession, including lawyers and accountants; 2) set minimum standards for professional credentials and experience; and 3) erected a complex regulatory structure that combined self-regulation with government oversight. This had the effect of resolving most problems of incompetence

and unethical behaviour, and it drew more highly qualified reputable practitioners into the profession.

Indonesia, by contrast, has had a limited foundation on which to build its new receivers' profession. The results to date have been disappointing although the nature of its difficulties and attempted solutions are instructive for other countries (see Box 1).

Box 1. Establishment of a receivers profession in Indonesia

In Indonesia, after 1997, professional services in general were poorly developed, and corruption was purportedly widespread in legal and accounting practices. The Indonesian government confronted the policy hurdle of developing bankruptcy professionals capable of servicing the increase in corporate restructurings and liquidations brought about by the package of reforms.

The IMF-led international agencies pressed the government of Indonesia to permit foreign professionals to practice in Indonesia, at least for a period. The government refused, in effect, by demanding that practitioners speak Bahasa Indonesia. The government did create a receivers' profession, which could be staffed by accountants, lawyers and others.[36] Receivers were to be regulated by a professional self-regulatory body and appointed by a court.

The indifferent success of this policy option shows how high the hurdles to be surmounted are in situations where corruption is pervasive, professionals are in short supply, the economic stakes are high, and professional regulation is weak. Researchers on bankruptcy lawyers have concluded that "professional standards of the private legal professions not only are significantly weaker than those of the judiciary but also seem to be deliberately designed to obscure and obstruct the proper administration of justice."[37] Other research shows that particular lawyers are associated with doubtful records that can reasonably be associated with corruption,[38] a belief that is widely echoed by other actors in the Indonesian insolvency system.[39]

Research on the receivers' profession has shown it has even more problems. While a regulatory structure was created (AKPI), and the AKPI has administered qualifying examinations, the vagueness of rules and procedures in the law, and the almost complete absence of advice, continuing education and ethical controls by the AKPI, has permitted numbers of abuses. The ad hoc appointments process, initiated by creditors, debtors and/or the court has led to a small number of the eligible receivers being appointed over and over again while others are not appointed at all.[40,41] This has led to allegations of corruption and collusion between practitioners and judges.

In Indonesia the policy goal was therefore frustrated by: a) incomplete or ambiguous practice rules; b) failure to specify precisely the conditions and terms of appointment in ways that forestalled favouritism, kickbacks or collusion with interested parties; c) failure to create a functional self-regulating body with powers of enforcement; and d) failure of government to provide oversight and accountability of the regulatory body.

Together these helped contribute to the abandonment of the bankruptcy process in courts by many creditors, including the International Finance Corporation of the World Bank.

The Chinese government confronts a significant policy hurdle in the construction of a vibrant sector for professional services that can both service a bankruptcy regime and compete in the opening of the professional services market as WTO provisions come into force. China has taken notable steps to expand its professional services sector, with marked success in professional education and recruitment. Yet both the accounting and legal professions are very young and very small. A small proportion of mostly urban lawyers have university qualifications. They are disproportionately distributed across China. There are also multiple occupations providing legal services, each regulated by a different body.[42] Very few lawyers have experience in bankruptcy proceedings. And the form and powers of regulatory bodies for practitioners have yet to be unveiled.

In their economic development to the present, countries with advanced market economies have developed at least five models of professional regulation.[43] The models are suited to the particular historical development and current institutional matrix of each country. In Asia we can expect similar variation. It is not likely that the model for Japan or Korea, for instance, will be entirely appropriate for Indonesia and China, which have radically different histories and paths of development. This logic of analysis suggests that:

In a developing country where: 1) the formation of a professional services sector is very recent; 2) multiple occupations compete even within the domains of law and accounting; 3) demands for services range from the most sophisticated international standards to very simple local needs; 4) professional competence and ethics are in early stages of development; and 5) regulatory structures that are somewhat differentiated from the state are still evolving…

…a national adaptation of global norms might have the following attributes:

- Creating a tiered qualification for practice: the larger the enterprise and more complex the liquidation or reorganisation, the higher the credentials required by a professional or professional services firm for appointment as counsel or as an insolvency representative;
- Creating a unified intermediary organisation/professional association that would hold substantial regulatory powers for education, qualifications and credentials, continuing education, and ethical standards, including the powers to penalise, suspend or expel a professional from practice. This association would also have the capacity to protect professionals from illicit influence, a function critical for it to maintain its credibility among practitioners;
- Granting powers to a single–possibly new–government supervisory agency that would hold accountable the intermediary organisation;
- Creating and enforcing severe penalties for corruption; and
- Formulating precise rules of practice (*e.g.* appointment, conflicts of interest, dismissal) to be applied by the professional intermediary organisation and court, and as a reference for parties to professional services.

b) The compensation of private insolvency professionals

If the principal purposes of bankruptcy law are to maximise the value of assets, save businesses that are capable of being turned around, and redistribute assets to parties most capable of maximising their value,[44] a bankruptcy system must attract professionals with the skills capable of comprehending the complexity of current financial and operational structures, of distinguishing between businesses with no hope and those with hope, of creatively using legal means to swell the estate and obtain fresh capital, and of imagining new futures for a weak business.

The policy issues surrounding compensation become difficult because they are also politically sensitive. All these issues relate to the fundamental policy question–how to attract professionals of a competence commensurate with the complexity and stakes of the business challenge? At once, remuneration must attract the best professionals for the most complex tasks while making affordable professional services for relatively straightforward and even mundane tasks. A careful balance must be struck between preserving value for the estate and reorganisation, and allocating the value necessary to obtain competent professional services.

Global norms provide useful guidance about options. The UNCITRAL Legislative Guide points out that remuneration for an insolvency practitioner who administers a bankruptcy estate can be determined by a government agency, a professional association, creditors, or a court. The basis for determining fees varies markedly: 1) a time-based system that rewards practitioners for the hours they spend on a case; 2) a commission based system which rewards practitioners for the assets they bring into the estate; and 3) a creditor led system which has more discretion over the complexity of the case and the effectiveness of the practitioners. Each of these also balances reward with risk in different ways, and has benefits and deficits.[45]

Table 2. Global norm on professional remuneration

UNCITRAL Legislative Guide
Remuneration (paragraphs 53-59)
119. The insolvency law should establish a mechanism for fixing the remuneration of the insolvency representative and establish priority for payment of that remuneration.

The importance of remuneration is frequently underestimated by lawmakers. It becomes a "political football". Yet its significance can be observed in two national cases. In one, the United States, a change in remuneration dramatically increased the flow of skilled professionals into the handling of firm and industry restructurings. In another, Indonesia, a failure to adequately resolve problems of remuneration has severely hampered the construction of an effective insolvency system (see Box 2).

Before 1978, bankruptcy law in the United States was a low prestige and marginalised practice that did not attract the best and brightest professionals. Major corporate law firms seldom included bankruptcy specialists. Judges determined fees for lawyers who acted on behalf of bankrupt companies. While, in principle, fees were determined on the basis of hours plus expenses, in practice, lawyers remained uncertain until the end of the case about their compensation because judges had discretionary powers that were often exercised in arbitrary ways. Some judges refused to pay lawyers a higher hourly fee than judges themselves received. The result could be predicted: highly qualified corporate lawyers simply avoided bankruptcy work for it offered neither prestige, nor power, nor money.[46]

Policy makers responsible for the 1978 US Bankruptcy Code made a fundamental decision to prioritise corporate reorganisation. This could only happen if there was a radical shift in the basis of compensation for private practitioners. Their solution: for fees to be determined on the double basis of comparability to legal work of similar complexity and the value that practitioners brought into the estate, taking into account the complexity of the case, and the effectiveness of the outcome, among other criteria. The results were dramatic. Bankruptcy practice catapulted from one of the least prestigious and lowest paid specialties to one of the most prestigious and best paid areas of law. The best marginal boutique bankruptcy firms were absorbed into major corporate law firms. The restructuring of the largest firms and entire industries (*e.g.* airlines, automobile) now lay in the hands of some of the most talented professionals in the legal services market. This gave US industry a capacity to adapt and adjust to changing market conditions.[47]

Policy makers in Indonesia began with a similar incentive model in mind. It is salutary to observe how the best of intentions were derailed in practice (Box 2).

Box 2. Remuneration of receivers in Indonesia

In Indonesia the government proposed but ultimately failed to implement an effective compensation system. A 1998 decree mandated that receivers would be compensated on the basis of a percentage of the assets in the estate.[48] This offered potentially high rewards for enterprising professionals.

However, an early case that involved tens of billions of rupiahs would have paid millions of rupiahs to receivers. The Chief Judge of the Commercial Court decided this was excessive and replaced the percentage criterion by an hourly fee roughly equivalent to USD (United States dollars) 300 an hour. This included not only the lead receiver but all supporting professionals, support staff and expenses. Subsequently that figure was reduced by courts to approximately USD 200 an hour.[49,50] Even that figure was subject to the discretion of judges and it was not determined until the end, or close to the end, of a case.

Moreover, lack of enforcement capacity meant that fees were difficult to collect from debtors, so much so that receivers were often compelled to offer huge discounts of up to 75% of total fees in order to be paid at all. Sometimes debtors paid only in instalments or even, on occasion, with assets, not cash.[51] Because approval of fees depended on judicial discretion, a perverse economic incentive entered the system that encouraged corrupt practices between receivers and judges. A receiver's fee might depend on whether they were prepared to make a contribution of some part of it to a judge.

Remuneration also presents difficult policy choices for China. It is politically uncomfortable for lawmakers to rank professionals above all other creditors in liquidations or to reward professionals highly in reorganisations at precisely the moment when workers are being laid off or their compensation and benefits reduced. There is a natural tendency, therefore, for politicians to solve their political difficulties by restricting fees that would seem to increase inequality in the market. Similarly, judges in advanced and developing countries frequently resent the much higher levels of compensation of private practitioners.[52] Moreover, taking fees out of the estate appears to impede the capacity to reorganise successfully because it drains scarce resources required for reorganisation.

These considerations must be weighed against the value that highly qualified, expert and experienced professionals can bring to the prospects of saving large and complex enterprises. As a proportion of the present assets and future value of a company that is effectively reorganised, professional fees might be considered a very small transaction cost.

The UNCITRAL Legislative Guide makes it clear that professional remuneration can be adapted to a variety of national circumstances as nation-states vary bases for determining fees and the economic or government actors who set those fees. This logic of analysis suggests that:

In a developing country where: 1) the market for services is highly bifurcated between those that are highly complex and those that are straightforward or routine; 2) the outcomes of bankruptcy proceedings for major companies have significant impact on national or regional economies and social welfare; and 3) major creditors and debtors rely on sophisticated domestic and international professional services in their most critical commercial dealings…

…a national adaptation of global norms might have the following attributes:

- Maintaining an administrative priority for professionals in the liquidation of companies;
- Adopting a compensation system for professionals that provides incentives for the best professionals and best firms to engage in corporate bankruptcy;
- Graduating the compensation system so that professional services for middle-sized, small and routine bankruptcies are affordable by debtors and creditors; and
- Creating a bankruptcy administration within the state that handles routine bankruptcies where there are no fees from creditors or debtors, or where they are not sufficient to attract professional services.

c) Implementation of an effective judicial system

With rare exceptions,[53] the successful implementation of a bankruptcy system depends upon the construction of an effective judiciary. This is a most formidable task– arguably the most difficult of any aspect of insolvency institution building–because in most developing countries it involves changing the structure of the state. In the vast majority of countries, the executive arm of government dominates the legislative and judicial branches.

In countries where the state has led economic development, such as China, Indonesia and Korea, administrative guidance has been vastly more important than legislative or court interventions.[54] And, without a tradition of the rule of law, courts are by definition weak and avoided by powerful actors in a society.[55] As a result, to create a market system governed by the rule of law involves the most fundamental policy decision: will significant powers be transferred from the executive, or party, or legislative institutions to courts? Or, more generally, will courts be given sufficient autonomy to make legal decisions without the arbitrary interference of a party or state officials, market actors, or the public? The answers to these questions determine whether a market-based insolvency system is possible.

Inside this fundamental policy question sit several others. The UNCITRAL Legislative Guide identifies three.[56] How extensively involved will courts be in proceedings and in what aspects of proceedings? How much power will be delegated by courts to other participants, such as insolvency practitioners and creditors, and which of those decisions will require court approval? And, what powers will be given to court officials? The UNCITRAL/World Bank Principles specify in some detail global norms that will produce an effective judiciary (Table 3).

There are powerful arguments for the central involvement of courts in bankruptcy proceedings: optimally, they may protect the public interest alongside interests of other parties; they provide forums in which negotiations take place or in whose shadow negotiations occur; they offer a neutral forum for dispute settlement; and they can make binding agreements among parties as well as undo agreements to the benefit of reorganisation. Yet we shall observe further below that nations differ considerably in ways they distribute functions to courts and other institutions, out-of-court bargaining forums, state agencies, or contracting among parties. That is, more or less of the work of bankruptcy may be done in courts even though a court may ultimately be the institution of last resort.

Table 3. Global norms on courts

UNCITRAL/World Bank Unified Standard
D1.1 The system should guarantee the independence of the judiciary. Judicial decisions should be impartial. Courts should act in a competent manner and effectively….
D1.2 Insolvency proceedings should be… assigned, where practical, to judges with specialised insolvency expertise.
D1.3 The court's jurisdiction should be defined and clear….
D1.4 The court should... render decisions in proceedings in line with the legislation....
D1.5 The general court system must... effectively enforce the rights of... creditors....
D2.1 Adequate and objective criteria should govern the process for selection and appointment of judges.
D2.2 Judicial education and training should be provided to judges.
D2.3 Procedures should... ensure the competence of the judiciary….
D3 The court should [treat] all interested parties... fairly, timely, objectively.
D4 An insolvency and creditor rights system should be based upon transparency and accountability....
D5.1 Judicial decision making should encourage consensual resolution among parties where possible and otherwise undertake timely adjudication of issues....
D5.2 The court must have clear authority and effective methods of enforcing its judgments.
D5.3 A body of jurisprudence should be developed....
D6.1 The system should guarantee security of tenure and adequate remuneration....
D6.2 The court must be free of conflicts of interest, bias and lapses in judicial ethics....
D6.3 Persons involved in a proceeding must be subject to rules and court orders designed to prevent fraud, other illegal activity and abuse of the insolvency and creditor rights system.

The choice by a country on how much power to vest in courts will comprise a mix of factors including: a) the historical role of courts; b) the current situation of courts in the state and market; c) the political will and level of economic investment by the state in development of the judiciary; and d) state ideology and public support for court-based dispute resolution, and checks on the powers of executive agencies and legislatures, among others.

Three empirical cases underline the policy challenges of implementing effective courts for insolvency regimes. The case of the United States is instructive. Although the US already had a sophisticated judiciary and legal profession, it confronted significant

problems with bankruptcy practice. Before the 1978 reforms, federal bankruptcy courts operated at a much lower level of competence, prestige and power than the so-called Article III courts.[57] Low salaries, low prestige, short tenure, and limited power did not attract outstanding judges. Jurisdictions were confusing and overlapping. Judges were vulnerable to market pressures and some succumbed to corruption.

As a result, the American Bankers Association and other organisations of major creditors informed the congress they would simply avoid the courts and subvert bold proposals for law-driven reorganisation reforms unless courts were competent, and powerful with clear jurisdictions. Congress responded by elevating bankruptcy courts to an adjunct of federal district courts, where judges would be appointed by the president on the advice of the senate for fourteen years, with increased salaries to match. Courts were given greatly enhanced powers, their jurisdictions clarified, and an appellate court structure was added. The result: the quality of judges has risen markedly, the largest creditors and debtors bring their cases to the bankruptcy court, and corruption appears to have disappeared.

In Asia, the cases of Indonesia and Korea contrast sharply. Each emerged from the Asian financial crisis with a determination to transform the role of the judiciary in governing market relationships. Yet implementation has diverged markedly (Box 3).

China has made enormous strides in the development of its courts since 1979.[58] Courts are moving gradually from an administrative to an adjudicatory model; the recruitment and quality of judges is incrementally being upgraded so that more judges will have prior legal training; representation of parties by counsel can be found increasingly as numbers of lawyers and legal workers expand; and the Supreme Peoples' Court has outlined broad ambitions in its Second Five-Year Reform Plan.[59] Yet the most perceptive Chinese commentators identify major challenges to courts in general that will influence whether a court based bankruptcy system will succeed. In a comprehensive survey, China scholar Cai Dingjian[60] concludes that there is a "new crisis of people's faith in the law" and unless this is remedied quickly their "disappointment and lack of trust" could result in the "abandonment of the legal system."[61]

Box 3. Court reforms in Indonesia and Korea

Korea

The post-1997 reforms brought a demand for bankruptcy judges. Korea began with an advantage–the quality of judges, by and large, was high since they were recruited through a rigorous selection process. However, for courts in general, there were problems of competence and experience in commercial cases and there were also cases of corruption. Courts had no expertise in bankruptcy matters since, on average, they handled about one bankruptcy case a year.[62] The most fundamental policy challenge, however, centred on the possibility that the government of Korea would relax its administrative and executive control over corporate liquidations and reorganisations and transfer those powers to market actors operating through the courts. A deep-seated scepticism existed in the Ministry of Finance and Economy that courts, previously the least developed of the branches of government, could handle some of the most difficult issues in the economy–defining the limits of the market.[63]

The Korean government successfully responded to these challenges with a combination of methods over several years, culminating in a comprehensive bankruptcy act: 1) rotating judges from one court to another in order to reduce their vulnerability to local pressures; 2) creating a division of the court, particularly in Seoul, that specialised in bankruptcy cases; 3) creating ad hoc panels of business leaders, accountants, and others, who can sit with judges on complex cases and provide them expert commercial advice; and 4) moving slowly to permit courts rather than administrative agencies to make decisions in major restructurings.[64] Through this mechanism the government still continues to exert administrative influence on restructurings before they get to court.

Indonesia

A more severe policy challenge confronted the government of Indonesia. In the wake of the 1997 financial crisis, the IMF and international creditors compelled Indonesia to engage in significant court reforms as a condition of their loan agreements and disbursements.[65] Creditors and debtors seldom used courts.[66] Court powers were limited; they failed to recruit high quality judges, and their independence was deeply compromised by political and market interventions. Indonesian courts had little experience with significant commercial cases. Over decades, Indonesia's state bureaucratic-led economic development reduced the powers and independence of the courts almost to irrelevance.[67]

In negotiations with the IMF, the government of Indonesia made a series of policy choices that were implemented in rolling reforms: 1) to establish a new dedicated commercial court; 2) to recruit high quality judges who would be trained in commercial law; 3) to provide ad hoc outside judges or specialists to add judges in complex cases; 4) to create civil society monitoring groups that monitor all court bankruptcy decisions; 5) to make publicly available all court decisions; 6) to enact collateral legislation and set up bodies that would guard against corruption; and, perhaps, most fundamentally; 7) to establish a judicial commission that separates it from Ministry of Justice control and provides it some financial and administrative independence from the executive.[68]

While advances clearly have been made,[69] empirical analysis shows that certain policy hurdles have not yet been surmounted. The dedicated commercial court did not receive the resources initially envisaged; commercial court judges were not paid a premium in order to attract high quality judges, nor were judges recruited from the private profession; the initial and continuing training of judges fell short of desirable minimum thresholds; appeals continued to a Supreme Court that appeared sometimes corrupt and sometimes lacking in competence; many judges continued to be exposed to efforts to corrupt their independence and some decisions suggested that some succumbed; ad hoc judges were rarely used; and major creditors, especially foreign creditors, deserted the court.

Scholarly observers argue that these difficulties in implementation go beyond insolvency law to: a lack of political will by the Ministry of Justice to radically reform the entire court system; a lack of commitment by the government to provide adequate resources to the commercial court; resistance from the Supreme Court and other judges to a special status for commercial court judges; and a laxity by the government in taking corruption seriously in any part of public administration.[70]

Yet, advances have been made with a judicial commission that proposes that reforms initiated in the commercial court will be widened to the entire court system, the prospect of more powerful independent courts now is debated in the public arena, and a small civil society has developed to support court reform. It remains to be seen how effectively the judicial commission and blueprint for the Supreme Court will be implemented in practice.

Cai Dingjian identifies several challenges for policy makers in the structure and functioning of the judiciary. First, the judiciary is not independent, either from the market through financial corruption, or from local governments which "control judicial appointments and are responsible for financing local courts." "Trial outcomes," states Cai Dingjian, "are influenced by power, money, and relationships and the dictates of local interests and the local power structure."[71] Second, the internal organisation of the judiciary is problematic. Rather than using single-judge regimes, courts rely on court

adjudication committees in which judges remote from the case and hearings, including the president and vice-president of the court, contribute to decisions on a case. Third, judges are not well qualified whether in general legal education or in specific areas of practice, such as commercial law. Fourth, "with the advent of economic reform, such people completely lack the ability to resist the lure of money, pressure from those in power, and the corrupting influence of personal relationships. The result is an astounding amount of corruption in judicial agencies."[72] Fourth, enforcement of court decisions remains very weak particularly when they require confronting the instinctive protectionism of regional and local interests, not to mention those of government agencies. This analysis coincides substantially with the OECD's 2005 Economic Report on China.[73]

To the extent that these practices continue, they will preclude the development of a bankruptcy system that can regulate market practices, broaden lending and investment, and restructure firms. A huge gap will open up between enacted law and its implementation. This will quickly become apparent to creditors. Local protectionism is particularly perilous for bankruptcy regimes since local jurisdictions are inclined to favour local debtors and creditors over those outside a jurisdiction, which breaches a fundamental principle of bankruptcy law and discourages financing from parties outside a jurisdiction unless they have strong local relationships. Limited separation between the courts and political authorities similarly gives no confidence to creditors outside the jurisdiction or out of the country that they can extend credit with confidence and that their assets or security will be protected. If courts are not highly competent and skilled in commercial matters, especially for complex liquidations or restructurings, then they will not gain the confidence of major parties to bankruptcy proceedings. And even if judges are competent, a failure to combine rewards and sanctions that will inoculate them from economic corruption will similarly doom a bankruptcy system.

Governments find it difficult to muster the political will to invest heavily in courts because they do not have strong political constituencies. The centrality of courts to the entire economy (not to mention the social stability of the entire society) suggests that they warrant an investment by government comparable to other critical infrastructures, such as power and transportation. The cases of Singapore and Indonesia contrast sharply in this respect. Singapore's economic development plan included a dramatic upgrading of courts with heavy financial investment, strong sanctions and heavy inducements. Lee Kuan Yew attributes a significant part of Singapore's transition from a developing to an advanced economy to his successful investment in the judiciary.[74] Indonesia has headed more cautiously in a similar direction. Its trajectory is promising, but political will has taken time to gather momentum and economic investment in courts by the government has been limited. India's increasing appeal to foreign investors relies in part on its reputable court system.

The difficulty of institution building must not be minimised for it confronts enormous challenges on all sides. Few developing countries achieve significant results in less than several decades, if at all. Some academic commentators are quite pessimistic about the prospects of court reform in most developing countries.[75]

Since the structure and functions of judiciaries varies widely across countries with advanced economies, it is to be expected that the nature of those reforms will differ significantly in Asia. This logic of analysis suggests that:

For a subset of countries where: 1) countries intend to regulate their markets by law rather than relationships; 2) the development of judiciaries has been stunted and their legitimacy poorly established; 3) the current judiciary cannot protect itself from market, political or public interference in its decision-making; 4) local protectionism permeates the judiciary; 5) recruitment of judges has not kept pace with the sophistication of market transactions and legal development; 6) judicial authority will have wide-ranging potential consequences for local and national economies; and 7) political will is strong enough to create a necessary infrastructural condition for an advanced market...

…a national adaptation of global norms might have the following attributes:

- Create a *national commercial court* that would be financed by the central government and administered by a national judicial commission;[76]
- Vest in the *national commercial court* jurisdiction for commercial cases in particular areas of law, perhaps above a certain monetary level and/or in cross-jurisdictional cases;[77]
- The national commercial court could consist of two or three layers, from courts of first instance, to intermediate courts, to a national supreme commercial court. Alternatively, appeals might be made to a supreme court;
- Create a *national judicial profession* whose members are appointed nationally (perhaps nominated by provinces) and rotated throughout regions; judges would receive high salaries/rewards; recruitment might be open from within a judicial training institute or from the private legal profession;
- Create a mechanism for bringing non-judicial experts to aid the court; and
- Create and enforce severe penalties for corruption.

If the dramatic approach is not feasible, a dramatic end result might be accomplished by incremental steps. This approach might commence with the short-term establishment of a national court, which would begin in the largest cities, then widen to other parts of the country. Similarly, the court might begin with jurisdiction in one area of law, such as bankruptcy, and progressively widen to intellectual property, antitrust, and related areas.

d) Recursivity in the lawmaking process

Implementation itself has policy dimensions. Quite apart from the policy choices made about the substance of law or institutions, governments confront alternative ways of lawmaking. The process affects the product and therefore must also be taken seriously in the construction of functioning insolvency regimes.

Lawmaking frequently proceeds in episodes–long cycles of reform that continue until practice is normalised around policy goals set by the government.[78] The stabilisation of reforms occurs when the gap between formal law and law in practice is reduced sufficiently for the policy to be implemented in a form intended and acceptable by lawmakers, practitioners and stakeholders alike. If the demand for reform is held constant, better lawmaking occurs when cycles of reform are minimised–when courts and government agencies quickly converge on settled meanings of a statute. Fewer cycles also have the merit that they more readily produce predictability and certainty in the law and market.

Research on insolvency lawmaking in advanced and developing countries reveals that several pathologies can accompany lawmaking. Research proceeds on three premises about legal change: 1) lawmaking produces statutes passed by legislatures, cases decided by judges, and regulations generated by civil servants; 2) reforms or legal change oscillate in cycles between law-on-the-books and law-in-action; and 3) what occurs during lawmaking affects law in practice and what happens in practice influences subsequent lawmaking.

Four mechanisms drive cycles of reform in insolvency and other areas of commercial reform:

a. All lawmaking produces *indeterminacy.*[79] This results from ambiguities, inconsistencies or gaps in the principal governing statute and it is intensified by conflicts among rule-making agencies, general court interpretations, and limitations of particular judicial opinions. Indeterminacy is affected by the uncertain relationship between national, provincial and municipal courts.[80] Yet all parties that anticipate bringing actions under the law seek a measure of predictability and certainty about what law will be applied in a forum that has clear jurisdiction.[81] If significant players, such as financial institutions in bankruptcy proceedings, are not convinced that courts can offer the determinacy they expect, they will abandon them in favour of other arrangements.[82] Several instances of statutory ambiguity and judicial interpretations affected both Indonesian and Korean law reforms in adverse ways.

b. The implementation gap can be widened or narrowed by *contradictions* that frequently are built into laws. A contradiction occurs when lawmakers seek to resolve strong conflicts among economic, ideological or political actors by giving opposing actors concessions within the law itself but without resolving the underlying tension. In insolvency politics such a tension frequently turns on the relative rights of secured creditors versus labour or unsecured creditors or debtors. Unless satisfactory bargains have been struck by the principal parties with interests in the outcome, contradictions inside law lead to unstable political settlements. Unresolved contradictions consequently lead to an implementation gap where dissatisfied parties seek to nullify in practice what they could not manage in the law. They lead inevitably to further waves of corrective laws, regulations and court opinions thereby producing more short-term uncertainty for potential users of the laws.

c. The implementation gap can be widened by *diagnostic struggles* among players in a bankruptcy system over exactly what is right or wrong in the functioning of the system. All lawmaking proceeds on diagnoses of some problem and the prescription that will solve it. But contentious areas of lawmaking by definition include interest groups that define the problem in different ways. In debates over drafts of the Chinese Bankruptcy Law, the powerful trade union representatives and the banking sector have very different diagnoses of the relative situations of workers and secured creditors and what should be done about them. The differences within the Standing Committee of the NPC over the relative priority of secured creditors and workers reflect differing diagnoses of the situation of companies in distress. If the law is based on a diagnosis that is wrong or biased or contestable, then this again can lead to resistance and a derailing of the law when it comes to be implemented by those whose evaluations of the problems were ignored or rejected.

d. An implementation gap frequently arises when there is an *actor mismatch.* Very often those who implement laws and those who enact laws are not the same. In bankruptcy reforms, debtors, the business community, or company managers are often left out of lawmaking. Trade creditors, who play a critical role in economic development, seldom have a means of articulating their views. This was the case in the lawmaking of the 1978 US Bankruptcy Code, the 1986 English Insolvency Act, and in the substantive and institutional insolvency reforms in Indonesia and Korea.[83] In the drafting of a new Chinese bankruptcy law, it is not clear how fully private sector industry has participated in any phase of the bargaining and drafting of the law. The danger of allowing an actor mismatch to open up in lawmaking is that parties excluded from the lawmaking may fight strenuously against those laws when they come to be implemented.[84]

The number and extent of pathologies in reform can be avoided by anticipating and adjusting for them:

(1) Ambiguity can be lessened by clarifying jurisdictions among lawmaking agencies. Commentators on Chinese lawmaking have observed that much indeterminacy results from conflicting interpretations by competing government agencies and the Supreme People's Court. The proposed reforms in the Five-Year Plan of the Supreme People's Court may lead to more consistency across courts and a clearer jurisprudence arising from the courts.[85] An advance to a comprehensive bankruptcy act that unifies jurisdiction over almost all enterprises will be a notable advance. But unless clear determinations can be made at the point of enactment about which other lawmaking entities will have responsibility for drafting regulations, interpreting the statute, and handling conflicts, there will be adverse effects on market certainty.

(2) Contradictions are less easy to resolve. For instance, an ideological resolution of the tension between *socialist* market economy and socialist *market* economy would substantially lessen struggles in practice. Or, if the long-running debate between workers and banks over priority cannot be resolved so that each is protected, whether inside the bankruptcy law or outside of it (see below), it is probable that one or the other will continue the fight on the battleground of implementation. Contradictions are also structural: if agency responsibilities and jurisdictions are not very clearly delineated or their powers are reduced, they will continue to fight each other or resist implementation.

(3) Policy determinations depend on *diagnosis* of practices. Pathologies of lawmaking will be minimised if the government will build systematic data recovery and research activities into implementation. Such data may come from: a) professional practitioners, who can file data on enterprises or their management; b) courts which keep careful records of cases that pass through them; c) periodic research undertaken on samples of businesses in difficulty to track and explain the decisions made by enterprise managers to use or not use law for coping with financial difficulty; and d) government agencies which manage SOEs. These data–financial, managerial, personnel–will enable the government to construct its regime more on the facts of enterprise distress and bankruptcy than on unfounded allegations or representations by self-interested parties.

(4) Finally, in order to forestall resistance by practitioners, who can effectively nullify a new law, their views must be clearly solicited and interests recognised in the lawmaking. Comparative research shows that unless professionals, key business groups and workers are incorporated into the bargaining, they have the capacity and often willingness to subvert new law. Already the draft bankruptcy law is well advanced and it may be too late to involve parties who have been neglected or excluded. However, it is not too late for lawmakers to identify those potentially influential actors who have not been involved in the bargaining and to anticipate how they might frustrate implementation.

National variations in lawmaking processes influence the capacity for effective implementation. This logic of analysis suggests that:

In national circumstances where: 1) critical stakeholders and implementers of law do not participate in insolvency lawmaking; 2) lawmaking organisations have blurred, conflicting or indeterminate authority; 3) there is no determinate institutional structure for clarifying the meaning of law; 4) systematic monitoring and analysis of insolvency practice is absent; and 5) political consensus has not been reached on fundamental issues of meta-policy...

…a national adaptation of global norms might have the following attributes:

- Ensure that *all* actors that have the capacity to frustrate, derail or block insolvency implementation are integrated into the lawmaking process; if they are not involved in bargaining over the principal statutory enactment, *either*, anticipate the expression of their dissent in practice and adjust for it, or, draw them subsequently into discussions that could lead to further adjustments or reforms;
- Seek to identify ideological contradictions in the substantive law and *either* resolve them to the mutual benefit of parties (*e.g.* through a balance) *or* offer future channels through which they can be resolved;
- Provide clear jurisdictions and lines of authority among lawmaking bodies (legislature, courts, regulatory agencies, professional associations) so substantive struggles unresolved in the legislature do not continue through internecine contests among government entities;
- Build transparency into all kinds of lawmaking, including cumulative reporting of regulations and cases, most notably create a systematic jurisprudence;
- Build lawmaking and implementation on a foundation of systematic diagnosis of problems; examine each source of diagnosis for bias; encourage multiple sources; build in monitoring capacities to review implementation (*e.g.* technical assistance programmes from IFIs); and
- Build incentives and a culture of reform in which professionals, civil society groups, scholars, and the media publicise, codify, critique and advance regulations and cases.

e) Implementation process

Empirical research and theory on institutional change demonstrate that reforms are highly contingent: they depend heavily on the process whereby lawmaking becomes actualised in practice.[86] This *process* of implementation raises at least three issues.

First, even when national reforms conform to global norms–indeed, sometimes *because* they conform to outside standards–they may be rejected by key players or the public at large.[87] The greater the paradigmatic shift in thinking by the immediate stakeholders or the public, the greater the challenge to alter perspectives. Public

resistance, sometimes reflected by political representatives, can be observed in the Indonesian and Korean reforms. Insolvency reforms ran into difficulty in both countries because publics and stakeholders resisted the idea that major companies could be liquidated or that they were "too big to fail."[88] Reformers found it difficult to prod courts to liquidate companies, even going so far in the 1998 Korean reform to compel judges to apply an "economic criterion test" in order to remove their discretion that might preserve a company whose liabilities exceeded assets.[89] Citizens of both countries resented reforms that appeared to be imposed from outside, so much so that Koreans colloquially label the 1997 Asian Financial Crisis as the "IMF Crisis."

Second, institutions must be considered legitimate if they are to function effectively. The legitimacy of government organisations rests on: a) a perception that the institution's constituents get to participate in its composition and proceedings; b) a belief that procedures are fair and that diverse interests and differences in power have not captured the institution for sectional purposes; and c) that the organisation is or will be effective.[90] Insolvency reforms therefore run into either a problem of legitimating new institutions, or of re-legitimating previously discredited institutions. In Korea, government economists and officials doubted the legitimacy of the courts to take over market regulation from administrators. In Indonesia courts have been caught in a legitimacy squeeze between sceptical corporations and sceptical creditors. In China, critics of the fairness, neutrality, and effectiveness of courts suggest that they confront a major legitimation challenge.

Third, the process of implementation can be sharply divided between those approaches that are incremental, piecemeal or gradual, versus those that are dramatic, systemic and rapid. Indonesia, Korea and China represent three different trajectories of reform. In Indonesia the key reforms were made rapidly in a few months after the crisis.[91] Thereafter the government made a series of corrective and compensating decisions to deal with gaps or unanticipated consequences. In Korea, by contrast, there was no dramatic change but a series of amendments to substantive and procedural law, a new corporate restructuring law in 2001, culminating in a massive comprehensive bankruptcy law that integrated all three previous acts into a single statute.[92] In China, bankruptcy reforms have proceeded on several tracks, most notably the administrative-led reforms of SOEs managed by the State Economic and Trade Commission,[93] but also experiments in SEZs, and the Shenzhen experiment, among others.[94] The mark of this reform effort has been incremental and experimental despite pressure from international organisations to move more quickly.[95]

The policy choice between decisive and gradual change is not simple. On the one hand, the benefit of incremental change is that it reduces the likelihood of a radical mistake that would generate a sharp backlash from stakeholders or a loss of face by lawmakers. On the other hand, where a new institution is being constructed, a failure to proceed systemically, with all components in place at the outset and perceptible progress from the beginning, may also lead to a backlash from stakeholders who lose confidence quickly and de-legitimate the institution. Some Indonesian experts hold that the problems confronted by Indonesia's insolvency reforms were not that too much was attempted but that they did not go far enough fast enough.[96] By going too slowly, by not taking on corruption, the competence of judges, and the structure of the court system all at once, the Commercial Court quickly lost the initial support it gained from key stakeholders.

Implementation processes vary widely among countries, including those in the same region. This logic of analysis suggests that:

In national circumstances in which: 1) insolvency reforms involve a paradigmatic shift in public perceptions; 2) reforms require a reorientation of stakeholders towards problems of enterprise failure; 3) institutions lack legitimacy; and 4) incremental change may disillusion already frustrated stakeholders and the public…

…a national adaptation of global norms might have the following attributes:

- Cultivation of theorists and framers of change (*e.g.* academics, lawyers, accountants, party ideologists) who are able to conceive of new approaches to corporate restructuring in terms of culturally acceptable frameworks;[97]
- Cultivation of "entrepreneurs" or change agents who are able to express persuasively to publics the new concepts of insolvency (*e.g.* lawyers, accountants, journalists, party leaders);
- Mobilisation of organisational capacities by stakeholders in the new regime (*e.g.* media articles by professionals, testimonies by workers, press releases by corporate executives), including civil society groups and professions;
- Creation of new institutions, or their dramatic reform, with sensitivity to the factors that will generate and maintain legitimation by stakeholders and the public; and
- Systemic change that might be comprehensive in design (possibly stepped in by increments) and mutually supporting (*e.g.* insolvency practitioners, judges, creditors, academics).

f) Policy exclusions from bankruptcy regimes

Every government has enterprises that it dares not expose entirely to market forces alone. This is true not only for bankruptcy but for takeovers and investment, as we have seen recently in the US, in the attempted CNOOC acquisition of a US oil company and in France with resistance to a takeover of a flagship company by an Italian competitor. For reasons of national defence, national prestige, national autonomy/sovereignty, community protection (*e.g.* one company towns), or regional or ethnic or tribal sensitivities, nations frequently exclude particular companies or certain industries from market-only forces. This is one way of defining the limits of the market: it is not defined simply in terms of financial or economic criteria, but also by other criteria of public policy. Thus countries will trade off efficiency and growth in some sectors of the economy in order to give preference to another policy criterion. It is therefore a policy issue for developing countries to decide what the limits to efficiency are as the primary criterion of market functions as expressed through enterprise preservation or liquidation. This problem is especially acute for governments making major transitions–from command to market economies; or from state-led administrative control of the economy to market-led dynamics that are regulated through law and the courts.[98]

A related policy issue concerns the breadth of the principal insolvency legislation and exceptions to it or exclusions from it. In Asia, both Indonesia and Korea developed emergency institutions to handle a volume of cases that would overwhelm the courts. Indonesia created the Jakarta Initiative Task Force as a mediation mechanism to handle out-of-court restructurings for large enterprises.[99] While its success is still a matter of debate, it had the effect of introducing some orderliness into debtor-creditor restructurings without burdening courts that could not have handled them. Korea

followed two strategies. In one, the Ministry of Finance and Economy presided over a set of "Big Deals" in 1998 in which flagship companies in critical industries were financially restructured with the government as a mediator or guide. In another, a corporate restructuring agreement among major financial institutions in 1998, roughly modelled on the London Approach, led ultimately to the Corporate Promotion Restructuring Act 2001 which sought to keep bank-led restructurings out of the courts until they found their feet.[100] China has followed a similar policy as the SETC presided over mergers and dissolutions of SOEs outside the Interim Bankruptcy Law and away from the courts.[101] The current provisions in the draft law before the NPCSC envisage that all SOEs be included under a new law except for those approximately 180 SOEs/conglomerates under the responsibility of the State Asset Supervision and Administration Commission (SASAC).[102]

This logic of analysis suggests that Asian states will vary considerably on their policy choices. If a state has: 1) a sophisticated professional services market; 2) competent and clean courts; 3) binding powers of enforcement; and 4) the capacity to handle the fallout of closed factories, unemployed workers and lost production (*i.e.* a safety net that is not tied to a particular firm), as is largely the case in South Korea, then it makes sense to incorporate all firms, private and public, into the bankruptcy system.

In national circumstances in which a state has: 1) a limited safety net; 2) fragile social stability; 3) weak courts; 4) limited professional expertise; 5) an untested bankruptcy law; 6) regional or ethnic inequality that is associated with failing firms; and 7) a volatile economic or political environment...

…a national adaptation of global norms might have the following attributes:

- Exclude initially a class (or classes) of enterprises that represent the most danger to other policy concerns;
- Include classes of enterprises that a reformed system will have a high probability of handling successfully;
- And/or exclude indefinitely classes of enterprises that are vital to the economic, social and political stability of the state.

Indeed it is probable that implementation will be seen to be more effective and legitimate if the reformed system works well in a restricted subset of enterprises and then gradually expands as the capacity of the system is proved and its legitimacy is strengthened.

g) Collateral institution building: Social policy considerations

Bankruptcy law and regimes are always nested in other institutions. While it is convenient for scholars and norm makers to isolate bankruptcy law as if it were purely technical, policy makers know that its effects can ramify to the most fundamental social and political issues in a country.[103] The most critical issue for many developing countries concerns the social welfare of workers who are laid off. Their welfare safety net can be underwritten in several ways: by their enterprises, as in the state-owned enterprises of socialist countries; by a community or state support system, such as unemployment

insurance; or by the option to return to village life, if that is available, for housing, food, education and possibly work.

Each of these options has its own problems. A SOE that guarantees work at one point in a worker's life and then withdraws it at a later point implicates its owner–the government–in a double bind: if the SOE seeks to compensate the worker for several transitional years,[104] then this bleeds cash from the enterprise that might be used for restructuring. And, if the SOE cannot pay the worker, or chooses to pay other creditors first, this creates anger and grievance. If SOE managers, under heavy pressure to meet financial targets, withdraw partially or completely from providing health services or contributing to a health fund, this also can feed protest. If the state has not developed an adequate safety net for unemployed workers, not only compensating them for lost wages, but also compensating unemployed SOE workers for the loss of other social supports–health, education, childcare, not to mention self-esteem–that were part of the total compensation package, then workers lose the basic necessities of life.[105] This too breeds social unrest. These circumstances are compounded in their potential negative effects if workers were raised on a "social contract" that guaranteed them full social security in return for low wages, long hours and difficult working conditions.[106] In some countries (Indonesia) it is thought that the proximity of industrial workers to their villages of origin cushioned the effect of the Asian financial crisis. This may not be true for urban workers laid-off in other countries.

Economists and IFIs often underestimate the danger to an economy and society through the immiseration of the working class.[107] If workers are thrown out of employment, if they have no village to which they can return, if they despair of any other options, if they sense a growing inequality in which they are excluded from the conspicuous consumption of a small proportion of the society, this can create a volatile situation for social and even political unrest. And, social and political unrest ultimately increase uncertainty and unpredictability in markets. Thus the very purpose of *economic* development through market certainty can be defeated if *social* conditions are worsened to the point of social instability. At this point, political expediency and economic goals intersect and are mutually reinforcing.

If a narrow view of economic development is embodied in global norms, there is a potential tension between global standards (which are primarily focused on insolvency and markets), and local political realities (which must take into account the social and political–and potentially economic–costs of worker disenchantment). This logic of analysis suggests that:

In national circumstances in which: 1) economic development is accompanied by rapid social dislocation; 2) workers are becoming unemployed in large numbers; 3) workers are losing access to social welfare, including health, education, and housing; 4) workers believe there has been a breach of a social contract that previously protected their social rights; 5) a smaller proportion of the workplace appears to benefit unequally from economic growth; 6) widening inequality coincides with perceptions of regional, ethnic or religious discrimination; and (7) social protests are mounting...

…a national adaptation of global norms might have the following attributes:

- If a country can afford and implement it rapidly, vest rapidly and comprehensively a national social insurance programme for displaced SOE workers that includes: a) lost benefits from loss of employment (*e.g.* back pay, vacation, pension); b) access to lost education, health and housing benefits; and c) retraining or assistance with relocation.[108]
- If a country cannot afford or implement a comprehensive welfare net for a large number of displaced SOE workers, then it has the option to: a) modify financial targets for SOE managers to compensate for continued worker benefits at minimal levels; or b) exclude, at least temporarily, selected SOEs from full market forces that would lead to mass layoffs or liquidation; or (c) use policy criteria to screen SOEs financially eligible for treatment by courts until wider social and political circumstances permit.

3) Conclusion

This paper has argued that policy issues permeate and contextualise bankruptcy reforms. It makes five general conclusions:

First, in Asia every nation must adapt global norms to its particular circumstances. There is risk in going too far in either direction: too rigid an adherence to global norms will contribute to a "transplant effect" of incomplete implementation;[109] too much local deviation from global norms may reduce flows of capital and trade necessary for economic development. The Chinese capture this balance perfectly in the aphorism "bankruptcy law with Chinese characteristics." A bankruptcy regime may look different in a Chinese *socialist* market economy than a Singaporean capitalist economy or a co-ordinated German or Scandinavian market or a liberal English, US or New Zealand market. Fortunately, the global consensus represented in the UNCITRAL Legislative Guide on Corporate Insolvency provides high level principles that allow significant room for national variation within global parameters. These adaptations can adjust to levels and types of economic development.

Second, national adaptations of global norms in bankruptcy require explicit attention by policy makers to meta-policy issues. Most notable among these are definitive answers to the questions: what will be the functions and limits of markets in a society? Will political power be restructured to provide the institutional attributes necessary for a functioning bankruptcy system? Will society be empowered and protected through bankruptcy reforms? An effective bankruptcy system requires a social and legal infrastructure in the market, a restrained executive and strengthened judiciary in the state, and a rationalising, determinate system of lawmaking that produces legitimate institutions. None of this is easy politically since it requires a restructuring of the distribution of power in the state and society.

Third, implementation and institution building are as important as–indeed arguably more consequential than–formal lawmaking. It is a dangerous illusion that the legal framework and institutions of an effective insolvency system can be done cheaply. Effective bankruptcy systems require the careful design, infrastructural expenditure, and political will comparable to major infrastructural projects in transportation or energy or defence. This is especially so in circumstances where there is rapid economic development and social dislocation in a society that had previously invested little in legal institutions. Failure of governments to act boldly and decisively can lead not only to incapacity but instability in society and ultimately the market.

Fourth, markets have limits. They are embedded in social, political and cultural contexts that define how far values (such as efficiency and growth) should impinge upon values (such as equity and concepts of justice), and how much certain global values are consistent with national values. Nation-states will vary in where they draw those limits. A political backlash against a certain concept of markets that has been exported to Latin America demonstrates that the drawing of those boundaries has significant consequences for social, political and economic stability.

Finally, the logic of this paper points to a model of co-operation between developing nations in Asia, on the one side, and international organisations and OECD member countries, on the other. On the one hand, now that global norms have been clearly articulated by UNCITRAL and the World Bank,[110] there is a pressing need for sophisticated models of how global norms can be consistently adapted to the variety of national circumstances. These variations can be systematised by scholars and technical assistance experts so that implementation of global needs is properly adapted to the singularity of national situations. On the other hand, the policy significance of bankruptcy reforms, as this paper has argued, leads inexorably to the conclusion that national policy makers require a political will to engage in massive institution building, a project for which they may require heavy technical assistance from international financial institutions and aid agencies of advanced economies.

Notes

1. OECD (2005), *Economic Survey–China*, OECD, Paris, p. 92.
2. Socio-legal scholars bring the methods and theory of social science together to examine the behaviour of law.
3. Ngok, King-Iun (2002), "Law-making and China's Market Transition: Legislative Activism at the Eighth National People's Congress" *Problems of Post-Communism,* pp. 49:23-32; Pistor, Katharina and Chenggang Xu (2002), "Incomplete Law–A Conceptual and Analytical Framework and its Application to the Evolution of Financial Market Regulation", working paper, Columbia University.
4. European Bank for Reconstruction and Development (1999), *Transition Report 1999: Ten Years of Transition*, EBRD, London; Ramasastry, Anita, Stefka Slavova and Lieve Vandenhoeck, "EBRD Legal Indicator Survey: Assessing Insolvency Laws After Ten Years of Transition." *Law in Transition,* pp. 34-43.
5. See the *UNCITRAL Legislative Guide on Insolvency* (hereafter *UNCITRAL Legislative Guide*), United Nations, New York; Block-Lieb, Susan and Terence C. Halliday (2006), "How Global Law-Making is Possible: Legitimation Strategies and Rule Production in the UNCITRAL Legislative Guide on Insolvency Law", Working Paper, American Bar Foundation.
6. Berkowitz, Daniel, Katharina Pistor and Jean-Francois Richard (2003), "Economic Development, Legality, and the Transplant Effect", *European Economic Review*, pp. 47:165-195.

7. The first and second studies were sponsored by the American Bar Foundation, an independent inter-disciplinary research institute in Chicago, and the National Science Foundation, the US government's funding agency for advanced scientific research.

8. Extrapolation from one national experience to another is fraught with difficulty. Although it cannot be discussed here in length, it must be said that such transfers of bankruptcy systems can be effective only when the conditions under which they succeeded or failed in a previous situation have been clearly identified. This is why proposals later in this paper begin by specifying conditions under which they might operate.

9. State Council (2005), "White Paper on Political Democracy", State Council Information Office, Beijing, 19 October 2005.

10. Hall, Peter A., and David Soskice eds. (2000), "An Introduction to Varieties of Capitalism", *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford University Press, New York; Hall, Peter A. and David Soskice eds. (2001), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*, Oxford University Press, New York.

11. The former would emphasise the distributive functions of a market and register particular concern for workers and equality; the latter might emphasise efficiency functions in markets and attend most closely to the views of investors and large credit institutions.

12. These are the values repeatedly affirmed by the global norm-making bodies on insolvency regimes, such as the IMF, World Bank and the UNCITRAL Legislative Guide, and regional banks, such as the Asian Development Bank.

13. Carruthers, Bruce G. and Sarah L. Babb (2000), *Economy/Society: Markets, Meanings and Social Structure,* Pine Forge Press, Thousand Oaks.

14. It is a myth that markets are truly "free," particularly in periods of rapid economic development. Compare US economic history, where government guidance of the economy proved critical for its development (Moss, David A. (2002), *When All Else Fails: Government as the Ultimate Risk Manager,* Harvard University Press, Cambridge), and contemporary efforts by international institutions to create an "international financial architecture" to regulate the global economy (Gilpin, Robert and Jean M. Gilpin (2000), *The Challenge of Global Capitalism: The World Economy in the 21st Century,* Princeton University Press, Princeton, New Jersey; Stiglitz, Joseph E. (2002), *Globalization and its Discontents,* Norton, New York).

15. Weber, M. (1978), *Economy and Society,* Berkeley, University of California Press; Carruthers, B.G. and T.C. Halliday (forthcoming), "Law, Economy and Globalization: How Modern International Financial Institutions Embraced Adam Smith and Accidentally Discovered Max Weber"; Swedberg, R. and V. Nee, *The Spirit of Global Capitalism,* Stanford University Press, Stanford; *UNCITRAL Legislative Guide;* World Bank (2003), *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, World Bank, Washington D.C.

16. Gessner, Volkmar, Richard P. Appelbaum and William L.F. Felstiner eds. (2001), "Introduction: The Legal Culture of Global Business Transactions", *Rules and Networks: The Legal Culture of Global Business Transactions*, Hart Publishing, Oxford, pp. 1-135.

17. Wade, Robert (1990), *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialisation,* Princeton University Press, Princeton.

18. Ngok, King-Iun (2002), "Law-making and China's Market Transition: Legislative Activism at the Eighth National People's Congress", *Problems of Post-Communism,* pp. 49:23-32.

19. Cai, Dingjian (1999), "Development of the Chinese Legal System Since 1979 and its Current Crisis and Transformation", *Cultural Dynamics,* pp. 11:135-166.

20. Paler, Laura (2005), "China's Legislation Law and the Making of a More Orderly and Representative Legislative System", *The China Quarterly*, pp. 301-318.

21. *Id.*

22. *Id.*

23. *UNCITRAL Legislative Guide*, p.14.

24. Westbrook, Jay Lawrence (2000), "A Global Solution to Multinational Default", *Michigan Law Review,* pp. 98:2276-2328.

25. There are several criteria by which this centre may be determined. See United Nations Commission on International Trade Law (UNCITRAL) (1999), *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment,* United Nations, New York.

26. *Id.*

27. Cai, Dingjian (1999b), *op.cit.*, note 19.

28. Carruthers, Bruce G. and Terence C. Halliday (1998), *Rescuing Business: The.Making of Corporate Bankruptcy Law in England and the United States,* Oxford University Press, New York.

29. *UNCITRAL Legislative Guide*, Recommendations 1 (a), (d) and (e), p.18.

30 Campbell, John L. (2004), *Institutional Change and Globalisation,* Princeton University Press, Princeton.

31 *UNCITRAL Legislative Guide 2005*; *World Bank Principles 2003*.

32 The UNCITRAL Legislative Guide (2005) notes that insolvency representatives, as it labels them, can be an individual, corporation or some other kind of legal entity (p. 174). The focus here is on individual practitioners although they may be organised in partnerships or firms.

33 *UNCITRAL Legislative Guide (2005),* pp.174-5.

34 Halliday, Terence C. and Bruce Carruthers (1996), "The Moral Regulation of Markets: Professions, Privatisation and the English Insolvency Act 1986", *Accounting, Organisations and Society, pp.* 21:371-413.

35 HMSO (1980), *Bankruptcy: Interim Report of the Insolvency Law Review Committee,* Command Paper 7968.

36 Schröeder-van Waes, Marie-Christine and Kevin Omar Sidharta (2004), "Upholding Indonesian Bankruptcy Legislation", *Business in Indonesia, New Challenges, Old Problems*, pp. 191-203.

37 *Ibid*, p. 201.

38 Suyudi, Aria (2004), "Does the Court Impose Different Treatment for Different Kinds of Creditors in Bankruptcy Petitions? A Jurimetric Analysis of Indonesian Commercial Court Decisions on Bankruptcy", Erasmas University, Rotterdam.

39 Halliday, Terence C. and Bruce Carruthers (2003), "Conformity, Contestation and Culture in the Globalisation of Insolvency Regimes: International Institutions and Law-Making In Indonesia and China, Working Paper 2214", American Bar Foundation, Chicago.

40 "Survey of Receivers: Final Report (2004)".

41 The UNCITRAL standard for appointment is as follows: Appointment (paragraphs 44-47).

> 118. The insolvency law should establish a mechanism for selection and appointment of an insolvency representative. Different approaches may be taken, including appointment by the court; by an independent appointing authority; on the basis of a recommendation by creditors or the creditor committee; by the debtor; or by operation of insolvency law, where the insolvency representative is a government or administrative agency or official.

42 Liu, Sida (2006), "Client Influence and the Contingency of Professionalism: The Work of Elite Corporate Lawyers in China", *Law & Society Review,* 40(4).

43. Halliday, Terence C. (2001), "Five Models for Regulating Market Professions: Comparative Notes on Lawyers, Accountants, and Insolvency Practitioners", *The Changing Role of Government Regulation in China's Market Economy*, State Council Office on Restructuring the Economic System, Kunming, Yunnan Province, China.

44. *UNCITRAL Legislative Guide*, Part I, Key Objectives.

45. *UNCITRAL Legislative Guide*, pp.180-183.

46. Carruthers and Halliday (1998), *Rescuing Business,* pp. 441-449.

47. *Ibid.*

48. Minister of Justice Decree No. M.09.HT. 05.0, dated 22 September 1998, regarding Guidelines for Receivers and Administrators Fees (*Pedoman Besarnya Imbalan Jasa Bagi Kurator dan Pengurus*).

49. "Survey of Receivers: Final Report (2004)".

50. For small firms it appears that this was a substantial remuneration; for large multi-national accounting firms it would be much less attractive.

51. Receivers Report, *op.cit.*

52. In Indonesia it was said that judges made USD 200 a month whereas receivers made USD 200 an hour. How then, asked the judges, could the receivers complain about their compensation levels?

53. *Cf.* the Colombian bankruptcy system which is almost entirely administrative. Australia delegates a substantial proportion of insolvency work to private actors, although the court system provides an institutional framework for negotiation, dispute resolution, and binding decisions.

54. Pistor, K. and P. Wellons (1998), *The Role of Law and Legal Institutions in Asian Economic Development, 1960-1995*, Oxford University Press, Oxford.

55. De Sousa Santos, B. (2000), "Law and Democracy: (Mis)trusting the Global Reform of Courts", *Globalising Institutions: Case Studies in Regulation and Innovation*, Aldershot, Ashgate, pp. 253-84.

56. *UNCITRAL Legislative Guide*, pp. 43-46.

57. For a more extensive account of the politics of the new bankruptcy court in the US, see Carruthers and Halliday (1998), *op.cit*.; and Halliday, Terence C. and Bruce G. Carruthers (1998), "Making the Courts Safe for the Powerful: The Politics of Lawyers, Judges, and Bankers in the 1978 Rehabilitation of United States Bankruptcy Courts", *Lawyers and the Rise of Western Political Liberalism: Legal Professions and the Constitution of Modern Politics,* Oxford University Press, Oxford, pp. 265-304.

58. Peerenboom, *cf.* Randall (2002), *China's Long March Toward Rule of Law*, Cambridge University Press, New York.

59. Supreme, People's Court (2005), "Five Year Reform Programme", Supreme People's Court, Beijing.

60. Former Senior Researcher, Research Office, Standing Committee, National People's Congress; Professor, China University of Politics and Law.

61. Cai, Dingjian (1999b), *op.cit*., note 19, p.154.

62. Nam and Oh, *op.cit*.

63. Halliday, Terence C. and Bruce Carruthers (2004a), "Epistemological Conflicts and Institutional Impediments: The Rocky Road to Corporate Bankruptcy Reforms In Korea", *Korean Law Reform*, Routledge Press. Also, Oh paper.

64. Oh, Soogeun (1999), "An Institutional Perspective on Financial Reform in Korea", *Korea Development Bank Report,* Seoul; (2002a), "Drafting of New Insolvency Law of Korea", FAIR Conference*,* Bangkok, Thailand; (2002b), "Government Intervention in Corporate Exit Mechanisms: The Corporate Restructuring Promotion Act of Korea", Hong Kong University Faculty of Law, Hong Kong; (2003b), "Insolvency Law Reform of Korea: A Continuing Learning Process", Forum on Insolvency Risk Management, Washington D.C.

65. Halliday and Carruthers (2006), "Foiling".

66. Tomasic, Roman (2001), "Some Challenges for Insolvency System Reform in Indonesia", *FAIR II, Insolvency Reform in Asia: An Assessment of the Recent Developments and Role of Judiciary;* Tomasic, Roman and Peter Little (eds.) (1998), *Insolvency Law and Practice in Asia,* Sweet & Maxwell Asia, Hong Kong.

67. Lev, Daniel S. and Ruth McVey (1996), *Making Indonesia,* Cornell SEAP, Ithaca; Lev, Daniel S. (2000), "Judicial Authority and the Quest for an Indonesian Rechtsstaat", *Legal Evolution and Political Authority in Indonesia: Selected Essays*, Kluwer Law International, The Hague/Boston, pp. 215-44.

68. Halliday and Carruthers, "Foiling"; "Conformity"; "Recursivity"; Suyudi, Aria (2004), "Does the Court Impose Different Treatment for Different Kinds of Creditors in Bankruptcy Petitions? A Jurimetric Analysis of Indonesian Commercial Court Decisions on Bankruptcy", Erasmas University, Rotterdam; Schröeder-van Waes, Marie-Christine and Kevin Omar Sidharta (2004), "Upholding Indonesian Bankruptcy Legislation", *Business in Indonesia, New Challenges, Old Problems,* pp. 191-203.

69. *Op.cit.,* Suyudi (2004).

70. Lev, Daniel S. (2004), "Comments on the Judicial Reform Programme in Indonesia", International Monetary Fund, Washington D.C.; World Bank, East Asia Poverty Reduction and Economic Management Unit (2003b) "Combating Corruption in Indonesia: Enhancing Accountability for Development", World Bank, Washington D.C.

71. *Id*., p.160.

72. *Id.*, p149.

73. The OECD report concurs that the judiciary lacks independence in various ways, including the funding and promotion of judges by local authorities, and that courts are subordinated to local people's congresses. It further observes that enforcement is weak, the time to resolve disputes extended, legal costs are high, and that government interference in business decisions is extensive, (OECD, 2005).

74. Yew, Lee Kuan (2000), *From Third World to First: The Singapore Story: 1965-2000,* HarperCollins, New York.

75. Garth, Bryant G. (2002), "Building Strong and Independent Judiciaries Through the New Law and Development: Behind the Paradox of Consensus Programmes and Perpetually Disappointing Results", *DePaul Law Review,* 52:383-400.

76. The OECD recommends a narrower specialised insolvency court, a proposal also made by the Asian Development Bank. Asian Development Bank (1996), "Final Report, State Enterprise Insolvency Reform, People's Republic of China", Asian Development Bank.

77. Following Cai Dingjian (p. 161), jurisdiction might be determined such that national courts have jurisdiction over cases that are inter-regional, relating to the national interests, and/or large and complex.

78. Halliday, Terence C. and Bruce Carruthers (2006), "The Recursivity of Law: Global Norm Making and National Lawmaking in the Globalisation of Bankruptcy Regimes, Working Paper", *American Journal of Sociology*.

79. On financial law, see Pistor and Xu, *op.cit.* On criminal procedure law in China, see Halliday, Terence and Sida Liu (2006), "Birth of a Liberal Moment? Looking Through a One-Way Mirror at Lawyers' Defense of Criminal Defendants in China", *The Legal Complex and Struggles for Political Liberalism*, Hart, Oxford.

80. Zhang, Qianfan (2003), "The People's Court in Transition: The Prospects of the Chinese Judicial Reform", *Journal of Contemporary China*, 12:69-101.

81. This a central presumption of all international organisations that are promulgating global insolvency norms, principles and standards. Compare UNCITRAL Legislative Guide, *op. cit*.; International Monetary Fund (1999), *Orderly and Effective Insolvency Procedures: Key Issues,* International Monetary Fund, Washington D.C.; and World Bank Principles. See also Carruthers, Bruce G. and Terence C. Halliday (forthcoming), "Law, Economy and Globalisation: How Modern International Financial Institutions Embraced Adam Smith and Accidentally Discovered Max Weber", *The Spirit of Global Capitalism,* Stanford University Press, Stanford.

82. The American Bankers Association threatened precisely this during Congressional Hearings that preceded the 1978 US Bankruptcy Code. See Carruthers, Bruce G. and

Terence C. Halliday (1998), *Rescuing Business: The Making of Corporate Bankruptcy Law in England and the United States,* Oxford University Press, Oxford.

83. Carruthers and Halliday (1998), *op.cit*.; Halliday, Terence C. and Bruce Carruthers (2003), "Conformity, Contestation and Culture in the Globalisation of Insolvency Regimes: International Institutions and Law-Making In Indonesia and China, Working Paper 2214", American Bar Foundation, Chicago; (2004a), "Epistemological Conflicts and Institutional Impediments: The Rocky Road to Corporate Bankruptcy Reforms In Korea", *Korean Law Reform,* Routledge Press.

84. Corporations and the non-financial business sector were scarcely consulted in the Indonesian bankruptcy reforms after 1997. As a result, corporate owners led a determined effort to resist, manipulate and even subvert both the courts and out-of-court organisations, such as the Jakarta Initiative Task Force. Halliday, Terence C. and Bruce Carruthers (in press), "Foiling the Hegemons: Limits to the Globalisation of Corporate Insolvency Regimes in Indonesia, Korea and China", *Law and Globalization in Asia: From the Asian Financial Crisis to September 11*, Hart Publishing.

85. *Cf*. also the joint World Bank/UNCITRAL Legislative Guidelines, D 5.3, p.50.

86. Campbell (2000), *op.cit*.

87. Domestic politicians often have an incentive to blame difficult policy decisions on foreign influences.

88. *UNCITRAL Model Law on Cross-Border Insolvency*; Oh (2002), *op.cit*.

89. Oh (2003), *op.cit.*; Halliday, Terence C. and Bruce Carruthers (2004), "Institutional Lessons from Insolvency Reforms in East Asia", *Forum on Asian Insolvency Law Reform (FAIR), Insolvency and Risk Management in Asia*.

90. Hurd, Ian, (forthcoming), *Legitimacy and Power in International Relations: The Theory and Practice of the UN Security Council*, Princeton University Press, Princeton; Hurd (2005), "Deliberation, Procedures, and Effectiveness: A Model of Legitimation in International Organisations Working Paper", Northwestern University, Evanston.

91. These included a large number of amendments to the Bankruptcy Law, the establishment of the Commercial Court, the creation of the Jakarta Initiative Task Force to handle out-of-court restructurings, and the creation of the receiver's profession.

92. Oh (2003), *op.cit*.; Oh (2002), *op.cit*.

93. World Bank (2001), *Bankruptcy of State Enterprises in China–A Case and Agenda for Reforming the Insolvency System,* World Bank, Washington D.C.; OECD (2005), Economic Survey–China (2005), *op.cit*.

94. Halliday and Carruthers (2003), *op.cit*.

95. World Bank (2001), *op. cit*.

96. Lev, Daniel S. (2004), "Comments on the Judicial Reform Programme in Indonesia", *International Monetary Fund,* Washington D.C.

97. Campbell (2004), *op. cit.* Compare the role of Kenneth Cork in the English reforms (Halliday and Carruthers, *Rescuing Business*) and of Cao Siyuan in the 1986 Interim Bankruptcy Law in China (Cao Siyuan (1998), "The Storm Over Bankruptcy (I)", *Chinese Law and Government*: 3-93).

98. See Pistor, Katharina and Philip A. Wellons (1999), *The Role of Law and Legal Institutions in Asian Economic Development: 1960-1995,* Oxford University Press, New York.

99. The IMF reports that JITF had finalised the mediation of debt restructuring in the amount of USD 20.6 billion, or around one-third of the total corporate loans that had become nonperforming as a result of the crisis (International Monetary Fund (2004), "Indonesia: IMF Country Report No. 04/188", International Monetary Fund, Washington, D.C.).

100. Nam and Oh, *op.cit*.

101. In the decade from 1994-2004, China closed 3 484 SOEs, involving 6.67 million employees. Through 2008 another 2 167 SOEs are slated to be shut down, throwing 3.66 million employees out of work. Naughton, Barry (2001), "SASAC Rising", *China Leadership Monitor 14,* pp. 7-8. *Cf.* World Bank (2001).

102. *Id.*

103. Halliday, Terence C. and Bruce Carruthers (2004), "Institutional Lessons from Insolvency Reforms in East Asia", *Forum on Asian Insolvency Law Reform (FAIR), Insolvency and Risk Management in Asia.*

104. A common practice in China has been for the SOE to compensate a laid-off worker at 2-3 times the worker's salary. See World Bank (2001), *op.cit*.

105. On the current status of the social safety net in China, see the OECD's Economic Survey of China (2005), pp. 188-191.

106. Tang, Wenfang and William Parish (2000), *Chinese Urban Life Under Reform: The Changing Social Contract,* Cambridge University Press, New York.

107. Stiglitz, Joseph E. (2002), *Globalisation and its Discontents,* Norton, New York.

108. On developments in China's social insurance system see the OECD's Economic Survey of China (2005), pp. 188-191. The overall coverage of workers and pensioners is very low for private firms and SOEs.

109 . Berkowitz, Daniel, Katharina Pistor and Jean-Francois Richard (2003), "Economic Development, Legality, and the Transplant Effect", *European Economic Review,* 47:165-195.

110. These norms are by no means complete. UNCITRAL is presently considering the missing topic of corporate groups in insolvency, which is of great relevance to Asia. So, too, is there a need to relate insolvency norms to concepts of corporate governance that are appropriate for Asia.

COMPARATIVE OVERVIEW OF ASIAN INSOLVENCY REFORMS IN THE LAST DECADE

by
Soogeun Oh*

1) Introduction

History has shown that insolvency laws were developed amid economic turmoil because the magnitude of the insolvent debtors' unpaid debts acted as the pressure on the development of the insolvency law. Economic crisis let people realise that insolvency law is necessary in addition to normal creditor-debtor relationship laws. The US insolvency law evolved while being enacted, repealed and re-enacted four times during the economic downfalls of the 1800's.[1] Many economies in transition in Central and Eastern Europe must have developed insolvency laws in the 1980's as they first had insolvent firms which were not seen in the planned economy.[2] Latin American countries also reformed their insolvency laws when economies were in such bad shape that sovereign states were on the edge of bankruptcy in the early 1990's.

East Asian countries are not exempt from a similar history. When the Asian financial crisis hit the region in the late 1990's, the existing insolvency systems were blamed for standing in the way of eliminating unpromising and insolvent firms from the market and not efficiently restructuring promising but insolvent firms. Therefore, insolvency reforms followed in the aftermath of the economic crisis.[3] Efforts were exerted to improve insolvency law and practice by updating out-of-date insolvency laws, introducing reorganisation proceedings, creating insolvency courts and promoting out-of-court workout. Insolvency reforms were a trend even in countries out of the direct reach of the economic crisis.[4] Most countries in the region revised their existing insolvency laws or enacted new legislation. Insolvency reforms focused on corporate reorganisation, which was labelled a "restructuring revolution" by Lampros Vassilleu.[5]

East Asian countries have carried out insolvency reforms with different styles and paces during the last decade because every country has a different economic and judicial background. Moreover, economic development and judicial stability in the region varied widely. East Asia contains not only some of the richest countries in the world but also some of the poorest. Rule of law is a fundamental principle in some countries, but it is still shaky in other countries. Some countries have over one hundred years of history in insolvency law and practice, but other countries have not heard of it till recently. In this regard, it is not easy, if not impossible, to draw common features from insolvency law reforms in East Asian countries.

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Such differences, however, provide an opportunity to compare: insolvency law and practice as one of the competing schemes regarding the creditor debtor relationship; why judicial insolvency proceedings are frequently used in some jurisdictions and not in others; what makes insolvency reforms successful; and which policy measures should be prioritised to build an efficient and effective insolvency system.

Through legislative reforms, states have desired to effect the following changes: increased creditor confidence in implementation of their claims; increased entrepreneurship and fresh starts; decreased insolvency cases; and easier out-of-court debt rescheduling. Improvements can be noted in some areas, but not in others. It is time to evaluate those insolvency reforms, identify what was achieved (and what was not), and draw lessons for future tasks.

This paper analyses insolvency reform in East Asian countries over the past decade and finds factors for success and failure in light of the above-mentioned goals. Chapter II tracks insolvency law reforms in East Asian countries in order to figure out the features of reforms in each country. Chapter III deals with the analytical framework of debt settlement mechanisms as a basis for the analysis of insolvency law reforms. The structure of debt settlement mechanisms and incentive structures are also explained. Chapter IV evaluates each insolvency reform and finds causes of success and failure. Chapter V concludes with suggestions of future tasks for enhancing the efficiency and effectiveness of insolvency mechanisms.

Five East Asian countries are selected as the main targets of analysis: China, Indonesia, Japan, Korea, and Thailand. Indonesia, Korea and Thailand were countries severely hit by the Asian financial crisis in 1997 and 1998. Japan is the most industrialised country in the region and China is one of the transition economies. The soundness and effectiveness of the judicial system is different from one country to another. Japan and Korea have a relatively reliable judicial system, but others are in doubt. All of them have statutes on insolvency, but they have different levels of experience in insolvency practice. The insolvency reforms of other countries beyond these five will be mentioned as necessary.

In reality, several factors affect the performance of insolvency law. Rational (or profit-oriented) creditors, a transparent accounting regime, well-developed financial markets, and judges with high moral standards are all necessary for the best outcome of insolvency proceedings. These factors should be dealt with when evaluating insolvency reforms in order to grasp the "big picture". However, these are not the subject of discussion here. This paper, rather, focuses on the contents of legal reforms because it has been found that some factors play a critical role in the overall mechanism of the creditor-debtor relationship.

Information on the insolvency laws of each country was mainly collected from published literature.[6] Facts on insolvency law and practice come from OECD[7] and Asian Development Bank reports[8] and other collections of country reports.[9] Evaluation of the current systems of each country follows findings of the OECD Report (2001),[10] the SERI Report (2003)[11] and the World Bank Report (2005).[12] Unclear facts or issues were identified and cleared in close consultation with local experts.

2) Major insolvency reforms in East Asian countries

a) China

The insolvency law of China does not have a unified insolvency statute. Instead, different laws and rules supplement each other. Applicable laws in insolvency cases are divided into two categories depending on the ownership structure of the target firms: state-owned enterprises (SOEs) or non-SOEs. SOE insolvency cases are governed by the 1986 Law of the People's Republic of China on Enterprise Insolvency–Interim Implementation (SOE Insolvency Law). The SOE Insolvency Law is supplemented by two important judicial interpretations. The 1991 Opinions on Several Issues Regarding the Enterprise Insolvency Law, issued by the Supreme Court of China, provides detailed rules on SOE insolvency. The 2002 Opinions of the Supreme People's Court Concerning Certain Issues in the Trial of Enterprise Insolvency Proceedings (2002 Opinions) applies to both SOE and non-SOE insolvency proceedings. In spite of these supplements, the SOE Insolvency Law is still outdated and unclear in many respects including the scope of application.

One important feature in SOE insolvency proceedings is the Capital Structure Optimisation Programme (CSOP). The CSOP applies to SOEs located in 111 Chinese major cities and puts SOE insolvency cases into the central planning process supervised by the National Development and Reform Commission. The CSOP also gives top priority to employee resettlement payment. The CSOP makes SOE insolvency proceedings more politically oriented.

Chapter 19 of the 1991 Civil Procedure Law, which has only eight brief articles, mainly governs non-SOE insolvency. Non-SOEs include enterprises that are not owned by the state, for instance, foreign invested companies, privately owned companies and collective enterprises. In addition to the 2002 Opinions, the 1992 Opinions on Several Issues Regarding the Civil Procedure Law provide supplementary rules.

There are other laws that apply to insolvency cases. Chapter 8 of the Company Law applies to liquidation cases of companies established under the Company Law. The 1996 Foreign Investment Enterprises Liquidation Procedures, promulgated by a foreign investment regulator, authorise the Ministry of Commerce to control non-insolvency liquidation of foreign invested companies. Specialised laws and regulations apply to privately owned companies and collective enterprises. In addition, the 2002 opinions govern the insolvency of financial institutions. Several municipal governments have also promulgated local rules applicable to insolvency cases handled in the provinces. However, no Chinese law provides for insolvency of a natural person, sole proprietorships or partnerships without legal person status.

The Chinese government has been preparing a draft bill for the new insolvency law since 1994. In 2004, the draft bill of the unified insolvency law was submitted to the 10th session of the Standing Committee of the Nation People's Congress (the national legislature). After heated debate, especially about the priority to be accorded to insolvency claims by employees, the draft bill was passed on 27 August 2006. It will be effective from 1 June 2007.

The new bankruptcy law, the Enterprise Bankruptcy Law, which replaces the 1986 SOE Insolvency Law, applies to bankruptcy cases of enterprises regardless of the legal nature of the enterprise: state-owned enterprises; privately owned enterprises; or foreign investment enterprises. A debtor or a creditor can apply for a reorganisation proceeding.

It recognises the priority of secured claims over labour claims and tax claims, as well as general unsecured claims. Payment of claims is made according to the following order: secured claims; bankruptcy expenses and joint interest debts; unpaid employees' salaries and basic social insurance premiums; outstanding taxes; and ordinary unsecured credits. But, employees with claims on salaries and social insurance premiums, and agencies with claims on outstanding taxes form a separate voting class respectively in providing consent to a reorganisation plan. The new insolvency law adopts cram down. The UNCITRAL Model Law on Cross-Border Insolvency was not adopted. Instead, the new law provides that the validity of any bankruptcy proceeding commenced in accordance with this law shall extend to the properties of the debtor outside of China. But inbound cases can be recognised when: there are relevant treaties or reciprocal relations; the bankruptcy proceeding outside China does not violate state sovereignty, national security and social public interests; and the bankruptcy proceeding outside China does not harm the lawful rights and interests of creditors in China.

Insolvency proceedings in China have not earned credibility in general from observers due to their lack of transparency and equal treatment. Political and social concerns have come before economic and legal considerations in many cases. The Chinese government has tried to establish reorganisation proceeding that could save ailing SOEs, but foreign creditors have been more interested in compulsory execution systems which could ensure their security rights. It has been observed that the "rule of man" rather than " rule of law" prevails in the area of bankruptcy as well.[13]

b) Indonesia

Though Indonesia has had its Bankruptcy Ordinance since 1906, (inherited from Netherlands Indies legislation), the ordinance was seldom used and not amended until 1998 when Indonesia enacted a new insolvency law under IMF conditionality in the form of an emergency regulation. The new law has two tracks of insolvency proceedings: liquidation in bankruptcy and voluntary debt compromise. For the first time, it introduced private sector involvement (a private bankruptcy receiver and a private voluntary debt compromise administrator), and publication of insolvency law opinion. Though the 1998 Bankruptcy Law got the spotlight in the middle of the economic crisis, it was perceived more as a prod to debtor-creditor negotiations outside of court rather than a channel to bankruptcy proceedings through judicial institutions.[14] The Indonesian government also established the Jakarta Initiative Task Force, the Financial Sector Policy Committee and the Oversight Committee to facilitate out-of-court corporate restructuring. There was a minor revision of the Bankruptcy Law in 2004.

Commercial courts have been set up to cope exclusively with insolvency cases by the 1998 Bankruptcy Law. But the number of cases handled by the Commercial Court during the first years of its operation (September 1998 to December 2003) shows the weakness of judicial insolvency proceedings. Judges in the commercial courts have not been trained enough to handle business matters sophisticatedly and, after some training, they are transferred to other positions. It is reported that the number of cases filed in the Commercial Court has been decreasing.

Table 1. Insolvency cases in Indonesia

Cases Filed	353	100%
Cases Granted	114	32%
Cases Declined or Refused	205	58%
Cases Settled	24	7%
Cases Turned into Voluntary Debt Compromise	10	3%

The poor performance of the new insolvency law was not unexpected. Judicial practices have hindered the progress of insolvency practice under the new law. Indonesian courts have been criticised for limited *stare decisis*, poor information sharing of court decisions and other precedents, corruption, and interference from various sectors including the administration. If this continues, it is highly unlikely that the new insolvency law will be respected as it should be.

Regarding the debtor-creditor relationship, the most serious problem is that compulsory execution is not implemented properly. Debtors are not afraid of being put into compulsory execution because they believe that court procedures can be delayed if wanted. Creditors are also aware of this fact and are reluctant to apply for compulsory execution. Difficulties are not only in the opening of the process. It is also very hard to detect property eligible for compulsory execution. The compulsory execution procedure is slow and costly. Moreover, its outcomes are often unpredictable. For these reasons, a voluntary negotiation is preferred over law enforcement to secure creditor's interests, even though the recovery rate through voluntary negotiation is lower than the security's face value.

c) Japan

Since 1996, Japan has pushed for comprehensive insolvency law reform. When insolvency reforms started, there were five insolvency related laws: the Bankruptcy Act; the Composition Act; the Corporate Reorganisation Act; the company arrangement procedure under the Commercial Code; and the special liquidation procedure under the Commercial Code. The Composition Act was repealed in 2000 as the Civil Rehabilitation Act was enacted in 1999. The Bankruptcy Act and the Corporate Reorganisation Act were amended in 2003 and 2004 respectively,[15] and a special act on cross-border insolvency was enacted in 2000.

The Japanese insolvency procedures seemed to be complicated: two liquidation types (bankruptcy and special liquidation procedures) and four reorganisation procedures (civil rehabilitation, corporate reorganisation, company arrangement, and compulsory composition under the Bankruptcy Act). The unification of insolvency laws was discussed but not carried out because the government wanted to have legislation on the rehabilitation of small and medium-sized enterprises first. Insolvency law reforms were based on comprehensive study and preparation by scholars and practicing lawyers. The revision of the insolvency laws went through public discussions and hearings before it went to the floor of the national legislature which passed the bill unanimously without partisan issue.

Even though insolvency laws are not unified and there is no specialised insolvency court either, nobody considers the insolvency procedures of Japan unreliable or ineffective. The number of insolvency cases has increased during the reform period as shown in Table 2. Insolvency reforms in Japan, instead of changing the structure of

overall insolvency procedures, have focused on supplementing and strengthening weaknesses identified in insolvency practices.

Another important fact, which should be viewed as a part of insolvency reforms along with legislative reform, is that judges have adopted a flexible approach in admitting and proceeding cases. The Japanese courts, for example, have opened the door to new civil rehabilitation proceeding by interpreting the meaning of "evident proof of rehabilitation", which is a requirement for the commencement of the proceeding, much more flexibly than before. This generous construction has resulted in a rapid increase in applications for the proceeding. New legislation and judges' positive attitudes seem to be a timely response to the needs of society and pave the way for a better and more efficient judicial framework for insolvency cases.

Table 2. Insolvency cases in Japan

	1998	1999	2000	2001	2002	2003	2004
Corporate Reorganisation	88	37	25	47	88	63	45
Composition	361	231	42	n/a	n/a	n/a	n/a
Bankruptcy (Business Firms)	5 595	4 573	6 268	8 070	9 471	8 951	220 201
Bankruptcy (Consumer)	105 468	123 915	139 590	160 741	214 996	242 849	
Civil Rehabilitation	n/a	n/a	662	1 110	1 093	941	712
Individual Rehabilitation	n/a	n/a	n/a	1 732	6 054	15 001	19 552
Wage Earner Rehabilitation	n/a	n/a	n/a	4 478	7 444	8 611	6 794

d) Korea

Korea enacted three insolvency laws in 1962: the Bankruptcy Act; the Composition Act; and the Corporate Reorganisation Act. They were modelled after the corresponding Japanese acts, but were not frequently used until the economic crisis of the late 1990's. Amendments to insolvency laws were introduced first in 1981 in response to criticism of forum shopping. Though the judges and the courts had been highly respected among the public sector, their management of insolvency cases came under fire by the public. The Supreme Court of Korea issued the Regulation on Case Management of Corporate Reorganisation in 1992 and 1996 in order to make the commencement criteria clear and to prevent malpractice of receivers and major shareholders.

Legislative reforms were accelerated by the economic crisis. Insolvency laws were amended in 1998, 1999 and 2001 to enhance transparency and expedite insolvency proceedings. The Corporate Restructuring Promotion Act was introduced in 2001 to provide a statutory basis to structured workouts. The Individual Debtor Rehabilitation Act was enacted in 2004 for consumer bankruptcy. Following and keeping pace with these legislative works, a unified insolvency law had been prepared since 1999 and was finally enacted in 2005. As the unified insolvency act came into effect on 1 April 2006, four then existing insolvency laws were repealed. The Corporate Restructuring Promotion Act was repealed at the end of 2005.

The new insolvency law provides for a rehabilitation procedure, a liquidation procedure, a consumer rehabilitation procedure, and cross-border insolvency. Though automatic stay was not adopted, protection of the insolvency estate is enforced by a newly

introduced comprehensive injunction order. To ensure the finality of payment and settlement systems, the application of the insolvency law is waived in currency, securities and financial transactions. The rehabilitation proceeding, which applies to any type of legal entity, allows the continued control of incumbent management as a default rule to induce early application.

The establishment of a specialised insolvency court had been considered since the 1998 amendments, but it was not put into effect for two reasons: specialisation issues and case loads. Specialisation in insolvency law cannot be achieved through a specialised court because judges, under the current system of judge rotation, work for the court for only two or three years. When the insolvency court was considered, the number of insolvency cases was not big enough to maintain a separate court.[16] Instead of a specialised insolvency court, an insolvency division was established in the district courts with elite judges. The insolvency division of the Seoul Central District Court, in particular, has set guidelines for case management and has created precedents. It also published practice guides so that the general level of insolvency practice could be enhanced in a relatively short period of time.

Changes in the attitudes of judges have had an enormous impact on insolvency practices. Many reorganisation cases were pending for over 10 years before insolvency law reforms. Through the economic crisis in the late 1990's and insolvency reforms, judges have come to share the idea that early termination of reorganisation cases through mergers and acquisitions (M&A) is the best way to maximise the value of debtor firms. M&A is the only solution that provides new money and new governance structures that can reduce agency costs incurred by the management of the receiver and the supervision of the court. Currently, the average period for pending cases at the court is less than three years.

Another example that affected practices was discharge. Judges were very reluctant to render the discharge to the bankrupt for several reasons: discharge might cause moral hazard among debtors; discharge might contradict payment orders; and most of the debtors might be personally responsible for over-indebtedness. It took more than 30 years for the Korean court to render a decision to discharge a debtor for the first time after the introduction of discharge. Currently, the discharge ratio to bankruptcy decision goes up to 95%. That explains the drastic increase in personal bankruptcy cases.

Table 3. Insolvency cases in Korea

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Reorganisation	79	52	132	148	37	32	31	28	38	35
Composition	13	9	322	728	140	78	51	29	48	81
Bankruptcy (Firm)	12	18	38	117	230	132	170	108	303	162
Bankruptcy (Individual)	*	*	*	350	503	329	672	1 335	3 856	12 317

Note: The number of bankruptcy cases was not divided into firm and individual until 2000.

e) Thailand

Thailand has had a unified insolvency law since 1940. The 1940 Bankruptcy Act has been amended several times since its enactment, but the 1998 amendments changed the entire shape of the insolvency law. The 1998 amendments introduced a corporate reorganisation proceeding, and the 1999 amendments added issues dealing with corporate reorganisation proceedings. The 2000 amendments changed the status of the official receiver from an officer of the court to a private entity. The 2004 amendments provide for an automatic discharge against individual debtors after three years from bankruptcy adjudication.

The Bankruptcy Court (specialised in bankruptcy cases with exclusive jurisdiction), was created in 1999 pursuant to the Court Act. Specialisation in bankruptcy does not, however, seem to be as successful as expected because judges work for the Bankruptcy Court for only two to three years under the rotation system of the judiciary. Along with insolvency reforms, the amendments to the Civil Procedure Code were incorporated in 1999 to improve the issuance of execution orders (including their delivery procedures) and to restrict abusive or inappropriate applications.

The number of liquidation proceedings has steadily increased since the 1998 amendments. It seems that the court and insolvency proceeding are increasingly gaining confidence.

Table 4. Insolvency cases in Thailand

		1997	1998	1999	2000	2001	2002	2003	2004
Liquidation	Individual	1 321	1 660	1 118	835	968	1 591	2 209	4 778
	Legal Person			549	604	746	922	657	965
Reorganisation		n/a	n/a	n/a	9	79	61	52	50

Insolvency law and practice in Thailand can be viewed as evolving steadily.[17] The Thai government has tried to improve judicial procedures. The bankruptcy court handled mainly small and medium-sized firms with financial difficulties well enough to restructure about 30% of total non-performing loans of financial institutions. But the transparency of insolvency proceedings and the credibility of the court decisions have deteriorated as a result of recent cases. In the case of Thai Petrochemical Industry, the court rejected the plan decided by the creditors' meeting and virtually ordered the creditors' meeting to nominate a person appointed by the government. In the Natural Park case, the court approved a plan under which creditors were to be repaid less than what they could get. It has been reported that doubtful claims appeared, were approved at the last moment, and changed the formation of creditors in some cases. Political connections seem to influence court decisions. These are, of course, not purely insolvency matters but general judicial problems. It is another example of how the efficiency of insolvency proceeding cannot go beyond the general level of judicial practice.

3) Analytical framework

a) Value maximisation

Non-insolvency laws, including civil law, civil procedure law and civil enforcement law, generally govern the creditor-debtor relationship. In most jurisdictions, a creditor has the right to enforce claims against the debtor's property when debts are not repaid eventually. If the right of a creditor to enforce claims against the debtor's properties can be exercised properly, a creditor can minimise concerns and other transaction costs because they can collect claims through compulsory execution procedures. A debtor might do their best to repay in order not to have their properties taken away. Moreover, a creditor and a debtor may reschedule debts when due debts are not repaid in the assumption of compulsory execution. Therefore, it is in the interest of the creditor and the debtor that the compulsory execution system work properly.

This compulsory execution system, however, has the weakness that every procedure is carried out on an individual basis. Creditors are forced to compete with each other upon a debtor's default on a first-come, first-served basis. Individual enforcement usually results in a piecemeal sale of debtor's properties, so the realised value of the debtor's business is normally less than its total value as a whole, and the debtor's business is no longer afloat. Bankruptcy proceedings were introduced as a collective collection procedures that replace an individual collection proceeding, and aim at equal treatment of similarly situated creditors. The sale of a business as a whole is also possible under the bankruptcy procedure. The value of a debtor's property increases in a formal bankruptcy proceeding.

As a bankruptcy proceeding is basically a liquidation procedure, it is not appropriate for a debtor whose business is still viable. When the majority of creditors estimate the going concern value to be greater than the liquidation value, they need a legal mechanism that binds dissenting creditors and maximises the value of the debtor's business. This is a rehabilitation proceeding, which is sometimes called a reorganisation or restructuring proceeding.

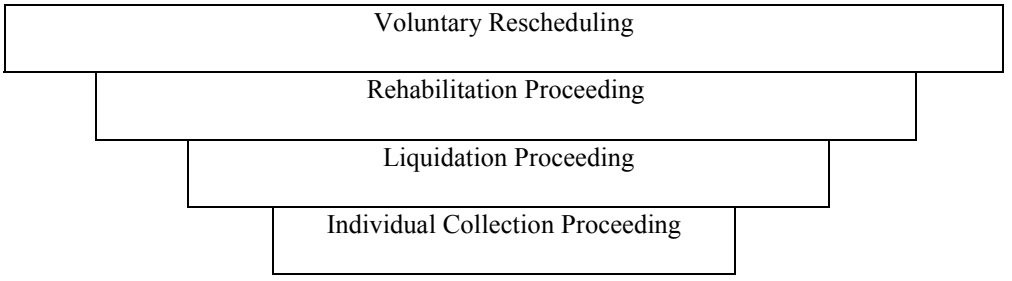
If debtors and creditors are rational, they will assess the credit risks that a debtor will bear in the future and will set the terms and conditions of credits. If their estimation turns out to be wrong for any reason, they will reassess future credit risks and reschedule outstanding debts. This private rescheduling is not unusual among creditors and debtors who trust each other, but it is not an easy mechanism to apply in a normal situation for two reasons. The first is information asymmetry. Creditors are not usually well-informed of the debtor's financial situation. Creditors must incur expenses in order to collect adequate and timely information regarding a debtor, which creditors are not willing to do. The second is the negotiation expense. To reschedule debts, a debtor and creditor negotiate with each other bilaterally and multilaterally. There is usually a party who tries to hold out or take a "free ride". Successful negotiation should overcome these obstacles. However, these transaction costs are not easy for a debtor or creditor to meet in a normal debtor-creditor relationship. Insolvency proceedings, whether liquidation or rehabilitation, can save such expenses by providing the information on a debtor to interested parties, and calling for negotiation if necessary.

Though a liquidation proceeding and a rehabilitation proceeding have different sets of rules on debt collection, both are value maximisation proceedings based on compulsory execution. A liquidation proceeding is justified when the total amount of money distributed through the proceeding is larger than that distributed through all individual

compulsory execution procedures. This logic applies to a rehabilitation proceeding as well. A rehabilitation proceeding can be justified only when the total amount of money distributed in a rehabilitation proceeding is larger than that in case of liquidation. As such, the total value of the debtor's property should increase and each interested party should receive greater benefits. Rehabilitation is justified when it assures liquidation value or the best interests of creditors principle.

The insolvency proceeding was designed and adopted in order to maximise benefits to interested parties by maximising the value of debtors' properties. For value maximisation, a reorganisation law adopts special rules including prohibition of execution of claims, avoidance, assumption or rejection of executory contract, and change of claims. If a debtor and creditors benefit more from a voluntarily rescheduling than a reorganisation proceeding, they will choose private rescheduling. Therefore, from the viewpoint of total benefit, these mechanisms form a hierarchy with a compulsory execution proceeding at the bottom and voluntary rescheduling at the top as in Figure 1.

Figure 1. Hierarchy of total benefit



b) Choices and competition

Judicial insolvency proceedings are not the only mechanisms that creditors or debtors can choose. Sales of business or M&A can be a means of debt settlement for a financially ailing firm. A debtor may choose to halt the business and voluntarily liquidate a failing firm. Faced with insolvency, the debtor or creditor may choose the mechanism that is most favourable to them. In some jurisdictions, however, a debtor could ignore the exercise of claims by creditors or judicial proceeding, and a creditor might resort to illegal collection activities. Governmental rescue programmes are also a mechanism for rearranging unpaid debts. Figure 2 shows such options.

Figure 2. Debt settlement mechanisms

Major Players of Proceeding	**Business**	
	Dissolved	**Maintained**
Debtor	Voluntary Liquidation	Ignoring Claims
Creditor	Compulsory Execution	Structured Workout M&A Rescheduling
Court	Bankruptcy	Rehabilitation
Government		Government Rescue Programme

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These mechanisms are not value neutral. They can be classified into four categories in the light of social costs and benefits. Different colours can be applied according to the social desirability of debt settlement mechanisms. The category of "red choices" is illegal activities, which do not comply with laws on debt collection. The category of "yellow choices" is government rescue programmes including rescue loans, tax incentives and administrative supports. The category of "blue choices' is legal mechanisms including insolvency and non-insolvency proceedings, which involve voluntary liquidation, compulsory execution, bankruptcy, and rehabilitation proceeding. The category of "green choices" is legitimate and voluntary transactions among a debtor and creditors, which include structured workouts, M&A, sales of business and individual rescheduling. These four categories can be called choices because they are, after all, choices that are made by or among interested parties.

The red choices must obviously be eliminated but, unfortunately, they are not unusual in some jurisdictions. Yellow choices pose some difficult issues. The government might take measures to save a failing firm or an industry that is important in the economy when there is the potential in the system or when the government's industrial policy is closely linked to the failure of the debtor's firm. "Too big to fail" is a frequently used slogan. Government intervention in debt settlement, however, used to result in a distortion in the distribution of resources in competitive markets; unpromising firms stayed in the market, and creditors and debtors were more interested in currying political favour than assessing and managing risks. So, yellow choices are less desirable than blue choices, which are subject to market principles in most cases.

Blue choices are part of the judicial system. It is noteworthy that the social usefulness of each scheme differs as shown in Figure 3. Green choices are most cost effective and maximise benefits. Since blue choices and green choices produce larger societal benefits, insolvency policies should encourage interested parties to choose blue or green instead of red or yellow.

Figure 3. Choice structure of debt settlement mechanisms

Green Choices	Individual Rescheduling
	Voluntary Winding-up
	M&A, Sales of Business
	Structured Workout
Blue Choices	Rehabilitation Proceeding
	Liquidation Proceeding
	Compulsory Execution
Yellow Choice	Governmental Rescue Programme
Red Choices	Doing Nothing
	Ignoring Creditors' Claims
	Avoiding Compulsory Execution

It is worth mentioning that individual rescheduling between a debtor and a creditor can occur as a result of a red choice when the normal collection process does not work properly. A creditor is actually forced to negotiate with a debtor to collect less proceeds than through a judicial collection process. Evidently, this kind of individual rescheduling is not one of the green choices.

The fact that parties can choose one among various choices means that these mechanisms are competing with each other. Liquidation or rehabilitation proceedings are also one of them and can be used only if they have greater merits than the other mechanisms. For example, if a governmental rescue programme is available, debtors and/or creditors tend to be dependent on it. Moreover, ignoring creditors' claims is an attractive option to a debtor if it is possible. Only when illegal activities are banned and a governmental rescue programme is not available, can debtors and creditors consider blue or green choices.

Only if compulsory execution proceeds expediently, and debtor's properties are realised and properly reflect the market value of debtor properties at public auction, can debtors and creditors establish a legal relationship based on the assumption that they can rely on compulsory execution in case of default. If a more favourable mechanism, for example reorganisation, is available, they will use that instead of compulsory execution. Liquidation, rehabilitation and voluntary restructuring proceedings are legitimate alternatives. Compulsory execution is a basis of other debt settlement mechanisms.

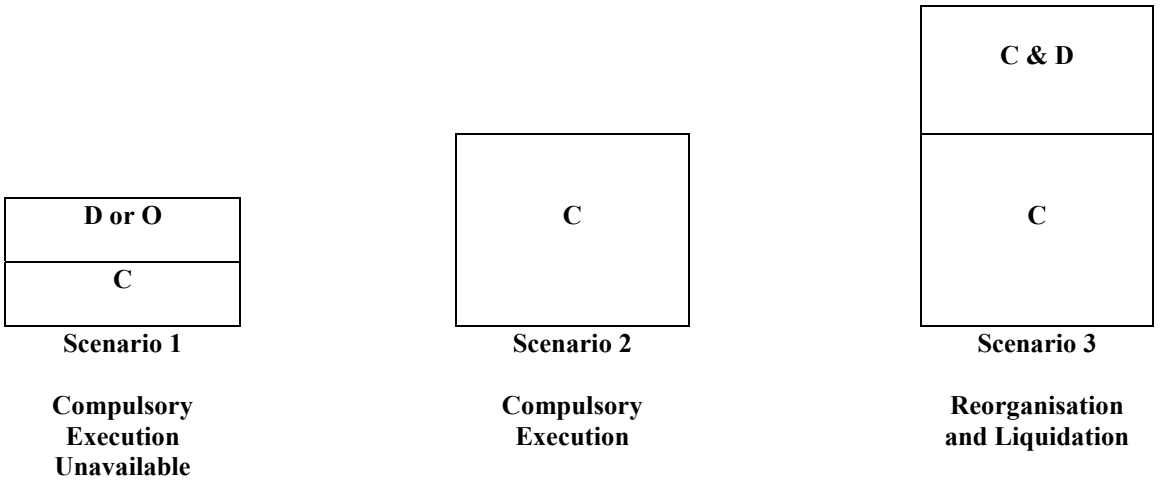
The core of compulsory execution is the public sale of debtor properties. This is the same in other debts settlement mechanisms. Liquidation is a collective public sales proceeding of debtor's properties. Rehabilitation is a more complex sales procedure. There are three possible buyers in a reorganisation proceeding: a debtor, creditors and new investors. When new investors invest money and obtain shares, they actually buy the debtor's properties for their investment. When creditors swap their claims for equity, they also buy the debtor's properties. When claims are changed (or impaired), debtor's properties are sold to a debtor for nothing. An actual reorganisation plan uses all or some of these methods. A debtor and creditors agree with a reorganisation plan because they can derive more benefit through the reorganisation proceeding than the liquidation proceeding. A debtor and creditors can employ such sales schemes used in a reorganisation proceeding in voluntary negotiations for debt rescheduling.

The benefits to both debtors and creditors come from and are the same as the total value of the debtor's property (the insolvency estate in an insolvency proceeding). The value of a debtor's property is divided among the debtor and the creditors. Each box in Figure 4 below stands for the value of the debtor's property in different scenarios. Scenario 2 in Figure 4 represents the case when compulsory execution or liquidation is implemented properly. The total value of the debtor's property goes to creditors if the value of the debtors' property is less than total amount of debts, in which case the debtor's benefit level is nil. In Scenario 3, where a reorganisation proceeding applies, the total value of a debtor's property increases and the increase (the so-called going concern surplus) is divided among creditors and the debtor pursuant to a reorganisation plan. The benefit to creditors and the debtor can be higher than in Scenario 2. This is the reason for reorganisation proceedings.

However, in Scenario 1, where normal compulsory execution is not available, creditors are forced to negotiate with a debtor at a lower level than in Scenario 2, or resort to other private collection schemes, thus incurring greater expenses than in Scenario 2. In this case the total amount of payment to the creditors decreases and the remaining portion

goes to a debtor or a third party. Figure 4 illustrates the importance of compulsory execution. As previously mentioned, the insolvency proceeding is a value maximisation procedure. To maximise the value of a debtor's property, the magnitude of Scenario 2 should increase. The value of Scenario 3 can then increase in turn. However, if Scenario 1 occurs, the total value available to creditors' is less than under Scenario 2, and the portion that goes to creditors decreases.

Figure 4. Value of debtor's property



Note: C stands for creditor's benefit, D debtor's and O other's.

For ex post efficiency of insolvency mechanisms, only the total value of the debtor's property should be taken into consideration. After a debtor becomes insolvent, the relative magnitude of firm value or the size of debts has nothing to do with ex post efficiency. If a legal system works properly, the value can be maintained as in Scenario 2 and the total value cannot go down below that of Scenario 2. Compulsory execution is, thus, the cornerstone of the insolvency system.[18]

c) Incentives and disincentives

A rational person is assumed to make decisions that maximise his or her own benefits. Benefits might be appraised from various aspects including economic, social, political, and emotional perspectives. Each alternative has incentives and disincentives for the person. People naturally weigh those merits and demerits and choose an alternative that can produce the best outcomes. This theory explains why people use one insolvency scheme more frequently than others. If there is a consensus in society that a certain insolvency scheme is more desirable than others, one can build a system that leads people to choose the desirable scheme by providing incentives and disincentives to each scheme. Consequently, the identification of incentives and disincentives for each insolvency scheme is the first step in building an efficient and effective insolvency system.

The biggest incentive is the economic benefit to creditors and debtors. Under a scenario where liquidation value exceeds going concern value, the economic benefit to creditors comes from proceeds realised in a liquidation proceeding. The amount of those proceeds is that realised in a public auction minus procedural expenses and priority claims (usually including some tax and labour claims). The amount of proceeds in public auctions depends on several factors: whether there is any entry barrier to the auction;

whether the information on public auctions is easily accessible; whether the decision of the court in charge of public auctions is finalised quickly without spending times in disputes; and whether public auctions are processed expeditiously. One can presume that public auctions are effective if the proceeds are almost the same as the amount available in normal transactions under current market conditions. In addition to these internal factors regarding public auctions, it is also important that creditors can easily find debtor's properties and put them up for auction. If finding hidden or uncovered properties costs time and money, the total amount of proceeds will be far less than what it should be even if the public auction process is efficient.

Under a scenario where going concern value exceeds liquidation value, a going concern must continue to operate in order to create economic benefits. A corporate reorganisation proceeding is the insolvency scheme to maximise the value of a debtor's properties as a going concern. Various rules can be employed for maximising going concern value: stay of execution of creditors' claims; avoidance of fraudulent conveyances or preferences; assumption or rejection of executory contract; and change of creditors' right. These tools can be used as incentives for a corporate reorganisation proceeding.

Since the proceeds in the liquidation proceeding are to be distributed among creditors and stakeholders, allocation rules create important incentives or disincentives for all interested parties. Prioritising the rules, setting out the normal execution process, is the basic rule in insolvency proceeding as well. The increased value through a corporate reorganisation proceeding should also be allocated among creditors, other stakeholder and, this time, debtors. Special consideration could be given to claims of employees and the government in the distribution rule. The share of the debtor in the increased value of the going concern would be decided through negotiation among creditors and debtors. Whether law or negotiation decides the distribution rules, they cannot satisfy all parties because an incentive to one party is a direct disincentive to another in the distribution process.

Most creditors and other stakeholders view direct economic benefits as the strongest incentive. A debtor or the management of a debtor corporation, however, might view the control of the debtor firm as a stronger incentive than anything else. A debtor usually tries to avoid or delay applying for an insolvency proceeding in order to save his or her control over the firm, which provide him or her with social and economic benefits. Delayed application eliminates the viability of an ailing firm or at least reduces the value of a firm as a going concern. Allowing a debtor to retain control over the firm (at least for a certain period of time) can be an attractive incentive for applying a reorganisation proceeding.

Disincentives to the red choices are criminal punishment and monetary disadvantages for not complying with law and regulation. Illegal activities subject to criminal punishments include hiding or destroying debtors' property, hindering public auction processes, preferentially providing economic benefits to some creditors, and fraudulently manipulating judicial debt collection processes. Monetary disadvantages to uncooperative debtors include applying higher rates in cases of default and ordering damage payments caused by illegal activities.

A disincentive to uncooperative parties and an incentive to co-operation is cram down. The corporate reorganisation proceeding is based on the approval of a designated majority among interested parties including creditors and shareholders. The court can approve a reorganisation plan according to which the rights of creditors and shareholders are to be modified when the plan acquires the necessary consent of all voting classes. But

a plan might deserve the court's approval even if there are dissenting classes. The court might cram down the reorganisation plan over dissenting classes if it deems the plan reasonable. As such, cram down prevents parties from using a hold out strategy and encourages them to co-operate in rebuilding failing companies.

4) Diagnosis and prescription

a) Evaluation

Evaluations of the efficiency of national insolvency systems do not differ greatly even if made by different researchers at different times. The 2001 OECD report,[19] the 2003 SERI report and the 2005 World Bank report[20] draw almost the same conclusions. Japan has a reliable and stable judicial system and insolvency mechanisms. Korea has a reliable judicial system but its insolvency mechanisms need to be refined and reinforced. Judicial systems and insolvency procedures are not reliable in China or Thailand. The situation in Indonesia is serious.

The 2005 World Bank report illustrates its evaluations with figures. The report selected seven fields,[21] which might have legal constraints and quantified a few indicators in each field in 145 countries as of 2004. Two fields ("enforcing contract" and "closing a business") are related with insolvency law and practice. In the field of "enforcing contract"[22] the number of procedures, time and cost were surveyed. The number of procedures means the number of procedures mandated by law and court regulation that demand interaction between the parties or between them and the court (or court officers). As for cost, it includes the official court costs, attorney's fees (if the use of attorneys is mandatory or common), and the costs of an administrative debt recovery procedure. Cost is expressed as a percentage of the debt value. Time is counted from the moment the plaintiff files the lawsuit in court until the settlement of payment. So, the "enforcing contract" field includes the concept of compulsory execution at its core.

The field of "closing a business" has three indicators under a hypothetical case.[23] In this case, cost means the cost of bankruptcy proceeding based on the questionnaire given to local experts. It includes fees paid to courts, lawyers, accountants and other professionals. Bribes are excluded. Time is the average duration to complete a bankruptcy procedure in a calendar year. Recovery rates shows how many cents on the dollar are recovered for claimants. So, the "closing a business" field corresponds exactly to insolvency proceeding.

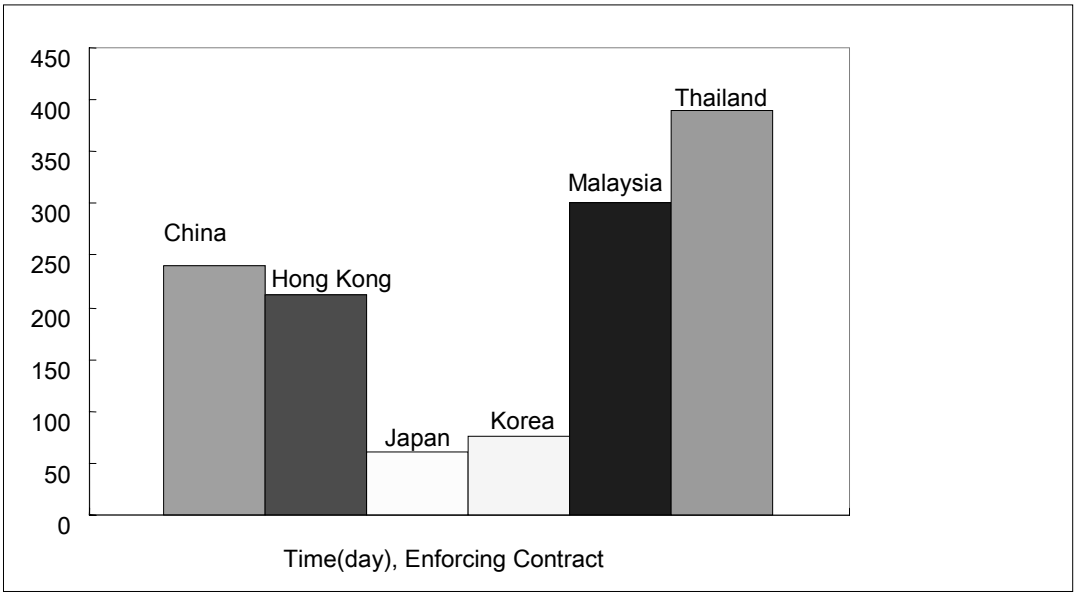
Table 5. World Bank evaluation

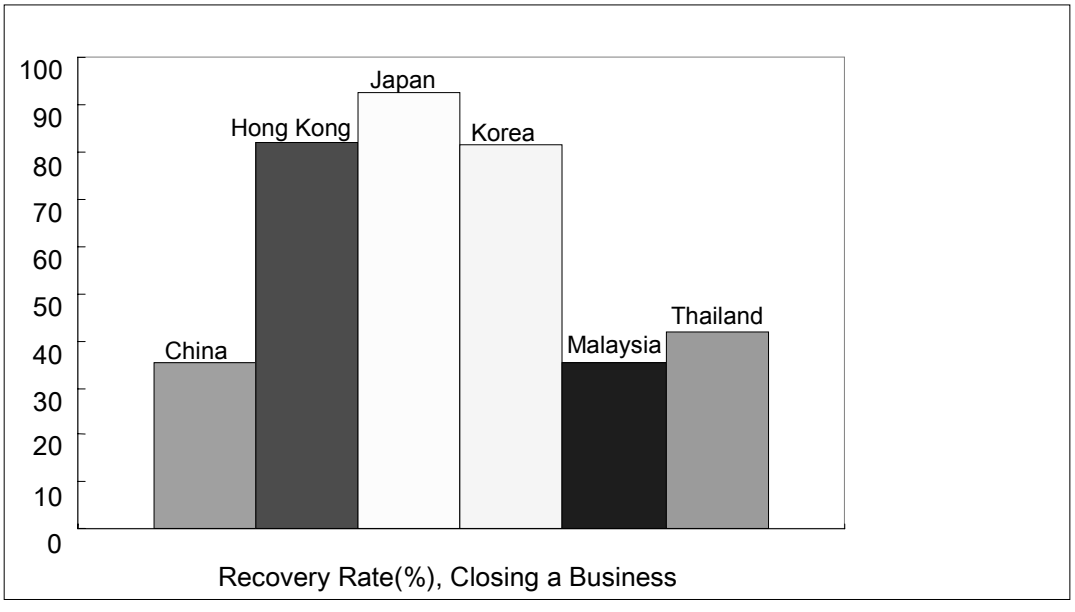
Country	Enforcing Contract			Closing a Business		
	Number of Procedures	Time (Days)	Cost (%)	Time (Year)	Cost (%)	Recovery Rate (Cent)
China	25	241	26%	2.4	18%	35.2
Hong Kong, China	16	211	13	1.1	8	82.3
Indonesia	34	570	127	6.0	18	10.6
Japan	16	60	9	0.5	4	92.4
Korea	29	75	5	1.5	4	81.1
Malaysia	31	300	20	2.3	18	35.4
Thailand	26	390	13	2.6	38	42.0

b) Diagnosis

Table 5 shows two important findings. One is that the efficiency of closing a business has a strong correlation with the efficiency of enforcing contracts. Part of Table 5 is shown using graphs in Figure 5. The top bar chart shows the time variable of enforcing a contract and the bottom bar chart graphs the recovery rate of closing a business. Considering the shapes of the graphs, a reverse relationship could be assumed between enforcing a contract and closing a business.

Figure 5. Comparison of two fields





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A multivariate linear regression was used to see whether the variables under enforcing contract could explain the variables under closing a business.[24] Independent variables of time and number of procedures (variables under enforcing contract) explained recovery rate variables of closing a business with a statistical significance of ($p=0.016$).[25]

In this model, the time variable of enforcing contract was a meaningful independent predicting factor with a negative coefficient value for the recovery rate variable of closing a business ($p=0.043$), but the number of procedures variable did not act as a meaningful predictor ($p=0.189$).[26] A model having a time variable of closing a business as a dependent factor, and time and number of procedures variables for enforcing contract as independent variables that is statistically significant could be assumed ($p=0.010$).[27] In addition, only the time variable of enforcing contract was a meaningful independent predictor with a positive coefficient value of ($p=0.023$).[28]

On the other hand, linear multivariate regression models explaining variables of enforcing contract as dependent factors could not be inferred from the variables of closing a business as independent factors. From this data, the time factor of enforcing contract could be an independent predictor for the status of closing a business *i.e.* recovery rate or time.

Furthermore, the efficiency of enforcing a contract and closing a business has nothing to do with the modernity of the insolvency law. The countries with new insolvency laws (Indonesia and Thailand) are in the lower ranks compared to countries without one (China; Hong Kong, China; Japan; and Korea). Why did new insolvency laws not improve circumstances as much as expected in Indonesia and Thailand? And, why did partial changes make the situation better in Japan and Korea?

A new insolvency law may not improve insolvency practices for the following two reasons. The first reason can be found in the choice of structure of debt settlement mechanisms in Figure 3 and incentive structures. Insolvency law is only one of the options that debtors and creditors can choose. If a red choice is available, the possibility that a debtor or a creditor resorts to it cannot be ruled out. In this situation, even though a well-tailored insolvency law exists, it cannot perform its anticipated function. A poorly conducted compulsory execution does not ensure the proper outcome of a liquidation proceeding, not to mention of a corporate reorganisation proceeding.

Another reason can be found in the infrastructure of insolvency mechanisms. Insolvency mechanisms operate on four infrastructures: political; judicial; financial; and corporate. Political infrastructure means whether politicians understand the function of insolvency rules and allow market rules to prevail without intervention. Judicial infrastructure means whether courts apply law as it is written and render timely decisions. Financial infrastructure means whether creditors are profit oriented and competent in evaluating future risks and trading non-performing loans. Corporate infrastructure means whether the governance of corporations is sound and business activities are legitimate. The stronger and more sound the infrastructure is, the more efficient and effective the insolvency mechanisms are. If the infrastructure is weak and fragile, insolvency mechanisms cannot work properly.

Even without a well-tailored insolvency law, markets can operate efficiently if compulsory execution is implemented properly. Hong Kong, China is a good example. Hong Kong, China has old British style bankruptcy laws that are scattered among statutes[29] and subsidiary legislation. It does not have a reorganisation proceeding.

However, Hong Kong, China has one of the most efficient markets in the world. Though Japan does not have a unified insolvency law or a specialised insolvency court, it shows the best performance in enforcing contracts and closing a business. That is the same in Hong Kong, China. On the contrary, Indonesia and Thailand both show poor performance even though they have well-tailored and unified insolvency law and insolvency courts.

Such a phenomenon is not only visible in judicial procedures. Indonesia (the Jakarta Initiative Task Force), Korea (Corporate Restructuring Programme, 1998) and Thailand (CDRAC, 1998) launched structured workouts to save ailing financial institutions and large firms, and pushed for debt restructuring with domestic creditors.[30] Foreign creditors were not bound by structured workouts. Negotiation with foreign creditors was conducted in parallel with structured workouts and dissenting foreign creditors have been demanding full repayment of claims. Japanese financial institutions, however, set up the Industrial Revitalisation Corporation of Japan (IRCJ) for a voluntary restructuring programme. IRCJ successfully completed debt rescheduling with foreign creditors. What made the difference? If creditors know how other creditors act and what they receive in judicial procedures, they tend to be co-operative with a rescheduling that provides more benefits than judicial procedures. Transparency and expediency are, thus, the key factors in determining the creditor-debtor relationship.

If a state has a sound compulsory execution system, it can go further to improve insolvency mechanisms by adopting new rules on insolvency proceedings. Amendments in Japan and Korea are examples of success. The Asian insolvency reform over the last decade has focused on introducing and adopting new insolvency rules and insolvency courts. Such efforts were successful in countries where compulsory execution was implemented properly. It is advisable for countries to adjust their approaches to their needs, and their economic and social environment. In addition, the order of implementing policy measures is important.

c) Prescription

The reason for the poor performance of insolvency laws in countries (even though they carried out insolvency law reforms) is that they overlooked the fact that the compulsory execution system is the basis of an effective and efficient insolvency system. In many jurisdictions where the principles of rule of law are not fully respected, the importance of a sound compulsory execution system is not fully recognised either. Many lawyers do not appreciate the negative effects of inefficient compulsory execution on business activities among others financial transactions. As explained in the previous section, debtors and creditors have no incentives to choose judicial insolvency mechanisms (including liquidation and reorganisation proceedings) in a situation where compulsory execution is not properly conducted. Judicial insolvency proceedings, where the level of repayment is unsatisfactory, may even be preferred.

Another factor that discourages judicial insolvency proceedings is government initiated rescue programmes. If the government has a programme to sustain ailing firms for any reason, debtors and creditors expect the government to do something. Government initiated rescue programmes give the wrong message to ailing firms (that they do not have to be cautious about liabilities) and create a vicious cycle (as with poor compulsory execution).

This kind of vicious cycle should be broken by enhancing the performance of compulsory execution or by treating ailing companies according to market principles. As

long as a vicious cycle exists, efficient insolvency systems cannot be expected. No one makes a choice that produces less profitable results and more difficulties.

When the economic crisis hit the Asian countries, most blamed outdated insolvency laws. So efforts focused on amending or enacting new insolvency laws that reflected good foreign practices. In some countries, however, the outcome of legislative reform fell far short of expectations because of structural weaknesses in the insolvency system. There were insufficient reasons for interested parties to resort to judicial insolvency proceedings. Insolvency reformers saw the superficial defects of insolvency legislation but missed hidden structural weakness.

The hierarchy of insolvency mechanism shown in Figure 1 can be used as the order of learning. Compulsory execution is first and corporate reorganisation last. Without an understanding of compulsory execution, it is very hard to learn corporate reorganisation. Furthermore, new concepts of insolvency proceedings are more difficult to adopt than those of compulsory execution.

Introducing new rules is also a process of learning for those affected by the rules, including judges, lawyers and businesspeople. In order to learn effectively and utilise what is learned, there should be enough reason for learning and adequate levels of learning. Adopting updated new insolvency rules without considering learning can result in a dead law that exists only in the books and not in the court.

Therefore, in some jurisdictions where sound compulsory execution cannot be expected, the efforts of insolvency law reform should focus on building an effective compulsory execution system first. What should be done to build a sound compulsory execution system? The answer is discourse. It should be repeatedly discussed why rule of law is important in the market economy, why a sound and efficient judiciary system supports economic development, and why ensuring creditors' rights enhances the efficiency of the economy in general. Research, education and training can make changes. Like technology in science and engineering, advanced rules and mechanisms in legal issues can be imported from advanced countries.

International fora for the exchange of information and ideas like the OECD Forum for Asian Insolvency Reform (FAIR), the technical assistance of the ADB and regional networking on insolvency issues have played an important role in providing advanced theories and practices. Their activities have been a valuable source of information. Sharing information and experiences are the most effective way to acquire knowledge. International co-operation should continue for the welfare of the world, but it should expand its scope of interests to compulsory execution and the infrastructure of insolvency mechanisms.

For there to be material progress in insolvency reform there should be a process of internalisation of new concepts in the domestic sphere as well. Knowing a concept is one thing and making it one's own is another. Concepts that may be fully understood by a few elite, may not find their way into legislation because legislators may be unfamiliar with new concepts. Even if legislation succeeds, it is difficult to implement unfamiliar rules because the people who apply them may only be generalist lawyers. The internalisation process should involve more lawyers, policy makers and businesspersons, and strive to develop a consensus among them. International co-operation on insolvency reform needs to help internalisation of insolvency rules and theories by enlarging the participants of international fora and networks.

China and Korea are good examples in terms of internalisation. Instead of drafting a new insolvency law by a few elite with the assistance of foreign experts, these countries have prepared draft bills over years and have listened to the opinions of domestic and foreign experts. Though it has taken several years, more lawyers and policy makers became aware of insolvency rules during this process.

5) Future tasks

Over the last decade, many East Asian countries endeavoured to reform their insolvency systems. These efforts focused on enacting advanced insolvency laws, and produced positive results but not to the extent wished. The areas where insolvency law reforms did not produce expected outcomes can be reduced by strengthening the weaknesses of insolvency systems. A six step policy plan is suggested that should help build effective and efficient insolvency mechanisms in East Asian countries. The ordering of the steps is a function of the duration of the individual projects; the first step represents the shortest project and the last step the longest.

1st Step: Let no one avoid compulsory execution

Problems lie first and foremost in compulsory execution and not insolvency law. If compulsory execution can be bypassed, the whole debt settlement structure becomes fragile and the outcome of debt collection activities (including insolvency proceeding) will be decided at a lower level than anticipated when loans are rendered. There should be strict sanctions and monetary penalties for illegal or uncooperative activities in compulsory execution. Compulsory execution is the foundation of the entire insolvency structure.

2nd Step: Make compulsory execution produce more distribution in less time

The recovery ratio is the most important incentive in debt collection activities. The recovery ratio in compulsory execution is the starting point of all other schemes including liquidation and reorganisation proceedings. Debtors' properties should be easily found out for realisation. Information on public sales at court should be subject to timely notice, and procedures for compulsory execution should be completed rapidly.

3rd Step: Provide incentives to creditors and debtors to apply for liquidation or reorganisation proceedings

If compulsory execution is conducted properly, incentives are a main driver of the application of insolvency schemes. Tools for maximising going concern value could be used. Debtors' concerns should be considered. Retention of control over the firm and other benefits, including retirement programmes could be considered.

4th Step: Upgrade insolvency laws on a standing basis or with participation of more people

Insolvency law is the product of history to solve a conflicted debtor-creditor relationship. It is impossible to enact a complete set of insolvency laws at one time. There will be provisions that need to be revised and supplemented. Changes in the market create new problems. Amending insolvency law should not just be a one-off event. It should be an ongoing process that results in more people getting interested in insolvency law. Lawyers are not familiar with insolvency law in some jurisdictions. The best way to learn

insolvency law is to participate in interpreting and amending insolvency laws. Questions and answers, discussion and proposals are means for spreading ideas and internalising rules. The more people participate, the more citizens can gain a deeper understanding of insolvency law.

5th Step: Reinforce the infrastructure of insolvency mechanisms

Insolvency mechanisms cannot be separated from related social systems. Political, judicial, financial and corporate infrastructure are the foundation of insolvency mechanisms. The operation of insolvency schemes cannot exceed the lowest level of these infrastructure elements. Since these elements relate to many fields in society and the economy, they can have synergistic effects.

6th Step: Ensure the principle of rule of law in the market

An insolvency proceeding is resorted to in a situation where the rights of one party collide with the obligations of another. If each party wants to solve the conflict by law, insolvency law will take charge of the situation. If not, there is no room for the legal intervention. If the law is fully respected and abided by in the market, every party in the market (including debtors, creditors and regulators) naturally assumes that the law will resolve the conflict. The rule of law applies not only to political issues but also to economic issues. The rule of law in a market economy must be constantly emphasised.

Notes

1. 1800-1804, 1841-1843, 1867-1878, 1898.
2. OECD Centre for Co-operation with the Economies in Transition (1994), Corporate Bankruptcy and Reorganisation Procedures in OECD and Central and Eastern European Countries.
3. Indonesia: 1998 Bankruptcy Act, 2004 Amendment to Bankruptcy Act; Malaysia: 1998 Pengurusan Danaharta National Berhad Act; Korea; Thailand: 1998, 1999, and 2000 Amendments to the Bankruptcy Act, 1999 Bankruptcy Court Act.
4. China: 2006 Enterprise Bankruptcy Law; Hong Kong, China: 1996 Bankruptcy (Amendment) Ordinance, 1998 Bankruptcy (Amendment) Rules; Japan: 1999 Civil Rehabilitation Act, 1999 Amendment to Civil Conciliation Act, 2000 Act on Recognition and Assistance for Foreign Insolvency Proceedings, 2002 Amendment to Bankruptcy Act, 2002 Amendment to Corporate Reorganisation Act; Philippines: 1999 SEC Rules of Procedure on Corporate Recovery, 2000 Securities Regulation Code, Draft Bill of Corporate Recovery and Insolvency Act, 2002 Special Purpose Vehicle Act; Vietnam: 2004 Bankruptcy Law.
5. Vassiliou, Lampros (2002), "Regional Report", meeting proceedings of FAIR II, Bangkok, Thailand, p.2.
6. The comparative research by the author and Il Chong Nam, under the auspices of the OECD, is the basis for this paper. Il Chong Nam and Soogeun Oh (2001), "Asian

Insolvency Regimes from a Comparative Perspective: Problems and Issues for Reform", Insolvency Systems in Asia–An Efficiency Perspective, OECD, 2001.

7. OECD (2001), Insolvency Systems in Asia. This publication contains six country reports.

8. Asian Development Bank (ADB) (2000), Report on: Insolvency Law Reforms in Asian and Pacific Region, in Law and Policy Reform, RETA 5795, Edition vol. I; ADB (2005), Final Report: Promoting Regional Co-operation in the Development of Insolvency Law Reforms, RETA-5975.

9. Morgan Stanley & Price Waterhouse Coopers (2003), "The Asia-Pacific Restructuring and Insolvency Guide 2003/2004", Globe White Page (a collection of country reports in 15 East Asian countries); (2005), "Insolvency & Restructuring", Law Business Research, (a collection of brief explanations of the insolvency and restructuring mechanisms of 43 countries); Tomasic, Roman, ed. (2006), Insolvency Law in East Asia, Ashgate, (a collection of 14 country reports in the region).

10. Footnote 6.

11. Strengthening Economic Legal Infrastructure Co-ordination Group (2003), Study on Debt Collection Litigation/Arbitration in APEC Economies.

12. World Bank and International Bank for Reconstruction and Development (2005), Doing Business in 2005–Removing Obstacles to Growth, World Bank, International Financial Corporation and Oxford University Press.

13. Tomasic, Roman and Margaret Wang (2006), "The Long March Toward China's New Bankruptcy Law", Insolvency Law in East Asia, Ashgate, p.94.

14. Linnan, David K. (2006), "Insolvency Law and Institutions in Indonesia," Insolvency Law in East Asia, Ashgate, p.356.

15. The Corporate Reorganisation Act was amended in 2005 again pursuant to amendments to the Commercial Code (Company Act).

16. Since 2004, the number of insolvency cases has exceeded 10 000 per year because of consumer bankruptcy. Discussions on the establishment of an insolvency court have been restarted recently.

17. Vongvipanond, Pairoj (2006), "Asian Insolvency Systems: the Thai Perspective Since the Last Two Years (2004-2006)", presented at FAIR V, Beijing, p.4.

18. The importance of compulsory execution can be found in ex ante efficiency too. The division of value between a debtor, creditors and other stakeholders determines ex ante efficiency. See Nam, Il Chong and Soogeun Oh (2001), p. 23. If compulsory execution is properly implemented, the value in Scenario 2 goes to creditors only. The division of value in Scenario 3 is beyond the scope of this paper.

19. Footnote 6. It does not cover China and Japan.

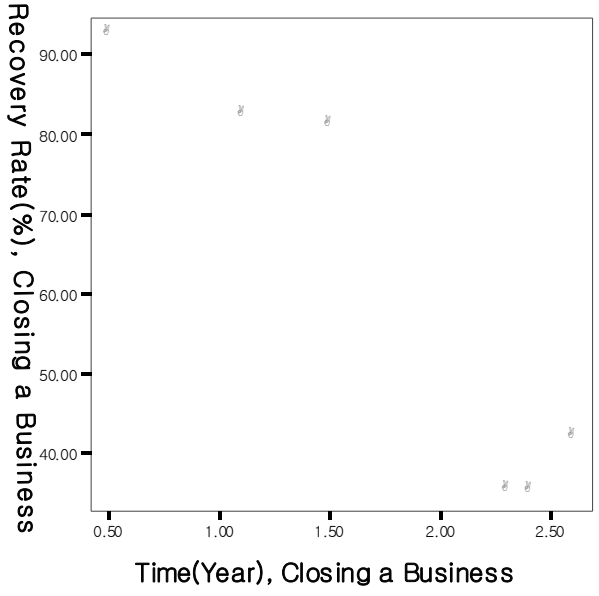
20. World Bank and International Bank for Reconstruction and Development (2005), Doing Business in 2005–Removing Obstacles to Growth, World Bank, International Financial Corporation, and Oxford University Press.

21. Starting a business, hiring and firing workers, registering property, getting credit, protecting investors, enforcing contract and closing a business.

22. To make the case comparable across countries, 10 assumptions are employed: 1) The debt value equals 200% of the country's income per capita. 2) The plaintiff has a 100% right. 3) The case presents a lawful transaction between businesses residing in the country's most populous city. 4) The bank refuses payment for lack of funds in the borrower's account. 5) The plaintiff attempts to recover the debt by filing a lawsuit or going through an administrative process. 6) The debtor attempts to delay service of process but it is finally accomplished. 7) The debtor opposes the complaint. 8) The judge decides every motion for the plaintiff. 9) The plaintiff attempts to introduce documentary evidence and to call one witness. 10) The judgment is in favour of the plaintiff. 2005 Doing Business, p. 86.

23. 1) The business is in default on its loan and the default will continue. 2) The creditor bank has security interests on the debtor's properties including floating charge. 3) Debtor's options are a reorganisation proceeding, a liquidation proceeding, and sales of business in or out of the court. 2005 Doing Business, p. 87.

24. For statistical analysis, a "p value" of less than 0.05 was considered to be significant. The Pearson method was used to evaluate the correlation between the two variables. The recovery rate variable of closing a business was strongly inversely correlated with the time variable of closing a business (r=-0.879, p=0.009).



25. A1. ANOVA of model with recovery rate of closing a business as dependent variable:

Model		Sum of Squares	df	Mean Square	F	Sig.	
1	Regression	5 000.906	2	2 500.453	13.594	**.016**	
	Residual	735.771	4	183.943			
	Total	5 736.677	6				

Note: Predictors: (Constant), time of enforcing contract, number of procedures of enforcing contract. Dependent variable: recovery rate of closing a business.

26. A2. Coefficients of model with recovery rate of closing a bank as dependent variable:

		Unstandardised Coefficients		Standardised Coefficients	t	Sig.	
Model		B	Std. Error	Beta			
1	(Constant)	124.774	21.272		5.866	.004	
Independent variables of enforcing contract	Number of procedures	-1.590	1.004	-.361	-1.583	**.189**	
	Time	-.115	.039	-.666	-2.924	**.043**	

Note: Dependent variable: recovery rate of closing a business.

27. B1. ANOVA of model with time of closing a bank as dependent variable:

Model		Sum of Squares	df	Mean Square	F	Sig.	
1	**Regression**	**17.189**	**2**	**8.595**	**18.017**	**.010**	
	Residual	**1.908**	**4**	**.477**			
	Total	**19.097**	**6**				

Note: Predictors: (Constant), Time of Enforcing Contract, Number of procedures of Enforcing Contract. Dependent Variable: Time of Closing a Business.

28. B2. Coefficients of model with time of closing a bank as dependent variable:

		Unstandardised Coefficients		Standardised Coefficients	t	Sig.	
Model		**B**	**Std. Error**	**Beta**			
1	**(Constant)**	**-1.599**	**1.083**		**-1.476**	**.214**	
Independent variables of enforcing contract	**Time**	**7.166E-03**	**.002**	**.718**	**3.567**	**.023**	
	Number of procedures	**8.113E-02**	**.051**	**.319**	**1.586**	**.188**	

Note: Dependent Variable: Time of Closing a Business.

29. The Companies Ordinance, the Companies (Winding-Up) Rules, the Bankruptcy Ordinance and the Bankruptcy Rules.

30. These structured workouts were closer to government-managed financial rescue programmes rather than voluntary bargaining processes. It was also often the case that the structured workouts replaced judicial insolvency proceedings. The government, rather than the court, determined the boundary of exit mechanisms. See Nam, Il Chong and Soogeun Oh (2001), p. 62.

INSOLVENCY LAWS IN SOUTH ASIA: RECENT TRENDS AND DEVELOPMENTS

by
Sumant Batra

South Asia is a multiracial and multilingual region, and the economic and legal systems of its countries reflect the customs of its various communities. Expanding at a rate in excess of 8% a year, the Indian economy is one of the fastest growing economies not only in the region but in the world. Constantly striving to raise the annual growth rate to 8-10%, the political leadership is taking steps to simplify tedious regulations and procedures, rationalise policies, and introduce an effective legal and regulatory framework in all sectors. In Sri Lanka, the breakdown of the cease-fire between the government and the Liberation Tigers of Tamil Elam continues to haunt the economy. Due to the cease-fire, Sri Lanka's economy grew at a rate of 6% of gross domestic product (GDP) in 2005. Sri Lanka continues to make steady progress in financial sector reforms, as well as in improving the efficiency of the banking sector. In Nepal, the Maoist insurgency brought the economic and financial system to a near state of collapse. The economic future of the country remains uncertain until a long-term political solution is achieved. Recent positive political developments have raised hopes of economic stability. A number of significant ordinances were issued in the last three years to introduce new laws or amend the existing as part of legal, judicial and financial sector reforms. These ordinances would require approval of the new parliament. Pakistan and Bangladesh continue to take measures to strengthen their financial and legal systems as part of their overall economic stabilisation programmes. Both countries have enacted copious legislation concerning the financial sector since 1990.

The legal and financial systems in the region have undergone significant transformation over the last two decades. Various reforms have been initiated aimed at promoting an efficient, well-diversified and competitive financial system with the ultimate objective of improving the allocative efficiency of resources so as to accelerate economic development. Exceptions are India and Nepal where insolvency law reforms have not received the required attention and priority. Sri Lanka recently asked the World Bank to assess its insolvency system. The assessment report is expected to place insolvency reforms on the agenda.

1) Legal systems

Common law systems predominate in the countries in the region. The legal system of Nepal also has some elements of the continental legal system. Though the common law system of Sri Lanka is derived from English law, the Roman Dutch laws remain the residuary or the common law of Sri Lanka (Table 1).

Table 1. Legal systems and influence

	India	Pakistan	Sri Lanka	Bangladesh	Nepal
Legal System	Common Law	Common Law	Common Law	Common Law	Common Law
Influence	British	British	Roman Dutch	British	Continental

Sri Lanka has a fairly well-developed legal and judicial system. In some areas of the financial sector, its legal framework is rather modern and sophisticated. Over the past twenty years, the legal framework has been regularly updated, and a host of new amendments have been passed. Though this framework provides an adequate foundation for a modern financial system, it suffers from a number of weaknesses affecting most developing countries such as antiquated concepts, absence of laws for new developments, and unconsolidated and overlapping laws. Piecemeal amendments over many years have led to inconsistencies in laws that make enforcement difficult. However, Sri Lanka started a process of consolidation and simplification two years ago by appointing special committees to look into the matter.

The legal system of Bangladesh has also witnessed reforms. The most significant step taken by the government is the enactment of the new Artha Rin Adalat Act of 2003, which sets up separate courts for the speedy recovery of defaulted loans. The Bankruptcy Act was enacted in 1997 to deal with cases of large loan defaults. In Pakistan, the legal environment is uniquely complex owing to the imbalance between creditor and debtor rights. The creditor-friendly laws have impacted the financial landscape, particularly the investment climate in Pakistan. Some laws are regarded as being overly punitive to debtors and as having frustrated attempts at restructuring. The National Accountability Ordinance of 1999 lead to the creation of the National Accountability Bureau, permitted the presumption of guilt, and shifted the burden of proof to the accused. The target of this law was corruption in all its forms including non-payment or delayed payment of bank debt. It was clearly drafted in haste and was seriously flawed.[1] For borrowers, a new legal term/concept was introduced whereby any default to any government institution (even on a utility bill) of more than 30 days was defined as "wilful default". Wilful defaulters were exposed to imprisonment, barred from holding any public office and put on the Exit Control List that barred them from foreign travel. Despite problems and difficulties, it is fair to state that a lot of progress has been made to improve the health and soundness of the financial sector in Pakistan in recent years. Although a few weak and vulnerable institutions remain in the banking sector and much more needs to be done, Pakistan is much stronger today compared to five years ago. There has been a strict monitoring and reduction of non-performing loans through the active involvement of the Corporate Industrial Restructuring Corporation and the Committee of Revival of Sick Units.

Largely influenced by common law, Nepal's legal system was recently updated through the introduction of various laws. The Constitution of Nepal (1990) is the supreme law. The Muluki Ain (the Country Code, codified in 1853 and replaced in 1963), is the general law of the country and includes substantive and procedural provisions for criminal and civil matters. The process of introducing commercial laws into the legal system was started in the mid-1980s, and a number of new laws were introduced in the last decade. However, several laws affecting the corporate and private sectors were promulgated only recently. These laws include the Banking and Financial Institutions

Ordinance 2004, the Secured Transactions Ordinance 2005, the Insolvency Ordinance 2005, the Companies Ordinance 2005, and the Securities Ordinance 2005. A few others such as the Asset Management Company Ordinance, the Company Ordinance, the Fiscal Transparency Ordinance and the Anti-Money Laundering Ordinance are under active consideration by the government.

India has undertaken significant legal reforms over the last two decades. In December 2002, the Indian parliament passed the Companies (Second Amendment) Act, 2002 (Second Amendment) to significantly restructure the Companies Act, 1956 (1956 Act) leading to a new regime that tackles corporate rescue and insolvency. The provisions of the Second Amendment are, however, yet to be notified. The Sick Industrial Companies (Special Provisions) Act, 1985 (SICA), which presently deals with the revival and rehabilitation of companies, was repealed by passage of the Sick Industrial Companies (Special Provisions) Repeal Bill, 2001 by the parliament. It too, is yet to be notified. Till then, the Board for Industrial and Financial Reconstruction (BIFR) set up under SICA continues to deal with revival and rehabilitation of companies, and the high court retains its jurisdiction as the liquidation court under the 1956 Act. In the same month of 2002, the Indian parliament passed further significant legislation. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFESI) regulates, for the first time, the securitisation and reconstruction of financial assets. SARFESI also deals with the enforcement of secured interests by secured creditors without the intervention of the court. In 2004, the government of India set up a High Level Expert Committee (the Dr. J.J. Irani Committee) to recommend, among other things, insolvency reforms. These are discussed later in this paper.

Globalisation and the opening of trade have led countries to consider adopting model laws and laws that come from fundamentally different legal jurisdictions. Today, the influence of a number of legal systems is visible in the region.

2) The legal framework for corporate insolvency

In all South Asian countries (except Nepal), the legal framework for corporate insolvency is provided under the company law, which deals with the winding up of companies. Nepal recently enacted the Insolvency Ordinance, 2005 (Insolvency Ordinance), which contains both the corporate insolvency and the rehabilitation framework. Except for Sri Lanka, where an official receiver is appointed from a panel of accountants to carry out the liquidation, in all other countries the liquidation is carried out by government liquidators. Although Nepal has notified the Insolvency Ordinance, it is yet to become operational. At present, the Office of the Company Registrar (OCR) conducts liquidations under the Companies Act, 1997 (Table 2).

In all countries (excepting India), the legal framework for commercial insolvency provides only for liquidation; there are no provisions in the laws for reorganisation of businesses or companies. In Nepal, the Insolvency Ordinance, that was recently notified, introduces a statutory framework for insolvency for the first time. The Insolvency Ordinance is yet to become operative. Nepal does not currently have a law on the rehabilitation of companies in effect. In Pakistan, an informal process of rehabilitation exists. The informal system does not meet the established standards of informal out-of-court workouts.

Table 2. Governing laws

	India	Pakistan	Nepal	Bangladesh	Sri Lanka
Law of Liquidation	Companies Act of 1956	Companies Ordinance of 1984	Insolvency Ordinance of 2005*	Companies Act (Bangladesh) of 1994 Bankruptcy Act of 1997	Companies Act of 1982
Law of Rehabilitation	SICA Composition and Scheme of Arrangement under the Companies Act of 1956	Under Part IX of the Companies Ordinance of 1984	Insolvency Ordinance of 2005	No Law Composition and Scheme of Arrangement under the Companies Act	No Law Composition and Scheme of Arrangement under the Companies Act

*Although notified, the Insolvency Ordinance is yet to become operative. Until it does, corporate insolvency is carried out under the Companies Act 2053 (1997).

3) Liquidation of companies

The winding up of companies in all countries in the region is outdated and inefficient. The liquidation of companies is a long drawn-out affair with no significant return from assets to the stakeholders (Table 3). It takes years to obtain statements of affairs, books of account, realisation of debts and sales of assets, distribution of assets to creditors, etc. before a company is finally dissolved with the sanction of the court. In the process, substantial corporate assets remain unrealised and undistributed. The inordinate delay in proceedings mars the potential for the productive and rapid use of dormant assets throughout the country. The key features of a sound insolvency system are absent, and no material aspects of the law and process are observed. The law does respond to the needs of modern industry. The process of seizure of assets is cumbersome. The absence of effective tools and instruments to supervise and manage the insolvency process renders the liquidation process an insignificant part of market dynamics.

Table 3. Timing, cost and recovery rate of proceedings

Country	Time (years)	Cost (% of Estate)	Recovery Rate (cents/dollar)
Bangladesh	4.0	8.0	24.9
India	10.0	9.0	13.0
Nepal	5.0	9.0	24.5
Pakistan	2.8	4.0	39.9
Sri Lanka	2.2	18.0	35.6

Source: Doing Business 2005, World Bank

Except in India, very few cases of winding up are filed due to the inefficiency of the system. On the whole, liquidation regimes in the region are crying for reform. The regional average is far below that of OECD countries (Table 4).

Table 4. Efficiency of liquidation regimes

Indicator	Regional Average	OECD Average
Time (years)	5.2	1.7
Cost (percent of estate)	8.3	6.8
Recovery rate (cents on the dollar)	21.4	72.1

Source: Doing Business 2005, World Bank.

The liquidation laws of the countries in the region are quite similar. A company can be wound up for several reasons. These include failure to deliver statutory reports to the registrar, holding a statutory meeting, or commencing business within a year of the company's incorporation. Other reasons include: suspension of business for one year; reduction of the number of members below the statutory requirement; when the court views it just and equitable to wind up a company; non payment of debt; inability to satisfy a judgment, and so on and so forth. The commencement process is satisfactory but the minimum amount to trigger a winding up can be as small as INR 500 (Indian rupees) (approximately USD 5 (United States dollars)) in India and Sri Lanka.

All property and effects of the company are deemed to be in the custody of the court as from the date of the order for winding up of the company. The official liquidator is required to take all property that belongs or appears to belong to the company into his custody or control. All present or past members of the management, officers and agents of the company are required to hand over to the liquidator all properties, books and papers of the company. The liquidators are entitled to official aid for recovering possession or control of property of the company. The liquidator has to maintain proper accounts regarding receipts and payments, and furnish them to the court at least twice a year. The liquidators are government officials, except in Sri Lanka where the official receiver is appointed out of a panel of accountants. The government officials acting as liquidators have added to the inefficiency of the process for various reasons discussed later in this paper.

Unless the court orders otherwise, any transfer of property or delivery of goods made by the company (except in the ordinary course of business or in favour of the acquirer in good faith and for valuable consideration) shall be void if made within one year prior to commencement of winding up. The liquidator may disclaim, with leave of the court, any land burdened with onerous covenants, shares and unprofitable contracts, or property not readily saleable, within 12 months after the commencement of winding up or an extended period allowed by the court. The liquidator has the power to sell all properties whether tangible or intangible belonging to the company by public auction or by private contract, by sanction of the court or a committee of inspection.

All debts, including debts payable on contingency, and all claims against the company, present or future, certain or contingent, ascertained or sounding only in

damages, are admissible to proof. Claims may be classified as those that are entitled to preferential payments and those that fall in the residuary class. Claims entitled to preferential payment are settled before dividends may become available for others. In Pakistan, as far as secured creditors are concerned, they are entitled to enforce their security by joining the winding up proceedings. The proceeds of such security, to the extent of the secured debt, are exclusively available for the secured creditors and cannot be reached by the liquidator. Other creditors are required to lodge their claims with the liquidator and furnish proof of their debts. They are not allowed by the court to pursue law suits.

When a liquidator is appointed, the board of directors of the company ceases to hold office. Unless required to continue the business of the company, the liquidator terminates the employment of all officers. They are also required to furnish a detailed statement of affairs to the official liquidator regarding the assets, debts and liabilities of the company, its properties and all its affairs. They are also bound to hand over all property of the company to the liquidator.

Once a winding up order for a company has been passed, no suit or other legal proceedings may be proceeded with or commenced by or against that company except with the leave of, and subject to any terms imposed by, the court responsible for the winding up. In Sri Lanka, a winding up order does not automatically stay the *parate* proceedings. In India, proceedings under the Recovery of Debts due to Banks and Financial Institutions Act, 1993 are exempt from stay against secured creditors in the event of a pending liquidation.

A debtor can commence winding up proceedings by presenting a voluntary winding-up petition. A voluntary winding-up takes place when: a) the company passes a resolution in its general meeting to that effect; b) the company resolves by special resolution that it be wound up voluntarily; or c) when the company resolves by extraordinary resolution that it cannot, by reason of liabilities, continue its business and that it is advisable to wind it up. A voluntary winding up process is expeditious as it receives co-operation from the debtor. Generally, companies that do not have many creditors resort to voluntary winding up.

The asset seizure process is cumbersome in the region. The sale is carried out by public auction and usually attracts significantly lower values than it would if the business were sold as a going concern.

4) The rehabilitation of companies

India is the only country in the region that has a formal law for rehabilitation of company's *viz.* SICA enacted in 1985. Nepal introduced the law of restructuring of companies recently by way of its Insolvency Ordinance which is yet to become operational. The SICA is predominantly remedial and ameliorative in so far as it empowers the BIFR, a quasi-judicial body, to take appropriate measures for the revival and rehabilitation of potentially viable sick industrial companies, and for the liquidation of unviable companies.

The SICA requires that, when an industrial company becomes sick, the board of directors make a reference to the BIFR to determine what measures need to be adopted within sixty days from the date of finalisation of the duly-audited accounts of the company for the financial year in which it became sick. No reference can be filed by a company where the assets of the company have been acquired by an asset reconstruction

company. Further, a pending reference before BIFR shall abate if 75 percent of secured creditors initiate action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Act, 2003 (SARFESI). The reference filed by a sick industrial company or by any of the parties prescribed under SICA is registered and placed before the BIFR for consideration.

The BIFR may make inquiries as it deems fit for determining whether the company has become a sick industrial company. If the BIFR deems it necessary or expedient for the expeditious disposal of an inquiry, it may appoint any Operating Agency (OA) to enquire into and make a report with respect to matters specified in that order. If the BIFR comes to the conclusion that the company is not a sick industrial company, it shall reject the reference. If on making an inquiry, the BIFR is satisfied that the company is sick, it shall decide whether it is practicable for the company to make its net worth exceed the accumulated losses within a reasonable time on its own, and shall give the company, directions as it may deem fit to make its net worth exceed the accumulated losses.

If the BIFR decides that it is not practicable for a sick company to make its net worth exceed the accumulated losses within a reasonable time, and it is necessary in the public interest to adopt remedial measures, it may direct any OA to prepare a scheme with measures as it considers necessary from out of the parameters laid down under the act. The OA prepares, if possible, a scheme providing, among other things, for any one or more of the following measures: the financial reconstruction of the sick company by change in or takeover of management; the amalgamation of the company with another company; the sale or lease of a part or whole of the sick company; the rationalisation of managerial personnel; incidental, consequential or supplemental measures as may be necessary; change in the board of directors; etc.

The OA assists the BIFR in the discharge of its functions. Generally, the BIFR appoints a financial institution or bank on its panel to act as the OA. The role and responsibility of the OA is to prepare, if possible, a scheme for the rehabilitation of the sick industrial company in accordance with the guidelines set out by the BIFR. Where the scheme prepared by the OA relates to preventive, ameliorative, remedial and other measures, it may provide for financial assistance by way of loans, advances, guarantees, relief, concessions, or sacrifices from the central government, state government, any scheduled or other bank, a public financial institution or state level institution, or any institution or other authority. Every scheme must be circulated to the institutions that are to provide financial assistance for consent, and must be received within sixty days from the date of circulation. If no consent is received, it is deemed that consent has been given, the BIFR shall sanction the scheme, and the scheme shall be binding on all concerned. If the consent is not given, the BIFR may adopt other measures, including the winding up of the company, as it deems fit.

When the BIFR comes to the conclusion that it is not possible to revive the company, and that it is just and equitable that the company be wound up, it shall record and forward its opinion to the concerned high court. The high court, on the basis of this opinion, may order the winding up of the company, and may proceed and cause to proceed with the winding up of the company in accordance with the provisions of the Companies Act, 1956.

The provisions of SICA have been abused by errant debtors to seek protection and moratoria from recovery proceedings. Unscrupulous promoters are easily able to enter into the reference (sometimes by manipulating their accounts to reflect erosions of net worth), and are then able to achieve immunity against recovery actions by creditors.

They then attempt to perpetuate that benefit. If the reference is rejected, a fresh reference is filed with respect to the accounts for the next year and the cycle goes on endlessly. Under SICA, an automatic stay operates against all kinds of recovery and distress proceedings against all creditors once the reference filed by the company is registered. This is the principal drawback of the existing legislation as this has led to the BIFR becoming a haven for defaulting companies. There is no fear of reprisal or punitive action against companies indulging in this malpractice.

There are inherent procedural and legal delays in proceedings before the BIFR. Sometimes, the BIFR takes nearly a full year to determine whether a company is sick. Time taken for preparing and sanctioning a scheme can run between three to four years. There is a lack of co-ordination between banks, and between banks and financial institutions, and often the whole process is held up due to the adamance of one party, thus delaying the rehabilitation process. By the time decisions are taken and communicated, the plan has lost its viability, which results in the failure of revival schemes even after sanction. A need has long been felt for reform of this law.

In Sri Lanka, Pakistan and Bangladesh there are some provisions for compromise and schemes of arrangement under companies acts, but they are neither directed at nor facilitate the rehabilitation of companies. Creditors do not use their provisions for restructuring debts or settling dues with debtors. A compromise or arrangement can be proposed between a company and its creditors, or between the company and its members, or between the company and both its creditors and members. If a majority, representing three-fourths of the value of the creditors or members, agrees to a compromise or arrangement, the compromise or arrangement will, if sanctioned by the court, be binding on creditors, the members, and the liquidator. A court order sanctioning the compromise or arrangement is only effective once it is registered with the Registrar of Companies. Efforts to restructure banks have been made by adopting special initiatives from time to time.

In Pakistan, in cases of companies, schemes for rehabilitation are governed by Part-IX of the Companies Ordinance. If a scheme of compromise proposed by creditors is approved in the prescribed manner by the requisite majority of creditors and also by the court (after a hearing given to all who might be affected), the scheme becomes binding on all creditors, subject to adjustments as might be made by the high court. Such schemes may result in moratoria, extensions in time for payment of the debt, restructuring of the debt, or even a composition where a part of the debt may be written off. Unlike liquidation, which is aimed at settling claims in an organised manner and then dissolution of the company, a scheme of compromise ordinarily aims at continuing the operations of the company so that it can discharge its obligations as a going concern subject to the terms imposed by the scheme. In case of individuals, a composition and scheme of arrangement may be proposed by a debtor after he has been adjudged to be insolvent. After the scheme is approved, the court may grant a discharge to the debtor with the result that pre-petition debts are paid according to the scheme. The discharged bankrupt may start a new life thereafter, subject to whatever conditions might be imposed by the scheme.

Where a compromise or rehabilitation/reorganisation scheme is proposed between the company or creditors, or any class of them, an application may be moved by the company or any creditor requesting that the court order a meeting of all the creditors or class of creditors for their consent. If a majority of members representing three-fourths in value of the creditors or class of creditors present and voting in person or by proxy at the meeting

agree to any compromise or arrangement, the same may be sanctioned by the court and become binding on all creditors or class of creditors and also on the company. If the company was in the process of being wound up, then the petition can also be moved by the liquidator.

There is little use of the provisions for arrangements and amalgamations to rescue businesses and undertake restructurings. Under the insolvency law and related procedures, there is little opportunity to preserve the business as a going concern to maximise value and enhance recovery for creditors. Generally, compromises and arrangements are used mainly for mergers and acquisitions, and not for restructurings. The availability of a restructuring law provides an option for banks to explore in the turnaround of businesses that face difficulties. A successful restructuring can result in assets remaining a part of the economic system compared to *parate* powers in Sri Lanka and India. Restructuring enhances returns on assets; there is, therefore, a need for a restructuring law.

In Pakistan, the Corporate Industrial Restructuring Corporation (CIRC), an asset management company, was created in September 2000 under broad legislation. It is a public sector corporation mandated by its enabling law "to make provisions for the acquisitions, restructuring, rehabilitation, management, disposition and realisation of non-performing loans" of public sector banks and financial institutions, *i.e.* the whole spectrum from rehabilitation to liquidation. All public sector financial institutions were required to offer their non-performing loans to CIRC. The rights to choose (cherry pick) which non-performing loans were acquired by CIRC and which ones "returned" to the parent bank(s) rested with CIRC. CIRC failed to develop the internal capacity to perform any role other than auctioning the non-performing loans it acquired. Secondly, by acquiring assets at a purchase price that was well below the forced sale values established by the banks themselves, the organisation had a negative effect on the secondary market price of industrial assets. Thirdly, the pricing methodology resulted in a situation whereby the asset management company generated a large profit on asset sales and left the parent bank(s) with a write-off which was larger than had CIRC not been created. Consequently, the combined failure of CIRC and the National Accountability Bureau forced regulators to revamp their whole strategy.[2]

The Committee of Revival of Sick Units (CIRSU) was created through a notification of Pakistan's Ministry of Finance in May 2000. This body does not, therefore, operate under an enabling law. CIRSU comprises representatives from the large public sector financial institutions and senior industrialists. At the time of its creation three years ago, Pakistan's economy was very fragile. The design objective was to create an entity that would probe the root causes of industrial sickness and come up with long-term solutions for sustainable growth in the major industrial clusters and segments. In practice, CIRSU chose to act as an "arbitration window" on non-performing loans between banks and borrowers. Periodic meetings are held in which very basic data is considered. In terms of actual revival, defined as a closed unit coming back into production, data is not maintained by CIRSU.

The concept of restructuring was introduced in the insolvency framework of Nepal for the first time through its Insolvency Ordinance. Till now, the insolvency regime of Nepal remained confined to liquidation. The Insolvency Ordinance provides the court with the power to explore the possibilities of restructuring at the time of considering the insolvency order. In case the court orders the reorganisation of a company, the reorganisation manager must prepare a reorganisation programme for the company. The

reorganisation programme must include the schemes: to amortise the debts of the company and change the structure of its capital; sell any portion of the assets of the company and settle the claims of the creditors; effect a change in the nature of the claims of the creditors of the company and issue securities in consideration thereof; issue shares to the creditors of the company in consideration of their claims and thus enlist their participation in the capital investment; amalgamate the company with another company; change the management of the company; or take any other necessary action deemed appropriate by the court to reorganise the company.

The Insolvency Ordinance requires the reorganisation manager to invite claims along with evidence from creditors. Every secured or unsecured creditor having a debt claim against the company must submit the details of his claim along with evidence to substantiate it. The reorganisation manager shall convene a meeting of the creditors. The creditors' meeting shall discuss the reorganisation programme presented by the reorganisation manager and adopt a resolution on any of the issues with or without any amendment, or liquidate the company immediately by not agreeing to the resolution.

5) The regulatory framework

An efficient insolvency system requires the bodies responsible for regulating or supervising insolvency administrators to be independent of individual administrators. They should set standards that reflect the requirements of legislation and public expectations of fairness, impartiality, transparency and accountability. Insolvency administrators should be competent to exercise the powers given to them and should act with integrity, impartiality and independence.

The regulatory framework for insolvency in the region is weak and bureaucratic. Since the liquidators are government officials, they are regulated by standard service regulations applicable to government employees. The supervisory role is left to the courts, which oversee the liquidation process. The registrar of companies has a limited supervisory role over liquidators (Table 5).

In Sri Lanka, no developed regulatory framework is available, nor is there a supervisory body responsible for regulating the conduct of official receivers and liquidators. This role is left to the courts, which oversee the liquidation process. The registrar of companies has some control over the liquidator. The liquidator is required to submit audited accounts to the registrar of companies. The registrar can monitor the liquidator and, where a liquidator does not perform his duties and duly observe the requirements imposed on him, or if any complaint is made to the registrar by any creditor or contributory, the registrar can inquire into the matter and, if necessary, report to the court under Section 282 of the Companies Act. The liquidator can obtain release from the court only if he satisfies the court by filing a final report confirming the disposal of assets, distribution of sales proceeds and the status of settled and unsettled claims.

The office of the Registrar of Companies lacks the capacity to administer the official receivers and the liquidation process. They are not exposed to any education and training and are not schooled in best practices. However, their integrity, impartiality and independence are not in doubt. There is a need to create a specialised insolvency administration office that would be responsible for administering the liquidation process and overseeing the liquidator's functions.

Nepal's Insolvency Ordinance provides for the establishment of the Insolvency Administration Office (IAO) to: register insolvency practitioners; issue and renew

licenses; subject the management of insolvent companies to general supervision; investigate the official code of conduct to be complied with by insolvency practitioners; keep records of all insolvent companies; and discharge such other functions as are prescribed. The Insolvency Ordinance enables the government to designate any of its offices to work as the IAO until such time as the IAO is established. To date, the IAO has not been established nor has any substitute office been designated.

There was no regulatory framework under the Companies Act of 1997, and no one supervised liquidators except the Office of the Company Registrar, which did not have the capacity to discharge that function efficiently. The IAO could, when established, perform a very important role regulating and supervising insolvency practitioners. It is desirable that such an institution be established at the earliest. It should function independently and be administered by persons with appropriate qualifications and knowledge. Such persons should be independent and of known integrity, and should be trained adequately from the beginning of their appointment and on an ongoing basis.

Table 5. Supervision of liquidators

India	Pakistan	Nepal	Bangladesh	Sri Lanka
Ministry of Company Affairs	No specific regulatory authority	Office of the Company Registrar (OCR)	No specific regulatory authority	Regulatory powers only with the court No other regulatory framework

India, Pakistan and Bangladesh face similar problems and challenges in the area of regulation, which rests with the respective concerned ministries. The government staff is neither adequately qualified nor trained to regulate the sophisticated insolvency process. Part of regulation is done by courts such as in India where every high court has an official liquidator attached to it. The performance standards of the regulating body have not been satisfactory, given the level of inefficiency and the lack of performance by the department of liquidators. There is a significant backlog of cases which hampers the quick and effective resolution of sick industrial companies.

Building an efficient insolvency framework can enhance the value of the insolvency process and make it meaningful for stakeholders. A regulatory framework that would provide credible oversight of insolvency practice needs to be established. This would also ensure that receivers, administrators and insolvency practitioners are competent, duly licensed and supervised, and that minimum standards of practice and expertise are maintained. Further, the regulators also need systematic and ongoing training in the area of insolvency.

6) The role of the judiciary

The judiciary is held in high esteem in the region, and is an important part of each country's internal structure. But, judicial procedures suffer from common weaknesses, such as: a lack of resources and specialisation; lack of infrastructural and institutional capacity; and inefficient procedures and processes. The judiciary, as an institution, has

played a very important role in the development of countries such as India and Sri Lanka as civilised societies that respect the rule of law. It remains largely independent and its integrity is not a matter of debate (though some concern exists in the region regarding political affiliations and the proximity that some judges maintain with the executive and politicians).

The courts perform an important role in the liquidation process (Table 6). Nepal did not provide for a role for courts. Under the Insolvency Ordinance, the commercial courts supervise the liquidation and restructuring process. India is going to experiment with a mix of judges and experts in the NCLT.

Table 6 Courts in the liquidation process

India	Pakistan	Nepal	Bangladesh	Sri Lanka
Designated company court in the high court of every state	High Court	No role of courts*	High Court	District Courts

*After the Insolvency Ordinance becomes operational, the commercial benches designated under the ordinance will supervise insolvency.

Although the lack of resources and infrastructure is a constraint, Sri Lanka has a well-regarded court system. The creation of the Commercial High Court has improved the situation in the area of insolvency law, but delays in the disposal of cases and appeals are common. The judiciary in Sri Lanka is fairly independent and impartial. The judges are held in high esteem in society and are under constant pressure to maintain transparency in imparting justice. Even though judges are highly regarded, the insolvency rules and regulations may not be firm, thus allowing for the potentially unfair exercise of discretion.

There are no specialised bankruptcy courts in Sri Lanka. Under the Companies Act, the district court, within whose jurisdiction the registered office of the company is situated, has the jurisdiction, among other things, to make orders in respect of winding up, amalgamation and compromises. A district court is a court of general jurisdiction, with unlimited civil jurisdiction in all civil, revenue, family, insolvency (of natural persons) and testamentary matters. The absence of a specialised bankruptcy court and effective tools to supervise and manage the insolvency process makes the whole liquidation process an insignificant part of market dynamics.

Presently, winding up cases are heard by an additional district judge in Colombo, as most winding-up cases take place there. Most of the additional district judges do not have sufficient exposure to commercial law. Lack of facilities and insufficient competent staff affect the insolvency process. No established standards exist for evaluating the performance of the district courts and the judges that supervise the liquidation process. There is a need for training, continuous education and greater interaction of judges with insolvency experts. The quality of judges can be enhanced by providing for transparent, predictable and efficient rules of procedure that leave little room for corruption. The company court rules that govern the liquidation process require review to incorporate modern practices.

In India, there are two separate insolvency courts: the company courts and the BIFR. There are no specialised bankruptcy courts. The company courts are the part of the high court that hears winding up petitions. It is drawn by roster from the judges that make up the full bench of the high court in that state. While high court judges are well regarded and are known to be capable, some are inexperienced in insolvency. This is further complicated by the divergence in procedure between various high courts. SICA provides that the BIFR consist of a chairman, and not less than two, or more than fourteen members. All appointments are made by the central government. The chairman and members of the BIFR are to be drawn from persons of ability, integrity and standing who have special knowledge of and experience in science, technology, economics, banking industry, law, labour matters, industrial finance, management and reconstruction, accountancy or other special knowledge that in the opinion of the central government are useful to the board. In practice, political decisions drive appointments.

Under the Second Amendment, the BIFR would be dissolved and the jurisdiction of the company court transferred to the NCLT. The jurisdiction of high courts in matters pertaining to the Companies Act would also be shifted to the NCLT. The NCLT will have 10 benches across the country and an appeal bench in New Delhi. Any grievance with an appeal bench would have to be addressed to the Supreme Court. The NCLT will have powers and jurisdiction to deal with all the matters relating to the amalgamation, reconstruction, rehabilitation, oppression, mismanagement, revival, and winding up of companies. The proposed NCLT is to be composed of a president and not more than sixty-two judicial and technical members appointed by the central government. The president shall be a person qualified to be high court judge. Judicial members are to be chosen exclusively from persons with a strong legal background. Technical members are to be chosen from persons with other backgrounds, mostly with strong experience in company law or accounting. As with the BIFR, members can also be chosen, provided their experience and knowledge are, in the opinion of the central government, useful to the tribunal.

Judges in India generally enjoy a high degree of independence. Judges at higher court levels enjoy a reputation that is equal to their peers in the leading developed countries. At lower levels of the judiciary, skills and court practices are wanting, especially in commercial areas. Greater specialisation of judges in commercial matters and insolvency is required. The lack of specialisation is a factor in the lack of uniformity in treatment, and the efficiency and handling of cases, which often leads to long drawn-out procedures that take many years to conclude. The creation of the NCLT will go some way toward redressing the inefficiencies of the existing regime. In commissioning the introduction of a new insolvency regime, administrators have flagged their concerns over the operation of the existing structure and recognised the inefficiencies inherent to a decentralised system of corporate insolvency management. The Second Amendment is, therefore, not a complete solution and has a number of defects.

In Nepal, the Insolvency Ordinance provides for insolvency proceedings to be conducted under the supervision of a commercial bench of courts as may be notified by the government in consultation with the Supreme Court of Nepal. No such notification has been issued to date. Till the promulgation of the Insolvency Ordinance, no role was provided for courts in the liquidation process, which was administered and supervised by the OCR.

The judiciary in Nepal is considered reasonably independent though there is a need to improve its efficient and capability, particularly in commercial law. This can be achieved

by enhancing the quality of judges appointed to the courts, and providing for transparent, predictable and efficient rules of procedure that leave little room for corruption. No established standards exist for evaluating the performance of judges. With the assistance from the Asian Development Bank, a national judicial academy was set up for the education and training of judges. Special training programmes on insolvency laws for court judges designated under the Insolvency Ordinance organised by the National Judicial Academy can assist in building the capacity of judges to deal with complex insolvency issues. There is also a need for judges and units with specific expertise in commercial and financial matters.[3]

Prior to the promulgation of the Insolvency Ordinance, the principal participants in liquidation proceedings were the Office of the Company Registrar, liquidators, companies and auditors. There was no role for the courts. Under the outgoing system, there was limited scope and role for supervision by the Office of the Company Registrar. The companies in voluntary liquidation appointed their own liquidator for which no qualification criteria were prescribed. There was no material to judge the integrity of the participants. The process and players were inefficient and unregulated. There were no rules or procedures for conducting liquidation proceedings, and sufficient provisions did not exist to prevent fraud or contain abuse of the system.

The Insolvency Ordinance contains provisions that subject the principal participants to court process and accountability. The court may, (if a complaint is lodged against a licensed insolvency practitioner who fails to act in accordance with the license or the Insolvency Administration Office) report to that effect. The court can suspend or cancel the license after providing an opportunity for defence. The court may issue an order on the following grounds if a license holder: commits any act that is prohibited under the Insolvency Ordinance; carries out the duties negligently or fails to properly carry out duties; becomes bankrupt; or is convicted by a court for an offence of dishonesty or fraud. The court can replace the liquidator, and review the administrator and restructuring managers on the grounds set out under the Insolvency Ordinance.

In Pakistan, the court that administers liquidation is the high court having jurisdiction where the company is registered. The federal government is empowered to confer this jurisdiction on other civil courts as well, but this has not been done. Pakistan has high courts in each of its provinces, namely: Baluchistan, North Western Frontier Province, Sindh and Punjab. The Pakistan high court, though competent and high in its standards, has faced criticism of its independence in some cases. Political interference in the appointment process has raised concern over the continuing influence of the executive over the judiciary.

In general, courts in the region are ill-equipped with material resources. The sheer number of cases before the courts and the cumbersome legislative regime render the system ineffective. Another area of concern in the region includes the lack of independent appointment of judges to forums. The absence of any direct or indirect accountability of these quasi-judicial forums to the people also needs to be addressed. While the high court is generally held in high esteem, and considered impartial and objective, the same is not said of other courts, the lower courts or the tribunals. Written standards, guidelines, advisory opinions, complaint and investigation procedures, and tools to redress improprieties are largely lacking, and it remains to be seen whether they will be adopted to guide new tribunals such as the NCLT which is being set up in India.

Bankruptcy cases should be overseen and disposed of by an independent court or a competent authority and assigned, where practical, to judges with specialised bankruptcy

expertise. Significant benefits can be gained by creating specialised bankruptcy courts. The law should provide for a court or other tribunal to have a general, non-intrusive, supervisory role in the rehabilitation process. The court/tribunal or regulatory authority should be obliged to accept the decision reached by the creditors that a plan be approved or that the debtor be liquidated. Standards should be adopted to measure the competence, performance and services of a bankruptcy court. These standards should serve as a basis for evaluating and improving the courts. They should be enforced by adequate qualification criteria as well as training and continuing education for judges.

Similarly, firm and public rules and regulations, that help to prevent the corruption and undue influence that undermine public confidence in the system, do not exist. As discussed above, the court system is overworked and understaffed. This seems to have led in numerous instances to allegations of less than fair administration of justice. This, coupled with political rather than merit-based judicial appointments, has lead to disputes being settled that are not based on a strict interpretation of law.

There are no performance standards that apply to the courts that have jurisdiction over insolvency or bankruptcy. Bankruptcy cases are handled following the general standards applicable to court procedures. There is no requirement for formal or ongoing training, which means that the experience and knowledge of judges in specialist areas can vary immensely. The Second Amendment (India) seeks to improve upon the standards to measure the competence, performance and services of the NCLT by defining necessary qualifications for the appointment of members of the NCLT and a transparent process for selection and appointment. However, the quality and skills of judges (newly appointed or existing), needs to be reinforced by continuing training. No provision has been made for evaluation procedures for judges based on the standards.

There is a clear need to develop and require specialised training in bankruptcy if such cases fall within a judge's competence and jurisdiction. Training should become more systematic and mandatory. Training will be essential in the event of the introduction of new rehabilitation procedures. It would be beneficial if a training manual were developed to assist those dealing with new or novel types of issues and proceedings.

There is also a need to adopt a specialised approach to resolution and disposal of insolvency cases by courts. Legalistic approaches lead to delays in addition to having an impact on the outcome of proceedings. The supervision of courts should be unobtrusive in nature, confined to setting the roadmap of insolvency, and interjecting only to resolve questions of law. The courts should optimise the use of creditors' committee and professionals in their discharge of various insolvency processes. Questions of law, if raised, should be decided in a timely manner and, unless absolutely necessary, adjournments should be avoided.

An insolvency system should be based on transparency and accountability. Rules should ensure ready access to court records, court hearings, debtor and financial data and other public information. The court should be organised so that all interested parties (including the administrator, the debtor and all creditors) are dealt with fairly, objectively and transparently. To the extent possible, publicly available court operating rules, case practice and case management regulations should govern the court and other participants in the process. The court's internal operations should allocate responsibility and authority to maximise resource use. To the degree feasible, the court should institutionalise, streamline and standardise court practices and procedures. Judicial decision making should encourage consensual resolution among parties where possible, and otherwise undertake timely adjudication of issues with a view to reinforcing the predictability of the

system through the consistent application of law. The court must have clear authority and effective methods of enforcing its judgments.

Court operations and decisions should be based on firm rules and regulations to avoid corruption and undue influence. The court must be free of conflicts of interest, bias and lapses in judicial ethics, objectivity and impartiality. Persons involved in a bankruptcy proceeding must be subject to rules and court orders must be designed to prevent fraud, other illegal activity or abuse of the bankruptcy system. In addition, the bankruptcy court must be vested with appropriate powers to deal with illegal activity or abusive conduct that does not constitute criminal activity.

7) The creditors committee

The existing legal framework in the region does not provide for creditors committees. SICA has no provisions for creditors committees. The Insolvency Ordinance in Nepal introduced the concept of a committee of creditors. The Irani Committee has also recommended creditor's committee for the proposed law on the restructuring of companies. In liquidation, there is a committee of inspections in the laws of India, Pakistan, Sri Lanka and Bangladesh (Table 7).

Table 7. Creditors committees

	India	Sri Lanka	Nepal	Pakistan	Bangladesh
Creditors Committee	None. There is a committee of inspections in liquidation which is rarely used.	None. There is a committee of inspections in liquidation which is rarely used.	Yes. 5 member committee. Terms and procedures not provided.	None. There is committee of inspections in liquidation.	None. There is committee of inspections in liquidation.
Secured Creditors	Fairly defined role. Right to initiate proceedings and seek information, in decision making. Needs improvement.	Fairly defined in liquidation law. Needs improvement.	Fairly defined. Needs improvement.	Fairly defined in liquidation law. Needs improvement.	Fairly defined in liquidation law. Needs improvement.
Unsecured Creditors	No right to initiate restructuring or participate under SICA.	No right to initiate restructuring or participate under SICA.	Can initiate proceedings. Role exists.	Can initiate liquidation only. Role insignificant.	None.

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In Nepal, the establishment of creditors committees is limited to the liquidation process. The law does not prescribe: its role; the terms of reference; process of appointment; meetings; voting; or removal. Classes of creditors are not established. The general assembly of creditors has to determine the jurisdiction and other issues at the time the committee is appointed. The committee cannot appoint a chairman of its choice; the liquidator or the restructuring manager, as the case may be, must chair the committee. The committee has to take decisions by simple majority and, in case of a tie, a draw of lots breaks the deadlock. The current provisions leave scope for manipulation, uncertainty and disputes. Provisions do not exist for consultation with the committee on important decisions. The creditors have no role in appointing the investigator, the reorganisation manager or the liquidator. There is no provision for the creditors' committee in reorganisation proceedings.

8) Insolvency professionals

Engagement of experts (insolvency practitioners) in the insolvency process enhances the efficiency of the insolvency system. Insolvency, bankruptcy, receivership, liquidation and voluntary administration can be complex. The absence of the involvement and participation of professionals possessing appropriate knowledge and skills can impact the quality and efficiency of the entire process. Currently, the laws in the region do not support effective participation of professionals and experts in the insolvency process. Government officials are appointed as liquidators in all South Asian countries except Sri Lanka. The laws do not provide the frameworks that recognise the various services that can be provided by professionals. There is no privatisation of any part of the insolvency process. Outsourcing is limited and disorganised. This has contributed to the inefficiency of the rehabilitation and liquidation process. Some progress was made in India with the passing of the Companies (Second Amendment) Act, 2002 (Second Amendment), which provides for the appointment of liquidators from a panel of firms of chartered accountants, cost and works accountants, advocates, company secretaries or others, as may be prescribed. The initiative was considered insufficient. In any case, it remains unimplemented, since the provisions of the Second Amendment were not notified by the government of India.

9) India: The Irani Committee Report: Opportunities for professionals

The constitution of the Dr. J.J. Irani Expert Committee offered a valuable opportunity to re-visit the issue of participation of insolvency professionals in the insolvency process for Indian policy makers. One of the key recommendations that the Irani committee made was to provide a larger role for and participation of experts and professionals at various stages in the insolvency process. The Irani committee noted and recommended that:

…currently, the law does not support effective participation of professionals and experts in the insolvency process. There is no shortage of quality professionals in India. Disciplines of chartered accountancy, company secretaryship, cost and works accountancy, law etc. can act as feeder streams, providing high quality professionals for this new activity. In fact, private professionals can play a meaningful role in all aspects of process. Insolvency practice can also open up a new field of activity for service professionals while improving the quality of intervention at all levels during rehabilitation/winding up/liquidation proceedings. Law should encourage and recognise the concept of insolvency practitioners (administrators, liquidators, turnaround specialists, valuers etc.).

Greater responsibility and authority should be given to insolvency practitioners under the supervision of the tribunal to maximise resource use and application of skills.

The inspiration for this recommendation is drawn from paragraph 394 of the UNCITRAL Legislative Guide on Insolvency which describes the concept of insolvency practitioner as follows:

Insolvency laws refer to the person responsible for administering the insolvency proceedings by a number of different titles, including administrators, trustees, liquidators, supervisors, receivers, curators, official or judicial managers, or commissioners. The insolvency representative may be an individual or, in some jurisdictions, a corporation or other separate legal entity. However appointed the insolvency representative plays a central role in the effective and efficient implementation of the insolvency law, with certain powers over debtors and their assets, a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially. Accordingly it is essential that the insolvency representative be appropriately qualified and possess the knowledge, experience and personal qualities that will ensure not only the effective and efficient conduct of the proceedings but also that there is confidence in the insolvency system.

If the recommendations of the Irani Committee, including those extracted above, meet the favour of policy makers, the Indian insolvency system will undergo a revolutionary change and come to a par with the international benchmark. Professionals will get the opportunity to participate and perform various roles in the insolvency process. They would be able to be appointed as liquidators, administrators, valuers, turnaround advisors, and supervisors. In addition, they would be able to perform services such as representing and advising creditors committees, individual creditors and other stakeholders, investigators, inspectors, auctioneers, trustees, security advisors, etc.

Nepal has taken a giant leap forward by recognising the concept of insolvency practitioners in its Insolvency Ordinance. The new law provides for licensing of practitioners by the Insolvency Administration Office. Where the liquidation of a company is ordered, the court will appoint an insolvency practitioner as a liquidator, who will take charge of the debtor's management and assets, books and accounts. In restructuring proceedings, the insolvency practitioner also acts as a restructuring manager.

In other South Asian jurisdictions legal reforms are required to provide for the recognition of insolvency practitioners in the framework. Professionals in these countries should engage in a dialogue with policy makers to steer reforms in this area. In Sri Lanka, the Business Recovery and Insolvency Practitioners Association of Sri Lanka (BRIPASL) was established recently and is performing an important role in this direction. Similar initiatives are required in Pakistan and Bangladesh.

The abovementioned situation clearly reflects the growing concern that various Asian jurisdictions share with respect to the need for and importance of a recognised and efficient organisation of insolvency professionals that not only makes insolvency more efficient and expeditious, but also brings the values of the profession to existing insolvency regimes.

The introduction of the concept of insolvency practitioners offers a number of challenges for law makers and professionals. The main challenge is to agree on a suitable

framework for insolvency practitioners and address implementation issues. This needs to be done before the law is drafted in India so that the concept is recognised in law and so that certain substantive and fundamental provisions are incorporated. In Nepal, regulations are required to address these issues.

Regulation

Insolvency affects the interests and rights of broad groups: creditors; employees; shareholders; and debtors. There is also a wider public interest in: limiting the damage of insolvency; supporting the efficient reallocation of resources to productive use; containing the risk of systemic failure; preventing misconduct and pursuing it when it occurs; maintaining confidence in the markets; and providing honest debtors the opportunity to start fresh. In the centre of this stands the insolvency practitioner who has wide powers, duties, responsibilities and functions. This creates the need for a regulatory regime that: requires appropriate qualifications and experience; prescribes codes of professional conduct and ethics covering integrity, impartiality, independence and objectivity; and provides a mechanism for overseeing the performance and conduct of insolvency professional, and for dealing with abuses.

The regulatory framework could be statutory and more formal (as in the case of the other disciplines like advocates, chartered accountants, company secretaries and others). Alternatively, it could be less formal and implemented through a government-recognised self-regulated insolvency practitioners association as is the case in the United Kingdom. The other model is that of Australia where the Insolvency Practitioners Association of Australia (IPAA) and the government of Australia jointly regulate the profession (though the larger role is performed by IPAA). Indian models, like the Institute of Company Secretaries of India (ICSI) and other disciplines, may be worth emulating but would take time to establish if a new law needs to be enacted. The UK model could be ideal for a start. The government should encourage the setting up of an association of insolvency practitioners and provide it recognition.

Most jurisdictions, including the UK and Australia, have adopted licensing regimes. Such a regime is inevitable in India, and professionals should be ready for licensing. The beginning could be made by adopting the process provided in the concept paper and the recommendations of the Irani Committee: the preparation and maintenance of a panel of professionals and experts through an independent process and the appointment out of that by the National Company Law Tribunal (NCLT).

Qualifications: Education, knowledge and experience

The complexity of many insolvency proceedings makes it highly desirable that insolvency practitioners be appropriately qualified with the requisite knowledge of the law. Their knowledge should not only cover insolvency law, but also relevant commercial, finance and business law. Adequate experience in commercial and financial matters is also required. Insolvency practitioners will be required to demonstrate competence in carrying out their assigned functions in a range of different cases and circumstances that: are likely to be contentious; are in both liquidations and reorganisations; where time limits may be imposed; where commercial requirements have to be balanced against legal considerations; and where there is a need to serve the interests of others (such as creditors or the public interest). If further or more specialised knowledge is required in a particular case, it can always be provided by hired experts. Some insolvency laws also require that a person appointed as an insolvency practitioner

in a particular case have expertise and skills suited to that case, and knowledge of the debtor's particular business, its assets and the type of market in which it operates.

The UNCITRAL Guide notes that the qualifications required of a person to be appointed as an insolvency practitioner may vary depending upon the design of the insolvency regime with regard to the role of the insolvency practitioners (including whether the proceedings are liquidations or reorganisations) and the level of supervision of the insolvency practitioners (and of the insolvency proceedings generally) by the court. They may also vary depending upon the procedure for appointment. In determining the qualifications required for appointment as an insolvency practitioner, it is desirable that a balance be achieved between stringent requirements that lead to the appointment of a highly qualified person (which may significantly restrict the pool of professionals considered to be appropriately qualified and add to the costs of the proceedings), and requirements that are too low to guarantee the quality of service required. Where there is a lack of appropriately qualified professionals, the role given to the court in appointing and supervising insolvency practitioners may be an important factor in achieving the required balance.

Different systems adopt different approaches to ensure the appropriate qualification of insolvency practitioners, including: requirements for professional qualifications and examinations; licensing where the licensing system is administered by a government authority or professional body; specialised training courses and certification examinations; and requirements for levels of experience (generally specified in numbers of years) in relevant area (for example, finance, commerce, accounting and law, as well as in the conduct of insolvency proceedings). There may also be requirements for ongoing professional education to ensure familiarity with current developments in law and practice. Those systems that require some form of licensing or professional qualification and membership in professional associations often address issues of supervision and discipline. In addition, an insolvency practitioner may be subject to regulation by the court, a professional association, a corporate regulator or other body under legislation other than the insolvency law.

In addition to having knowledge and experience, it is also desirable that insolvency practitioner possesses certain personal qualities, such as integrity, impartiality and good management skills. Integrity may require that the insolvency practitioners have a sound reputation and no criminal record or record of financial wrongdoing or, in some countries, no previous insolvency or removal from a position of public administration.

Selection and appointment of insolvency practitioners

Whether it is by way of licensing, by panel or any other process, the fundamental prerequisite would be an additional qualification that can form the basis of licensing or empanelment. The Second Amendment leaves a huge gap in this area. While it provides for the creation of a panel from various disciplines, it does not prescribe any criteria to qualify for empanelment. In other words, while advocates, company secretaries and chartered accountants and others would be eligible, there is no basis for allowing or disallowing such a request.

Insolvency laws adopt a number of different approaches to selection and appointment of insolvency practitioners. The UNCITRAL Guide identifies four main selection processes in different country systems.

Insolvency practitioners can be selected from a number of different backgrounds such as from: the ranks of the business community; the employees of a specialised governmental agency; or from a private panel of qualified persons like lawyers, accountants or other professionals. In some jurisdictions, the insolvency law provides that a public official (entitled official trustee, official receiver, official assignee or some other name) will be automatically appointed to all insolvency cases or to certain types of insolvency cases. India follows this process under the Companies Act, 1956. In many countries, insolvency practitioners must be natural persons, but some countries provide that a legal person may also be eligible for appointment, subject to certain requirements such as that the individuals who undertake the work on behalf of the legal person are appropriately qualified and that the legal person itself is subject to regulation.

In many jurisdictions, it is the court that selects, appoints and supervises insolvency practitioners. The selection may be made from a list of appropriately qualified professionals at the discretion of the court. This is what is proposed by the Second Amendment. In some jurisdictions it may be made by reference to a roster, or through a rotation system, or by some other means such as the recommendation of the creditors or the debtor. Roster systems, while ensuring a fair and impartial distribution of cases, may have the disadvantage that they do not ensure the appointment of the most qualified person to conduct a particular case.

In some jurisdictions, a separate office or institution, which is charged with the general regulation of all insolvency practitioners, selects the insolvency practitioners after the court directs it to do so. This approach may have the advantage of allowing the independent appointing authority to draw upon professionals that have the expertise and knowledge to deal with the circumstances of a particular case, including: the nature of the debtor's business or other activities; the type of assets; the market in which the debtor operates or has operated; the special knowledge required to understand the debtor's affairs; or some other special circumstance. The use of an independent appointing authority will depend upon the existence of an appropriate body or institution that has both the resources and infrastructure necessary to perform the required functions; otherwise, it will require the establishment of an appropriate body or institution.

Another approach allows creditors to play a role in recommending and selecting insolvency practitioners, provided that the selected person meets the qualifications for serving in the specific case. The approaches that rely upon the independent appointing authority and the creditor committee may serve to avoid perceptions of bias and assist in reducing the supervisory burden placed upon the courts. A different approach permits the debtor to appoint the insolvency practitioner in cases where the reorganisation proceedings are commenced by the debtor. This approach allows discussions to take place between the debtor and other parties, such as secured creditors, before commencement of the proceedings to familiarise the prospective representative with the business and to allow the debtor to select the insolvency practitioners that it considers best able to conduct the reorganisation. Concerns may be raised, however, as to the independence of insolvency practitioners. These may be addressed by permitting creditors, under appropriate circumstances, to replace an insolvency practitioners appointed by the debtor.

The Irani Committee proposes a process whereby empanelment is done by an independent body and appointment out of them by the NCLT. It is clear that it is essential to filter the feeder streams so that professionals possessing appropriate skills and knowledge can be appointed to provide the various services needed in the insolvency process. These professionals will be termed insolvency practitioners.

Remuneration

In addition to the reimbursement of expenses incurred in the course of the administration of the estate, insolvency practitioners are entitled to receive remuneration for their services. One of the main concerns that arises is the proper determination of the remuneration of insolvency practitioners. It is necessary that the remuneration be commensurate with the qualifications of the insolvency practitioner and the tasks they are required to perform, and achieve a balance between risk and reward in order to attract appropriately qualified professionals.

The UNCITRAL Guide examines several methods for calculating that remuneration. It notes that remuneration may be fixed: by reference to an approved scale of fees set by a government agency or professional association; determined by the general body of creditors, the court or some other administrative body or tribunal in a particular case; based upon the time spent by the insolvency practitioner (and the various categories of person who are likely to work on the insolvency administration from office staff through to the principal appointee on administration of the estate); or based upon a percentage of the assets of the estate which are realised or distributed, or a combination of both (calculated at the end of the procedure when the assets have been sold and their value determined).

A time-based method operates in some cases as an incentive to maximise the time spent on administration without necessarily achieving a proportional return of value to the estate. An advantage of the commission system, at least from the creditors' perspective, is that at least some, if not a substantial proportion, of the assets recovered will be distributed to them. From the insolvency practitioner's point of view, however, it may be an uncertain method of calculation because the amount of work involved in an administration is not necessarily proportional to the value of assets available for distribution. It may also encourage an approach of "maximum return for minimum cost" and provide little incentive for undertaking functions that are not directly related to increasing returns to creditors, such as obligations to report to both the court and to creditors, and to assist regulatory authorities with investigations into the debtor's affairs and possible misconduct. This method of calculation may also lead, in large cases, to very large fees being paid out of the estate, which can deter both creditor and debtor applications.

In some countries, creditors play a role in fixing or approving the remuneration, having regard to factors such as the complexity of the case, the nature and degree of the responsibilities of the insolvency practitioners, and the effectiveness with which these have been discharged, as well as the value and nature of the assets of the estate.

Unattractive fees face the risk of discouraging the best talent from offering its services. The experts and the best of the professionals expect appropriate fees for their services. High fees paid to insolvency practitioners have been the subject of criticism and debate. Clearly, guidelines need to be established for remuneration.

In 2004, the United Kingdom took an initiative in this direction by issuing a Policy Statement entitled The Fixing and Approval of the Remuneration of Appointees, which sets out the court's approach to, and basis for, determining applications for remuneration. The statement identifies eight guiding principles by which applications are to be considered by the court, and considered by applicants in the preparation and presentation of their applications. These guiding principles are: justification; benefit of the doubt (against the appointee); professional integrity; value of service rendered; fairness and

reasonableness; proportionality; professional guidance; and practicality. Inspiration and guidance can be drawn from the 2004 principles.

Liability

The standard of care to be employed by the insolvency practitioner and its personal liability are important to the conduct of insolvency proceedings. Establishing a measure for the care, diligence and skill with which insolvency practitioners carry out their duties and functions requires that the difficult circumstances in which insolvency practitioners finds themselves when fulfilling their duties be taken into account and balanced against payment of an appropriate level of remuneration and the need to attract qualified persons to act as insolvency practitioners. A balance is also desirable between a standard that will ensure competent performance of the duties of the insolvency practitioners and one that is so stringent that it invites lawsuits against insolvency practitioners and raises the costs of their services.

The insolvency law also needs to take into consideration the fact that the liability of insolvency practitioners often involves the application of law outside of insolvency or, where the insolvency practitioner is a member of a professional organisation, the relevant professional standards of the organisation. Under many legal systems, insolvency practitioners are liable in a civil action for damages arising from misfeasance or malfeasance, although different approaches are taken in setting the standard required. To some extent, the measure adopted will depend upon how the insolvency practitioner is appointed and the nature of the appointment (*e.g.* a private practitioner as opposed to a government employee). One approach may be to require insolvency practitioners to observe a standard no more stringent than would be expected to apply to the debtor in undertaking their normal business activities in a state of solvency (that of a prudent person in that position). Some countries, however, may require a higher standard of prudence in such a case because the insolvency practitioner is dealing with assets belonging to another person, and not its own assets. A different formulation is one based upon an expectation that the insolvency practitioner act in good faith for proper purposes. A further approach may be based upon the standard of care required to determine negligence.

One means of addressing the issue of liability for damages may be to require the insolvency practitioner to post a bond or take out insurance to cover the potential loss of assets or damages payable as a result of a breach of duties. A number of insolvency laws require both payment of a bond and insurance (where the bond will cover one kind of damage and the insurance another), while others require only insurance. In some cases, the level of the bond required relates to the book value of the assets of the insolvency estate. In others, both the value of the bond and the amount of insurance cover required are established in the rules of the relevant professional association or regulatory body, or even in the insolvency law. A further distinction between the two approaches may relate to the procedure for making a claim for damages and whether it is different for claiming against a bond or against insurance.

Paying a bond or obtaining personal indemnity insurance, however, may not be possible in all countries and other solutions will be needed. In designing the solution to this issue, a balance may be desirable between controlling the costs of the service provided by insolvency practitioners and distributing the risks of the insolvency process among the participants, rather than placing it entirely upon the insolvency practitioners on the basis of availability of personal indemnity insurance.

Another issue may be the personal liability of insolvency practitioners for obligations incurred in the ordinary course of insolvency proceedings (particularly in reorganisation), such as those relating to the ongoing operation of the business. The advantages of adopting an approach that makes insolvency practitioners personally liable is that it creates certainty for suppliers to the debtor and may operate as a check to incurring debt. At the same time, however, it may also operate as a disincentive if the risk of personal liability far exceeds the fees that may be earned. One solution is to make only the assets of the estate liable, rather than the personal assets of the insolvency practitioners. A further issue of liability relates to the liability of insolvency practitioners for the wrongful acts of the debtor, depending upon the level of control the insolvency practitioner exercises over the debtor's activities. Under some laws, insolvency practitioners may be liable for the wrongful acts of the debtor during the period of their control. But it is not desirable that the insolvency practitioner be liable for acts of the debtor that occurred prior to their appointment such as, for example, environmental damage.

The legislation and implementation of the framework will require further study and discussion, and is expected to take time. There are a number of issues that need to be debated. It is therefore essential that, in the meantime, initiatives be adopted by policy makers and professional bodies that can create a suitable environment for smooth transition when a formal framework is created. The first initiative required is the setting up of an association of insolvency practitioners drawn from various feeder disciplines. The association should develop into a representative body that can enter into a dialogue with policy makers and debate the various issues to form a consensus on the regime that should be created for insolvency practice.

10) Recent developments and ongoing reforms

In December 2002, the Indian parliament passed the Second Amendment to restructure the 1956 Act, leading to a new regime for corporate rescue. The Second Amendment proposes amendment of the provisions of the 1956 Act for setting up of a NCLT and its appellate tribunal. Under the proposed legislation, NCLT will have the power to consider: the revival and rehabilitation of companies; jurisdiction and power relating to the winding up of companies; and jurisdiction and power exercised by the Company Law Board under the 1956 Act. The Company Law Board will stand abolished. The government of India notified certain selective provisions to facilitate the setting up of the NCLT and appointing its chairman and members. The intention is to set up the tribunal, create infrastructure and then notify other provisions to provide jurisdiction to tribunals. The implementation of the Second Amendment, however, suffered a setback when, earlier this year, the Madras High Court set aside certain provisions of the amendment on a challenge made by the bar association of that court, thus bringing the setting up of the NCLT to a grinding halt. The high court found a few provisions relating to the appointment and conditions of service of members of the tribunal to be unconstitutional. The matter is currently before the Supreme Court of India in an appeal proffered by the government of India.

The rest of the provisions of the Second Amendment are yet to be notified, and the SICA has still not pulled the shutters down, as the Sick Industrial Companies (Special Provisions) Repeal Act 2002 passed by the parliament still awaits notification. Till then, while the BIFR continues to deal with the revival and rehabilitation of companies, the high court retains its jurisdiction as the liquidation court under the 1956 Act.

11) Ongoing reforms: the Dr. J. J. Irani Committee

The Second Amendment was received by stakeholders with caution. The alternative mechanism under the Second Amendment is perceived as an old tablet in a new foil. The powers and jurisdiction of the BIFR are now to lie with the tribunal with some cosmetic changes. The only substantial difference is that while the BIFR had the responsibility for attempting the revival of dying companies, the tribunal will have to not only attempt revival but also perform the last rites if the attempt fails. Barring a few significant changes, the Second Amendment does little to solve the problems faced under SICA. No significant change is made to expedite the liquidation process and make the process efficient.

The Indian experience with rehabilitation has been so disappointing that there has been a knee jerk reaction by taking away the moratorium provision which, under SICA, sounded the death knell for many creditors. Under the existing provisions of SICA, it was experienced that the entry level for seeking ameliorative measures by the sick unit was too late, owing to the criterion of 100% erosion of net worth. Under the Second Amendment, 50% erosion in average net worth for the last four years of the reference year, or three successive defaults in paying instalments to creditors becomes the deciding factor for entry-level eligibility of a sick unit. However, bringing into the purview of the NCLT a case of incipient sickness would be defeated, considering the period of 180 days and a further extension of 90 days that are provided for filing a reference.

In other words, the Second Amendment does not provide a comprehensive law to deal with corporate bankruptcy. In the fast changing scenario of growing cross-border investment, trade and commerce, cross-border insolvency problems are bound to increase and only a comprehensive bankruptcy law can address such issues taking into consideration international practices. It does not introduce the required roadmap for bankruptcy proceedings *viz.* application for initiating bankruptcy proceedings; appointment and empowerment of the administrator; operational and functional independence; accountability to the court, including the power of the court to remove the administrator in case of mismanagement; the relationship with current management; monitoring or substitution; day-to-day operation; time-bound restructuring/recognition plan: who should submit; procedure of acceptance; mechanism to sell off; pro-active initiative of the administrator; number of time-bound attempts for restructuring: decision to go for insolvency and winding up; and strategies for realisation and distribution.

The establishment of the Dr. J. J. Irani Expert Committee on Company Law offered an excellent opportunity to deal with the weaknesses of the Second Amendment.

12) The Irani Committee recommendations

On 31 May 2005, the Dr. J.J. Irani Expert Committee on Company Law handed its report to the government of India. The committee was set up by the government to recommend a new company law, including the insolvency law, as a part of the ongoing legal and financial sector reform process in the country.

The committee proposed significant changes in the law to make the restructuring and liquidation process speedy, efficient and effective. Recommendations are directed at restoring the eroded confidence of key stakeholders in the insolvency system while balancing their interests.

An early and easy access to debtors to explore revival opportunities that is triggered on default in payment of due debt is proposed. A limited standstill period was

recommended. This provision was taken out by the 2002 amendment to the insolvency law due to its abuse by dishonest debtors seeking protection from creditors. To check its misuse, it was proposed that, rather than being automatic, stay should be on the order of the court, made with consent of the majority of the creditors. It proposed measures that enable decisions by the majority of creditors on key issues including voting on the plan through the establishment of a creditors committee. A separate committee for other creditors with no voting rights is also proposed.

The committee recommended the recognition of the concept of insolvency practitioners and suggested effective engagement of professions in the insolvency process to maximise resource use and the application of skills. Currently, the law does not support the effective participation of professionals and experts in the process.

Other significant recommendations include: a definite and predictable timeframe of one year for rehabilitation and two years for the liquidation process; testing debtor's capacity to continue in management and their replacement by independent administrators failing such test; automatic stay on the debtor's right to deal with assets except in the normal course of business; establishment of an insolvency fund to meet the costs of the insolvency process; public interests and government claims not getting precedence over private rights; rules dealing with jurisdiction, recognition of foreign judgments, co-operation and assistance among courts in different countries; and choice of law including by adoption of the UNCITRAL Model Law on Cross Border Insolvency.

It has been recommended that the NCLT should have a general, non-intrusive and supervisory role in the rehabilitation and liquidation process. Greater intervention of the tribunal should be required only to resolve disputes by adopting a fast track commercial approach observing the established legal principles of fairness. The tribunal should possess specialised human resources, who are trained and educated on a continuous basis.

The recommendations of the committee, when translated into law, will bring the Indian law up to international standards. The recommendations are based on established global principles such as the UNCITRAL Legislative Guide on Insolvency Law.

However, any sound legislative framework depends for its success upon a predictable and effective judicial process coupled with efficacious enforcement mechanisms. There is a need to focus and improve upon implementation and execution. Also, there is a need for more creative and commercial approaches to corporate entities in financial distress, and attempts to revive, rather than the more traditional and conservative liquidation or bankruptcy. As such, socio-economic compulsions dictate that before liquidating financially distressed companies, some attempts must be made to rescue them. The quality and skills of judges (newly appointed or existing), will need to be reinforced by continuing training.

The new law would offer tremendous opportunities to professionals to provide services in various forms through the insolvency process. The professionals need to prepare for the provision of such expert and specialised services. The respective professional bodies would need to establish appropriate education and training programmes for their members.

The international and domestic business and financial community are keenly observing developments in India. Many global investors are waiting at India's doorsteps for the new insolvency law to be enacted so that they can start making investments. It is hoped that the bill would be introduced in the parliament and passed as a law as soon as possible.

The recently promulgated Insolvency Ordinance in Nepal introduces a new legal framework for the insolvency of companies in Nepal. Until now, there was no law on reorganisation, while the repealed Company Act 2053 (1997) governed liquidation. The old law did not have any role for the courts; the highly inefficient Office of the Company Registrar supervised liquidation. In comparison, the Insolvency Ordinance is a fairly comprehensive legislation.

At present, a bill is in preparation in Pakistan whose object is stated to be "to amend and consolidate the law regarding corporate insolvency and financial rehabilitation". This bill, if enacted, would replace the existing corporate insolvency regime. The bill is divided into five chapters. The rehabilitation aspects of the proposed legislation bear similarity to the Chapter 11 provisions of the United State Bankruptcy Code. The first chapter covers general provisions which describe jurisdiction of the courts, the entities covered by the legislation, and the main roles of players. It visualises the creation of the office of an "official administrator", and the constitution of "advisory committees". The second chapter relates to case administration and contains sub-chapters covering commencement and prosecution of cases, the role of officers (such as the administrator, who may also engage services of professionals); administration matters relating to committees and the examination of the debtor; and a sub-chapter relating to administrative powers. The third chapter relates to creditors, debtors, and the estate, while the fourth covers rehabilitation. The final chapter refers to provisions of existing law that stand repealed.

A distinctive feature of the new legislation is that commencement of the case operates as a stay of: all legal proceedings; attempts to collect or recover claims against the debtor that arose before the commencement of the case; exercise of right of set-offs; and also any acts aimed at creating, perfecting or enforcing any lien against the property of the estate or taking possession or control of the same. In the existing law, a petition for corporate re-organisation does not operate as an automatic stay. The court has the power, if it sees fit, to grant a stay. Under the proposed legislation, commencement of a case would at least ensure breathing space for the debtor while the rehabilitation plan is under the process of approval, so that the debtor would not be harassed by creditors or persons laying claim to the debtor's estate. The office of the liquidator would be substituted by that of the "official administrator".

Hopefully, Sri Lanka and Bangladesh will provide the necessary attention to the reforms required in this area.

There are considerable efforts underway in South Asian countries to introduce reforms into their respective systems. The ultimate impact of the actions put forward in these countries will be reflective of the degree of enforcement by regulators. There is a need to provide an insolvency regime that strikes a balance between liquidation and reorganisation. There is a need for more focus on implementation. Even a well-intentioned law, if not properly implemented, can fail to serve its purpose however good the law may be. The essential features governing a model formal restructuring process in any part of the world are common (if not alike), though they may be structured differently. Then why do they fail to work in one country and do well in another? Greater focus on improving implementation and execution is required. Also, there is a need for more creative and commercial approaches to corporate entities in financial distress, and greater efforts to revive them rather than applying the more traditional and conservative approach of liquidation or bankruptcy.

Notes

1. Ali Shaikh, Salman (2003),"Value Maximisation of Non-Performing Loans and Distressed Assets: Pakistan's Experience", Third Forurm for Asian Insolvency Reform (FAIR).
2. Ibid.
3. World Bank (2005), *Nepal–Legal and Judicial Environment for Financial Sector Development–A Review by the World Bank.*

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INDONESIAN BANKRUPTCY LAW: AN UPDATE

by
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The Law on Bankruptcy of June 1905, as amended in 1998 during Indonesia's economic crisis, has been fully replaced. The new Indonesian Bankruptcy Law (Law Number 37 of 2004 on Bankruptcy and Suspension of Payment) was promulgated on 18 October 2004. But, the new law has yet to obtain legitimacy due to inadequacies in the amendments made in 1998 and some fundamental problems in the judiciary itself, which are now being addressed by a Judicial Commission that was established on 2 August 2005.

The following important provisions have been made in the new law: 1) definitions; 2) more detailed limitations on who may file bankruptcy petitions; and 3) procedures and time frames involved in the process of bankruptcy and suspension of payment of companies in Indonesia.

1) Definitions

To avoid different interpretations, the new law contains clearer definitions of the legal principles, concepts and words used in the law.

A loan is defined as an obligation that: can be measured/stated in the form of money; can be either in Indonesian currency or any foreign currency; will mature directly or contingently; is based on an agreement or laws; and will entitle the creditor to be compensated from the debtor's assets in the event of default.

Maturity (due and payable) is defined as the obligation to repay a loan that is due in accordance with an agreement, or is due based on a sanction or fine imposed by an authorised government agency, or based on a decision of a court or arbitrator.

Maturity means that a debtor, who has two or more creditors and does not repay in full at least one debt which is due and payable, can be declared bankrupt by the court. The requirement that the loan be repaid in full was not in the old bankruptcy law. If the above conditions are met, then a petition for bankruptcy may be filed with the relevant commercial court.

2) Petitions

Subject to the specific limitations mentioned below, a bankruptcy petition or suspension of payment submission may be based on the debtor's own application or an

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application by one or more of its creditors. Specific procedures and limitations apply for the following legal entities: 1) Bank Indonesia is the only institution authorised to file a bankruptcy petition (or suspension of payment petition) relating to a bank; 2) the Capital Market Supervisory Board is the only institution authorised to file a bankruptcy petition (or suspension of payment petition) relating to a security company, the stock exchange, a guarantee clearing institution, or a central securities depository; and 3) the Ministry of Finance is the only institution authorised to file a bankruptcy petition (or suspension of payment petition) relating to an insurance or re-insurance company, pension funds, and state-owned enterprises that operate in the public interest. (State-owned enterprises that operate in the public interest are those whose capital is entirely owned by the government of the Republic of Indonesia.)

Public prosecutors may also submit bankruptcy petitions in the event that: a company (debtor) has two or more creditors and fails to repay at least one due and payable loan, and no bankruptcy petition has been filed against such debtor, and the reason for filing the bankruptcy petition is to protect the public interest. "Public interest" refers to the following: 1) the debtor has absconded; 2) the debtor has embezzled part of its assets; 3) the debtor owes money to state-owned enterprises or another entity which collects money from the public; 4) the debtor has obtained a loan which is derived from the accumulation of public money; 5) the debtor does not show good faith or is uncooperative in solving its matured debts; or 6) other reasons that according to the public prosecutor are within the scope of the public interest.

3) Procedures and time frame

The following are the relevant procedures and time frame for a bankruptcy proceeding:

1) A bankruptcy petition will be submitted by the court registrar to the chairman of the commercial court within two days after the date of registration (extended from the previous 24 hours);

2) Within three days after the date on which the bankruptcy petition was registered, the court will review the application and determine the date of hearing (the previous time frame was two days);

3) The bankruptcy decision must be felled within 60 days from the date the bankruptcy petition was registered (previously 30 days);

4) The bankruptcy decision must be sent by express registered mail to: the debtor, the applicant, the receiver, and the supervisory judge, within three days of the date on which the decision was read (previously within two days by registered mail or via courier);

5) A petition for cassation (appeal to the Supreme Court) or civil review (by the Supreme Court of its decision), can be submitted only to the court registrar who will forward it to the counterparty within two days of the date the petition was registered (previously the party who filed the petition had to also distribute it to the other counterparty on the date of registration, and the time frame for the court register to send the application was 24 hours);

6) The counterappeal must also be distributed by the court registrar to the applicant within two days of the date on which it was received;

7) The appeal hearing must be conducted within 20 days of the date the application was received (as before);

8) The decision must be made within 60 days from the date the application was received (previously 30 days);

9) A copy of the decision must be delivered by the registrar of the Supreme Court to the registrar of the district court within three days after the date on which the decision was read (previously the Supreme Court had to deliver copies to the registrar, applicant, counterparty, receiver and supervisory judge within two days);

In bankruptcy proceedings, a summons issued by the court registrar will be deemed to be validly received by the debtor if the summons has been issued by registered express mail at least seven days before the first hearing is to be conducted.

Receiver

A receiver must be independent, have no conflict of interest with the debtor or creditor, and not be handling more than three bankruptcy and suspension of payment cases.

The right to manage the company under bankruptcy status

It is clear that despite a debtor company losing its right to control and manage its assets from the date the bankruptcy decision has been declared (from midnight at the beginning of that date), the board of directors (BoD) and the board of commissioners (BoC) of the company will remain responsible for the day-to-day activities of the company, provided that any and all corporate actions that will cause a decrease in the bankruptcy estate must be under the sole authority of the receiver. This is a significant amendment. However the BoD and BoC will have no right to conduct any corporate action which may decrease the value of the bankruptcy estate.

Transfer of funds and transactions on the stock exchange

The new law has also made it clear that if before the declaration of bankruptcy: 1) a fund transfer has been made through a bank or other financial institution, such transfer must be continued (this is to guarantee the legal certainty of the fund transfer to be conducted through the bank); and 2) a security exchange transaction has been conducted on the stock exchange, then such transaction must also be continued (this is to ensure the legal certainty of capital market transactions on the stock exchange).

Detention

Based on the new law, a debtor who is under detention (*gijzeling*) by the police or the public prosecutor must be released immediately once the bankruptcy decision has been declared. It should be noted that this differs from the previous law which provided that such debtors will be released only when the bankruptcy status has obtained legal certainty (*in kracht van gewijsde*).

Employment relationship

Under the new law, an employment relationship may be terminated by either the employer (the company) or the appointed receiver, subject to the provisions of the prevailing labour laws, provided that at least a 45 days' notice is sent before the termination (the old law mentioned that the time frame was limited to at least six weeks). The new law also clearly provides that after the date of the declaration of bankruptcy, any

unpaid salary prior to or after the declaration of the bankruptcy decision will be a part of the debt of the bankruptcy estate.

Suspension of payment

With regard to the suspension of payment, it is interesting to note that the new law provides that an unsecured creditor may file a petition for suspension of payment. Previously, only the debtor was entitled to file such a petition.

If a petition for suspension of payment is filed by a debtor, the court must approve the temporary suspension within three days after the petition was registered, and appoint a supervisory judge and one or more administrators that will jointly manage the debtor's asset with the debtor. On the other hand, if the petition is filed by a creditor, the court will approve the temporary suspension of payment within 20 days, and appoint a supervisory judge and one or more administrators that will jointly manage the debtor's assets with the debtor.

Immediately following the declaration of temporary suspension of payment, the court, through the administrator, must call the debtor and creditor by registered mail or courier to appear in a hearing to be conducted within 45 days from the date the temporary suspension of payment was declared. In the event that the debtor is not present at such hearing, the temporary suspension of payment will immediately terminate and the court must declare the debtor bankrupt.

Under the new law, the court will determine the granting of suspension of payment based on the votes of both unsecured and secured creditors, with the approval vote of more than half of each type of creditor that is present at the hearing as long as creditors represent at least two-thirds of the total outstanding receivables payable to respective secured and unsecured creditors who are present at the hearing.

4) Ongoing issues

Risks

The general risks that those using the bankruptcy legislation face are both the lack of experience and the lack of knowledge on the part of those with the responsibility to administer the law. The special risk that debtors face is the relative ease with which a declaration of bankruptcy can be obtained. But this was the specific intention of the drafters of the law–to force debtors to pay. While this ease is the basic criticism that the law faces, it is its basic strength in the hands of genuine creditors.

Who may petition?

Who may petition for bankruptcy? Art 2(1) defines this as a creditor of a debtor with two or more creditors with at least one debt due and payable. The creditor must, therefore, establish in his petition:

1. That there is another creditor besides himself; and
2. That a debt (not necessarily his own) is due and payable and has not been settled in full.

It is important that the amount of the debt be clearly established and that the debt is due and payable. It is not sufficient that an invoice has been issued. An invoice must always state when the amount becomes due and payable. And it is not sufficient that the

creditor claims that the debt is due. It must be clear that the debtor acknowledges the debt, but refuses to pay. It is this point that has caused much controversy in some recent high profile cases (*e.g.* the Manulife matter), where the court did not grasp this basic requirement, and brought the law into disrepute.

It is not for the creditor to claim that it is clearly solvent. That is not the basic issue. It is firstly and above all the duty of the claimant to show that an agreed debt has not been paid in full, and then it is the duty of the creditor to explain why it has not paid all its debts.

Does bankruptcy mean insolvency?

Unlike in other jurisdictions, this is not the case in Indonesia. Bankruptcy is a simple declaration pursuant to Article 2 that a debtor with two or more creditors has not fully paid a debt which is due and payable. It is a separate issue from insolvency. Insolvency may follow. Formal insolvency does not occur until a composition (plan of action) is either not presented or is rejected.

Bankruptcy was a difficult declaration to achieve previously. The old repealed law provided that bankruptcy (still not insolvency) would be pronounced "if it appears… that the debtor's condition is such that he has stopped making payments". So, judges previously held that if a debtor paid even a small fraction of an agreed payment, he could not be declared bankrupt. This confusion has now been cleared away.

May a petition be withdrawn?

The nature of a bankruptcy petition is that there is always more than one creditor whose interests are to be considered. This distinguishes it from other civil actions. However, it appears that a petition may be withdrawn before bankruptcy is declared. After bankruptcy has been declared, progress on the matter becomes the decision of all creditors.

May a secured creditor petition?

The law is silent, meaning that a secured creditor may petition. While this is an issue of some debate, the fact is that the law does not prevent a secured creditor from petitioning.

Is there a minimum debt?

There is no minimum debt. But, there is public criticism of this coming from "big business". The basic purpose of the law is to force debtors to pay, regardless of the amount they may owe, big or small.

What if there is an arbitration agreement?

It may be necessary to arbitrate to determine whether a debt is in fact due and payable, and/or the amount of the debt. If there is no doubt regarding this, then a petition for bankruptcy may be made. This is then no longer a matter of arbitration, but debt recovery.

What if a debtor pays a reduced amount of agreed instalments?

The new law clarifies beyond doubt that a debt must be settled in full, or the debt may become the basis for a petition for bankruptcy.

Liabilities of directors and commissioners

Directors (Company Law Article 85) and commissioners (Company Law Article 98) may be held liable for fault or negligence. But fault and negligence are not defined. Some commentators view this as placing reliance on the common law concept of fiduciary duty.

There are provisions in the Criminal Code (KUHP) to deter directors and commissioners from entering into certain loans, but it is not clear whether these provisions would extend to penalties for continuing to trade when in a state of inability to repay (common law insolvency). The Bankruptcy Law itself is silent on this matter though, under common law, unless a director is fully informed and acts reasonably, he or she can be held personally liable for all faults of the company.

Can a guarantor be declared bankrupt?

The Indonesian Civil Code has been interpreted by the Supreme Court to mean that the civil status of the principal debtor cannot be transferred to a guarantor, even though the guarantor can be held responsible for the primary debt. Therefore, the guarantor cannot be declared bankrupt. However, if the guarantor waives its preferential rights (as is generally required by creditors), then it appears it may be able to be declared bankrupt.

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ISSUES ARISING IN THE CROSS-BORDER INSOLVENCY OF GROUPS OF COMPANIES IN JAPAN

by
Shinjiro Takagi

1) The Law of Recognition and Assistance for Foreign Insolvency Proceedings

In 2000, Japan enacted the Law of Recognition and Assistance for Foreign Insolvency Proceedings (LRAFIP) which adopted almost all the provisions of the UNCITRAL Model Law on Cross-Border Insolvency, and abolished the notorious territorialism contained in Japanese insolvency laws for so many years. Since the LRAFIP became effective in 2002, only two cases have been filed (one by a foreign trustee and the other by a debtor in possession), calling for recognition and assistance under the LRAFIP.

The former case was Jinro, a big Korean distiller, that filed a corporate reorganisation case in Seoul. The latter was Azabu Building, a Japanese real estate company, that filed Chapter 11 in Honolulu. Both cases were filed for the purpose of preserving their assets located in Japan. The Tokyo District Court issued its decision to recognise and assist the foreign proceedings. Jinro had several subsidiaries but, so far, no complications have arisen with respect to the corporate group problem in inbound cases.

As for an outbound case, in 1991, before the enactment of the LRAFIP, soon after the filing of a petition by the trustee of Maruko (a reorganising company under the Corporate Reorganisation Law pending in the Tokyo District Court), a parallel Chapter 11 proceeding was commenced in the Bankruptcy Court of the Central District of California. Both cases proceeded simultaneously. The reorganisation plans were filed, accepted and confirmed in Tokyo and Los Angeles in almost the same week. Both plans were substantially similar in respect of the impairment of debts and equities. Maruko's subsidiary located in Australia owed trade debts to Australian contractors for ongoing projects of resort condominiums at that time. After negotiation with the contractors, the Japanese trustee paid the debts at the settled amounts to the contractors in order to sell the development project, and both the Tokyo District Court and the Bankruptcy Court for C.D. California approved the transaction.

2) Workout for international corporate group cases handled by the Industrial Revitalisation Corporation of Japan

The Industrial Revitalisation Corporation of Japan (IRCJ), which is a government-backed asset management corporation with a limited life, has assisted 41 business corporation groups between May 2003 and March 2005. The IRCJ has purchased debts owed by distressed companies to financial institutions. The IRCJ has restructured the purchased debts by means of partial debt forgiveness and/or debt equity swaps through

out-of-court workout together with financial institutions. In some cases, the IRCJ has also infused new money into the assisted companies as capital. The IRCJ has helped large corporate groups such as Kanebo and Daiei.

The IRCJ also helped Mitsui Mining, which was a corporate group. The parent Mitsui owed significant amounts of debt to a foreign bank. After repeated and intensive discussions, the foreign bank consented to the proposed debt restructuring plan.

Fortunately, only a few complex cross-border issues have arisen in the out-of-court workout reorganisation of large corporate group cases so far. However, difficulties may emerge in the near future as Japanese corporations resume their overseas investment in parallel with the economic recovery.

The Kanebo case

The Kanebo groups has engaged in several businesses including cosmetics, food, medicine, natural and chemical textiles, appliances and others. The group consisted of 55 domestic subsidiaries and 8 affiliated companies. In addition to these subsidiaries, there were 30 subsidiaries and affiliated companies in Brazil, China, France, Germany, Indonesia, Italy, Mexico, the UK, and the US.

The IRCJ helped to restructure debt owed to about 100 financial creditors by 35 domestic Kanebo companies, including the parent company, out of 59 domestic affiliated companies. Regarding the remaining 24 affiliated companies, there was no need to help because they were solvent or debts owed to creditors outside the Kanebo group were immaterial. As for the 35 companies helped by the IRCJ, the debts were so complexly tied up that it was not realistic to single them out. There were downstream, upstream and cross-guarantees between group companies. There were also inter-group debts. The brand name of Kanebo was well-established for more than a century in Japan and also widely recognised overseas. Management of the parent company controlled subsidies directly or indirectly.

After the public announcement of the IRCJ's assistance to Kanebo, the parent company guaranteed all debts owed by subsidiaries to external creditors, subject to the condition that all financial creditors whose debts were to be impaired by the proposed debt restructuring plan consent to the plan. After intensive negotiations, unanimous consent to the plan was obtained. Partial debt forgiveness on a prorated basis, and other debt restructuring were consummated according to the plan.

Except for selected viable cosmetics wholesalers that could continue their businesses in Europe and the US, most foreign subsidiaries were sold or closed because they were mostly engaged in non-core businesses with no synergies with the intended core business after debt restructuring.

When the number of shares was enough to control the subsidiaries, they were sold to buyers by auction. If the affiliated company was a joint venture with a foreign partner, the stock owned by Kanebo was sold to the partner at a price settled by negotiation based on a valuation made by professional advisers.

Fortunately, most foreign subsidiaries and their affiliated companies were solvent and able to pay their debts in full. Although a few affiliated companies located in China were insolvent, the parent Kanebo had to pay the affiliated companies' debts in full and supply additional money before leaving the country for fear that liquidation costs might exceed the unpaid debts. For these reasons, there was no need to file insolvency or out-of-court workout proceeding in foreign countries.

The Daiei case

Daiei was a giant retailers operating more than 250 general merchandise stores, supermarkets and discount stores. The IRCJ helped 12 companies out of 115 affiliated companies which belonged to the Daiei group. The group companies owed debts to more than 100 financial institutions which were not related to the group. The IRCJ helped only subsidiaries with excessive debts owed to unrelated creditors and controlled by Daiei. The parent Daiei also guaranteed the subsidiaries' debts and restructured these debts in a similar manner to Kanebo. Daiei had two subsidiaries in the US and three subsidiaries in China. These foreign subsidiaries were solvent and there was no need to help. Daiei sold these foreign subsidiaries according to the accepted reorganisation plan that had been drafted with the assistance of the IRCJ, and paid their debts in full using the money received from the sale of the companies.

3) Consolidated statutory corporate reorganisation proceedings

Both the Japanese Corporate Reorganisation Law and the Civil Rehabilitation Law provide for procedural consolidation when the administration of reorganising companies is practical and reasonable. Neither law, however, provides for the substantial consolidation that is provided by the US Bankruptcy Code.

Usually, both the Tokyo and Osaka district courts consolidate the reorganisation proceedings for corporate group companies. These courts used to appoint trustees for subsidiaries at the recommendation or consent of the trustee of the parent reorganising corporation so that reorganisation proceedings of the group companies could be dealt with in a harmonised way and reorganisation plans of group companies could be drafted simultaneously to avoid any possible contradiction and observe and duly refer to the fair, equal and equitable rule, which is the basic principle common to insolvency laws.

The reorganisation proceedings regarding group companies are administered in a collaborative manner by a team of trustees who are closely related to each other, and all the proceedings are developed simultaneously or at a harmonised pace.

LATEST TRENDS AND DEVELOPMENTS IN INSOLVENCY LAW IN NEPAL

by
Bharat Raj Upreti*

1) A brief overview of the Nepalese legal system[1]

a) Introduction

Nepal did not exist as a single country in a true political sense prior to unification by King Prithivi Narayan Shah Dev in 1768 (1825 Bikram Sambat). Present day Nepal was divided into various small kingdoms. The Kathmandu valley itself consisted of three separate kingdoms. All of the separate kingdoms had their own set of legal systems and ruled mainly on the basis of religion.

Even after the unification of Nepal in 1768, there was no unified set of legal rules, and the laws were scattered in various royal decrees, customs and religious practices. The first codified law that applied to a unified Nepal was the Muluki Ain (the Country Code), which was introduced in 1853. The Muluki Ain of 1853 was repealed by the existing Muluki Ain 1963 (2020). The Muluki Ain contains both substantive and procedural laws, and covers both criminal and civil matters. The Muluki Ain is a general law, the provisions of which are overridden by specific law. Matters dealing with the registration of security for immovable assets, such as land, the enforcement of such security, etc. are governed by various chapters of the Muluki Ain.

The legal system of Nepal is predominately influenced by the common law system, though there are some elements of continental law as well. For example, the Contract Act 2056 does not require consideration to enforce a contract. However, most commercial laws are based on common law.

Commercial laws were mainly introduced in the 1930s. In 1936, the Company Act, and the Patents, Design and Trademark Act were introduced. The legislation dealing with banks was introduced through the enactment of the Banking Law of 1937. Specific contract law legislation was introduced in 1966. Prior to that, contractual relationships were governed by Section 37 of the Muluki Ain entitled Loan Transactions.

b) Court system

There are three layers of courts. District courts are the courts of first instance. The Court of Appeal has appellate jurisdiction, and the Supreme Court of Nepal is the highest court. There are 75 district courts and 16 courts of appeal. All the regular courts have

* Pioneer Law Associates.

general jurisdiction. There is no separate commercial court to handle commercial disputes such as the enforcement of contract, or property rights. There are certain specialised courts and tribunals such as, for example, the labour courts, and the Special Court (which is the court of first instance to hear corruption and drug-related cases). Very recently the Debt Recovery Tribunal was also established.

c) Parliamentary system

The Constitution of Nepal of 1990 is the supreme law of the land; it contains the principle of constitutional supremacy. The Constitution also calls for a bicameral parliament. The lower house of the Parliament is called the Parthinidhi Shaba and the upper house is called the Rastryia Shaba. Laws are passed by the Parliament, which take force after receiving assent from the King. Unfortunately, the Parliament was dissolved two years ago when the King dismissed the elected prime minister.

2) Insolvency law before 2005

The concept of insolvency law in Nepal began with the personal bankruptcy law, which was introduced in 1853. The existing personal bankruptcy law is governed by the Chapter on Bankruptcy (Damasahi Ko Mahal) of the Muluki Ain. It is interesting to note that there have never been any reported cases of personal bankruptcy.

Before the promulgation of the Insolvency Ordinance, bits of corporate insolvency law were scattered throughout various items of legislation. For example, commercial banks were governed by the Banks and Financial Institution Ordinance 2005. The laws related to the registration of real estate mortgages, the enforcement of securities, and court judgments were dealt with by different chapters of the Muluki Ain. The insolvency of government corporations was governed by their respective acts of incorporation even though, in some cases, the liquidation of some government-owned autonomous business entities was not defined. Liquidation of companies with limited liability was governed by the Companies Act 1997, which lacked detailed provisions, and covered both voluntary and involuntary liquidation in a scant 19 sections. The Partnership Act 2020 dealt with the dissolution and insolvency of partnership firms. Thus, the old insolvency law regime suffered from a wide variety of defects and shortcomings.

Under the old regime, it was extremely difficult for creditors to initiate liquidation proceedings. First, only creditors representing a minimum of 50% of the total outstanding dues could apply and, second, the maturity date of the claim for the purpose of initiating proceedings was very long. If a borrower wished to initiate an insolvency process, the debt had to be outstanding and remain unpaid for more than one year. There was no room for individual shareholders to initiate proceedings, nor was there any legal authority to supervise or regulate the insolvency process.

Another serious shortcoming of the old regime was that it did not have any provisions for re-organisation. As a result, the only option for companies in financial difficulty was liquidation. Furthermore, the old law did not prescribe qualifications for liquidators. Liquidators were appointed without regard to objective criteria, and there was no regulatory authority to supervise the insolvency profession.

There was no separate Insolvency Administrative Office. As a result, all administrative matters related to insolvency were handled by the Office of the Company Registrar, which is not a judicial body. In addition, the Office of the Registrar was over-burdened with matters such as the incorporation of companies, and managing filings and

annual returns. Moreover, it had no unit devoted specifically to insolvency matters, and lacked trained manpower.

3) Latest developments in insolvency law : The Insolvency Ordinance of 2005

The government of Nepal promulgated its first corporate Insolvency Ordinance on 23 September 2005. The enactment of this law was a milestone in the process of modernising commercial law in Nepal. The process was started in 2002 with a technical assistance grant from the Asian Development Bank. The ordinance is based on the principle of "one law, two systems" as it covers both the law of liquidation and the law of rescue/restructuring.

4) The salient features of the new Insolvency Ordinance 2005

The Insolvency Ordinance of 2005 covers companies with limited liability. It leaves out personal bankruptcy and statutory corporations fully owned by the government from its ambit. It also covers banks and financial companies, though the prior approval of the central bank is required before initiating an insolvency procedure. Insurance companies are also covered, but require prior approval from Beema Sameti (the insurance regulatory authority). Voluntary liquidation was also excluded from the law, though it remains part of the new Company Ordinance 2005.

The recently introduced Insolvency Ordinance incorporates most of the accepted good principles of insolvency law and overcomes most of the difficulties under the existing Company Act 1977. The ordinance is one of a kind in South Asia and could be a valuable model for other countries in the process of reforming their insolvency law. In fact, no other country in South Asia provides for re-organisation as part of its general law on insolvency. Some of its salient features are discussed below.

a) Access

The ordinance provides for easy access to the insolvency process and is in line with accepted good principles of insolvency law in this respect. Under the ordinance, 5% of the creditors, or 5% of the total shareholders of the company, or 5% of the debenture holders can initiate insolvency proceedings. This should help root out insolvent companies from the market.

b) Supervision

Courts were not entrusted with the duty of supervising the insolvency process under the previous insolvency laws. Under the new law, this supervisory authority is given to the commercial bench of the court as designated by the government. The ordinance introduced the concept of a commercial bench in Nepal for the first time. The government is required to obtain the consent of the Supreme Court of Nepal in designating the bench. However, almost six months have elapsed since the promulgation of the new Insolvency Law and the government has not yet set up the commercial bench, thus stalling the process of reform.

c) Stay orders and avoidance of transaction

The Insolvency Ordinance provides for stay orders by which the court can give orders on the application of the concerned party or *suo motu*[2] for the protection of the assets of

the company in the insolvency process. The court can also appoint an interim administrator during the stay period if it deems it appropriate. The ordinance further incorporates a provision for automatic stay whereby the court orders the initiation of the insolvency process of the company.

The Insolvency Ordinance authorises courts to invalidate or void certain transactions. Under the ordinance, preferential transactions and transactions with related parties entered into six months before or after initiating the insolvency procedure are rendered void. But, in cases involving alleged fraudulent transactions, transactions entered into two years before or after initiating the insolvency procedure are rendered void. Such provisions are new in the history of commercial law in Nepal.

d) Re-organisation

The Insolvency Ordinance covers both liquidation and restructuring. In addition, it provides for liquidation subsequent to restructuring if the restructuring fails, or a change from a restructuring procedure to a liquidation procedure if it is found appropriate. The ability to convert from one insolvency process to another is new in South Asia.

The re-organisation proposal prepared by the re-organisation manager requires the approval of the court for its implementation. Once approved by the court, it is binding on all creditors, directors and shareholders. However, it does not bind secured creditors unless they have agreed to the programme. Nor are the lessors and the owners of property used by the company bound by the re-organisation programme ordered by the court. But, the court can issue orders to secured creditors, the lessors and owners of the property used by the company, if it is proved that the re-organisation programme will fail if the secured creditors or lessors of the property enforce their security or take back the leased property. However, the court shall require an assurance that the rights of secured creditors and lessors are properly protected under the re-organisation scheme.

e) Recognition of private sector insolvency professionals

The previous law dealing with the insolvency of limited companies never provided for the qualification of liquidators or insolvency practitioners. In fact, the old law never envisaged insolvency practitioners at all. The new insolvency law relies heavily on the efficiency and integrity of private sector insolvency practitioners.

In view of this, the new law sets out minimum qualifications. The minimum age criterion is 35 years. Amongst other requirements, qualified insolvency practitioners should be a member of the prescribed professional body, and should have degrees in commercial law, business studies, management or any other prescribed subjects from a recognised university. Furthermore, no one can practice in the insolvency profession without obtaining a license from the Insolvency Administration Office. The licensing requirement is equally applicable to liquidators appointed to conduct the voluntary liquidation of a solvent company under the new Company Ordinance 2005.

f) The Insolvency Administrative Office

The Insolvency Ordinance also deals with establishment of the Insolvency Administrative Office. This office functions as a regulator of the insolvency profession as well as the custodian of the files and documents generated by insolvency professionals. The liquidator or the re-organisation manager should file periodical progress reports to the Insolvency Administration Office. After an insolvency process has been completed,

the documents and records should be delivered to the office for recording and custody. Some other functions of this office are as follows:

1) To administer the insolvency profession;
2) To issue licenses to insolvency professionals;
3) General supervision of the management of insolvent companies;
4) To formulate codes of conduct for insolvency professionals;
5) To keep records on all insolvent companies; and
6) To perform any other prescribed functions.

g) Creditors' meetings and creditors' committees

The new Insolvency Ordinance requires material consultation with creditors in the insolvency process. The investigation officers appointed by the court should call a creditors' meeting before the finalised report is submitted to the court. Similarly, the re-organisation manager should call a creditors' meeting to seek their input on and approval of the re-organisation programme prepared by him. The liquidator should also call a creditors' meeting for the purpose of preparing the liquidation report to be submitted to the court. Creditors can also form a committee (not exceeding five members) to assist the liquidator in the liquidation process.

h) Payment priority

The new law has made significant changes in the matter of priority of payment. Employees and workers get priority after the costs of liquidation or re-organisation are settled. Outstanding payments to workers and employees have been classified into two categories for the purpose of priority; wages and remuneration have priority. There is no ceiling on the payment, but working directors do not get priority in the payment of their remuneration. Another departure from the past is that the government is no longer a preferred creditor. Governmental claims on items such as taxes are treated as unsecured debt, just as any other unsecured debt payable to a non-governmental debtor.

i) The implication of liquidation orders

The new law also deals with the implication of liquidation orders. The liquidators assumes all the powers and authorities of the board of directors, and takes control of all the assets and property of the company in liquidation. The services of all employees of the company are terminated on the date of the assumption of office of the liquidator, unless otherwise ordered by him. The standstill arrangement continues with the exception of the right of secured creditors to enforce their security, and the return of leased property to its owner.

5) Implementation problems

In spite of its utility in addressing the problems of insolvent companies, the new Insolvency Ordinance remains inoperative. The new law is already more than six months old, but the government has not created the basic infrastructure required for its implementation and operation. The licensing of insolvency practitioners and the creation of a commercial bench are two basic pre-requisites. Nor has the government established the Insolvency Administration Office, which issues licenses to insolvency practitioners.

6) Prospects for further reform

The new law has yet to see the day of its operation. Its defects and lacunae might be revealed after its implementation. Even so, four broad areas that require further improvement are already visible: i) cross-border insolvency; ii) protection of the interests of providers of essential services to insolvent companies during the insolvency process; iii) the insolvency of government corporations with unlimited liability; iv) personal insolvency; and v) the framework for informal workouts.

7) Difficulties and challenges ahead

The Insolvency Ordinance of 2005 represents a much needed reform of Nepal's insolvency regime. However, the difficulties do not end with its passage. The effectiveness of the Insolvency Ordinance is yet to be tested in practice, and more challenges lie ahead.

The major challenge at this stage is the lack of political commitment to its implementation. The availability of trained manpower is also a major concern. The insolvency profession is yet to be developed as an independent profession and more people need to be attracted to the field. Moreover, there is an urgent need for capacity building among regulatory bodies. Regulatory institutions have not yet been set up and, when they are, they will first need to gather experience. At present, there is virtually no one, either in the private or the government sector in Nepal, who has any kind of experience in regulating insolvency matters. The commercial bench of the court is yet to be established to hear matters of insolvency. Furthermore, the constitution of a commercial bench is of little help if judges are appointed without any specific training on the technicalities of insolvency matters. Training of all those involved in the insolvency process is, therefore, the need of the hour.

Notes

1. For a more detailed discussion of Nepalese legal history, refer to Anup Upreti (2003), "An Overview of Nepalese Legal History", Business and Law in Nepal, Centre for Development and Governance and Focal Point for Financial Sector Reform, pp. 139-146.
2. Suo moto, means "on its own motion". It is a legal term, approximately equivalent to the English term sua sponte.

ASIAN INSOLVENCY SYSTEMS: THE THAI PERSPECTIVE

by
Pairoj Vongvipanond*

1) Perspectives on progress and changes in financial and business restructuring in Thailand

Like all countries hit by the 1997 economic crisis, there is a positive correlation between the amount of debt being restructured and economic and industrial recovery. This correlation also extends to differences in the magnitude of economic recoveries among Asian countries. The first three to four years after the 1997 crisis tended to show that countries such as Korea, and Malaysia, which substantially reduced NPLs or had less initial NPLs, experienced greater corporate debt restructuring than Thailand or Indonesia, which also registered higher growth during this period.

However, one must be careful in making generalisations. In the Thai case, recovery seemed slow initially, possibly because of a delayed effect of corporate restructuring on Thai economic growth. However, over the longer time horizon from 1998-2004, Thai economic growth fared well after 2001 and, overall, did not perform worse than Korea or Malaysia, which are often cited as countries where government intervened more heavily by setting up centralised AMCs. Noteworthy is the fact that, in contrast to Korea, Thailand never experienced court-based corporate reorganisation until 1999. Thailand's NPL at their peak at year end 1999, were several times higher than those of Korea (see table below). Thailand's NPL at their peak were 47.7% of loans in May 1999, two years after the crisis, whereas they were about 15 % in Korea. Unlike Korea and Malaysia, where most NPLs from banks were transferred to centralised AMCs (KAMCO and Danardhatter) from the beginning, in Thailand about two-thirds of NPLs from banks had already been restructured by the end of 2000 and were being restructured by the banks themselves.

The Thai case was a market-based decentralised approach to financial restructuring. The substantial debt restructuring which took place paved the way for economic recovery after 2002 during the Thaksin government . By the end of 2001, the centralised Thai Asset Management Corporation (TAMC) only handled a small number of NPLs. Over a longer time frame there does not seem to be a significant difference in economic growth in Korea, Malaysia or Thailand despite the different methods of financial restructuring and the different roles of government.

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Table 1. Comparative economic growth (in percent)

	1998	1999	2000	2001	2002	2003	2004	Avg.
Korea	-6.7	10.9	8.8	3.8	7.0	3.1	4.6	6.4
Malaysia	-7.4	5.8	8.5	0.3	4.1	5.3	2.1	5.18
Thailand	-10.8	4.2	4.3	2.2	5.3	6.9	6.1	4.8
Indonesia	-13.1	0.8	4.8	3.8	4.3	5.0	5.1	3.9

Table 2. Korea and Thailand's NPLs as a percentage of loans

	Dec. 1998	Dec. 1999	2000	2001	2004	2005
Thailand	**45**	**38.9**	**17.9**	**12.5**	**10.7**	**9.93**
Korea	**17.7**	**14.9**	**10.4**	**5.06**	**-**	**-**

One of the salient features of Thailand's corporate restructuring is that the financial side of restructuring is more significant than the business side. Mergers and acquisitions, and company consolidations did not take place on a large scale as experienced in the US. The crisis had reduced the number of firms in many industries and caused consolidation. Foreign ownership increased in some sectors. But most Thai family firms (80% of court cases), managed to work with creditors and earn another opportunity to run their previously insolvent firms despite a loss of ownership share. NPLs used to constitute almost 50 % of loans or GDP. Almost half of financial institution NPLs were restructured through the CDRAC co-ordination channel. The firms that went through CDRAC were mostly solvent based on a balance sheet test, but unable to pay debt. Thirty percent of the rest was being restructured through the bankruptcy court which handled a large number of medium and large-sized insolvent firms based on the balance sheet test. All in all, and in spite of moving too slow in the first two years, Thailand, along with other Asian countries managed to move its economy forward over the longer term. Most firms that survived regained their former strength and competitiveness. The turnaround in listed company profitability, and healthier financial structures were empirical evidence of a fairly satisfactory corporate restructuring.

With respect to corporate governance, though economic recovery resulted in some improvement in the governance of listed companies according to findings of the Thai Institute of Directors Association, poorly governed companies still exist as evidenced by SEC charges. Worse still, Thailand's Prime Minister (who is chairman of the National Governance Committee), was charged with unethical conduct and serious conflicts of interest. Massive public demonstrations called for his demission. Politically, good public sector governance is a more serious and more urgent goal than good corporate governance.

2) Legal aspects of Thai corporate reorganisation

Shareholders rights in private and public corporations (as residual claimants on corporate property), were given reasonable protection under the Thai civil and commercial codes, the Thai penal code, and the public company law. Shareholders in public companies, in comparison to private companies, may receive better treatment as far as their monitoring role is concerned, as well as the legal punishments imposed on directors of public companies. Creditor protection rights are believed to be acceptable, though there is still room to improve legal procedures in public auctions of assets and foreclosures.

Under the reorganisation part of the Thai Bankruptcy Act (which was revised in 1999), shareholder rights were completely suspended when debtor firms became insolvent (according to the balance sheet test) and were put into reorganisation by the court. Following this, a debtor executive legally represented the general interests of the previous management. To pass the reorganisation test by the court, the balance sheet insolvency test needed to be passed, and honesty in intent and prospects of success needed to be shown. Unless the debtor executive, plan preparer, and plan administrator were the same entity (natural or legal), the debtor executive could act as a check and balance, and a monitoring agent to ensure that debtor and previous shareholder interests are protected by the new management (*i.e.* the plan administrator) running the company.

In all reorganisation procedures, creditors' meetings are always given the ultimate deciding voice. In this sense, one can say that Thai reorganisation law is creditor friendly, but it would be wrong to say that the law is excessively pro-creditor. Firstly, certain groups of creditors can be crammed down. Lost unsecured creditors can suffer a great deal if debtors use various schemes to mobilise over $50 or a simple majority of aggregate creditors' claims (plus only one group of creditors commending two-thirds of creditors' claims) to get the plan accepted in their favour. This is not just a possibility, but has happened in several cases in practice. Such outcomes are made possible by unscrupulous and dishonest methods that the court is unable to prevent.

Secondly, the Thai law permits either creditors or the debtor executive (as agent of the debtor), or both, to file for or initiate reorganisation, and submit the plan preparer, the plan and the plan administrator. If the debtor takes this initiative and creditors disapprove, the voting requirement for creditors is slightly stricter. Thirdly, in a systemic crisis, there are multiple creditors for each debtor firm, and creditor co-operation can be costly (especially for foreign creditors). Co-operation between debtors and creditors was the norm, not an exception.

Since Thailand's legal experience in corporate reorganisation is recent (compared with that of Singapore, Korea, and others), Thai law is said to lack detail. The price of missing detail is high when the judges become less circumspect and judicious. It may lead to excessive discretion and arbitrary decisions that eventually lead to legal contest. A bankruptcy judge at the Supreme Court observed that Thai legal criteria for passing a reorganisation plan are only about one-third of those found in the US Bankruptcy Code. A similar pattern can be found throughout Thai reorganisation. Suggestions for future changes are being discussed.

3) The relative importance of the institutional channel in debt restructuring

Rational self interest will influence the institutional channels that both creditors and debtors choose. Unsecured creditors with less bargaining power will not choose liquidation, whereas secured creditors have more options. Creditors, in general, will handle debtors on the basis of the debtor's long-term ability to pay and the availability of collateral. Generally speaking, and other things being equal, minimisation of litigation and other transaction costs will determine each party's institutional mode. In this regard, out of court or private workout is least costly and, though direct information is hard to get, it is believed to account for 15-25% of all channels in Thailand. For financially insolvent debtors, the maximum institutional protection and accompanying debt reduction can be secured through court approved reorganisation under optimal conditions. In between, the Bangkok Approach or CDRAC have played a vital role for mostly non-insolvent firms.

The statistical information below on the distribution of debt restructuring via different institutional channels accords reasonably well with the above reasoning.

Table 3. Relative role of debt restructured by different institutional channels

Year	NPL	NPL (%) Loan	Debt Restructured by Financial Institution	Debt Restructured Outside Central Bankruptcy Court		Debt Restructured via Central Bankruptcy Court	
				CDRAC	TAMC	Verified Debt	Debt Approved with Plan
1998	2 674.5	45	156.8	47.7	-		
1999	2 094.4	39	1 072.0	495.5	-	215.6	38.5
2000	863.6	18	1 953.5	1 043.0	-	1 221.3	332.5
2001	477.4	10	2 429.1	1 275.3	28.1	1 523.0	636.3
2002	770.3	16	2 725.9	1 481.0	501.1	1 600.5	784.8
2003	641.8	13	2 961.2	1 443.6	432.3	n.a.	927.5
2004	598.6	11	n.a	1 494.6	762.4	n.a.	1 011.5
2005	583.9 (Oct.)	10	n.a	1 498.4 (May)	772.4 (June)	n.a.	

Note: Unit: billion THB (Thai baht).
Source: Bank of Thailand, TAMC and Central Bankruptcy Court.

The breakdown of debt being restructured by various institutional channels cannot be summed to yield the total NPLs being restructured at financial institutions under supervision of government authorities because the debt being verified and approved for restructuring by the Central Bankruptcy Court in the reorganisation process includes debt owed to trade creditors, domestic non-financial firms and financial institutions registered aboard. For the case of Thailand, suffice it to say that approximately THB 3-3.5 trillion (Thai baht) of NPLs are being restructured, and that court-based reorganisation at the Central Bankruptcy Court amounts to one-third. The rest is settled out of court, of which CDRAC (via the Bank of Thailand as co-ordinators) accounts for almost half of the total. Since the choice of channel is voluntary, one can conclude that this is also an efficient channel from a private party's point of view.

4) Some empirical aspects of Thai corporate restructuring

Quasi US Chapter 11: The unintended consequence of systemic insolvency, and embedded institutions

In general, despite the lack of experience in implementing reorganisation via the courts when the crisis hit Thailand in 1997, court-based reorganisation has been quite successful. Success can be attributed to court perceptiveness and leniency towards debtor firms to be reorganised plus a simple aggregate majority voting rule required for creditor approval. The overall rejection rate of reorganisation requests is surprisingly low at not more than 10%, which is believed to be lower than that of Korea. Rejected reorganisation requests or rejection of plans, as well as subsequent court orders for liquidation are also very low.

In spite of the law giving the power of approval of plan preparers, the plan, and plan administrator to creditors, studies based on almost 200 firms have shown that debtors have been given privileges by creditors to manage their insolvent firms and to prepare plans (see Table 4 below). This is partly specific to Thai culture where family ownership and management are still predominant.

These majority inside owners are also willing to be co-operative with creditors. Another reason is that Thai banks did not develop close relationships with debtors like those found in Japan or Germany. Thai financial institutions lend on the basis of collateral. They do not seem to know the debtor firms that well. Another reason is the shortage of management expertise.

Table 4. Planner and plan administrators

Debtor as planner	Number of companies	Percentage of total
Debtor as planner	139	77
Creditor as planner	41	23
Total	**180**	**100**
Debtor as plan administrator	106	77
Creditor as administrator	32	23
Total	**138**	**100**

Source: Pairoj et al. (2002).

Rehabilitated companies' performance: Empirical findings

The crisis in 1997 did not hit all firms equally. For instance, listed companies on the Stock Exchange of Thailand (SET) showed negative profits throughout 1997-2000. Yet, overall, equity did not turn negative. Insolvent companies on the SET did, however, require a separate treatment and classification, and were referred to as "rehab companies" or rehabilitation companies. Until 2003, equity was negative. As of September 2005, about 102 listed companies were classified as rehab companies. These companies were likely to be under court-based reorganisation at the Central Bankruptcy Court. Cross section data between 1998 and 2004 of 41 companies permit statistical testing of two periods (1998-2000 and 2001-2004) to see what variables explain corporate and financial performance. The variables chosen are short-term debt levels, industry performance, the reduction in debt (or haircut), and management control. The management control variable is a dummy variable with a value of zero if the company is creditor controlled and one if it is debtor controlled. Corporate performance and financial health are represented by EBITDA or Earning Before Interest and Tax plus Depreciation Allowance, which is a measure of cash flow. Financial health is measured by the improvement in share price and debt/asset levels. A linear model gives ordinary least square results as follows.

Corporate Performance			
EBITDA/Asset	=	-	$0.1238 - 0.0019^{*}$ Short run debt + $.0002^{*}$
			(1.75) (1.84)
Size of Debt reduction		+	0.2019^{***} + 0.7260 Industry Performance
			(2.93) (0.84)
		+	(2019^{***} Management control
			(2.93)
R^2	=	.2967	
Adjusted. R^2	=	.1962	

Financial Health			
Improvement in Share Price	=	0.6954	
		(0.81)	
		-	0.0138 – 3.9906 Industry Performance
			(-1.6) (0.59)
		+	0.0017^{**} Size of Debt Reduction
			(2.45)
		+	.692 Management Control
			(1.16)
R^2	=	.2101	
Adjusted R^2	=	.0972	

*, **, *** Indicate statistical significance at 10%, 5% and 1% respectively.

Source: Pairoj and Nuttanan (2005).

It is interesting to see that most variables show the right sign. The size of debt reduction is important, and the statistical tests seem to confirm that, in the Thai case, insolvent firms being managed by debtor appointed plan administrators perform better than those of creditors.

Table 5. Financial indicators of 41 listed firms under rehabilitation

	1996	1998	2000	2002	2003	2004 (Q3)
Total Assets	524.9	628.0	453.4	423.9	453.0	428.2
Total Liabilities	355.4	544.7	591.7	449.4	377.8	394.3
Total Equity	169.5	83.4	-138.4	-25.5	75.2	87.8
EBITDA	77.8	70.0	-44.5	31.9	44.7	28.0
Debt/Assets	.68	.87	1.31	1.06	.83	.82

Note: Unit: Billion Thai baht.

Some empirical observations on the effects of the crisis on ownership and management control

The data from the tables below show ownership and management control changes in Thailand. It needs to be pointed out that, unlike the pioneering study in the US by Berle and Means where separation of ownership and control is usually assumed, most Thai companies that are listed on the stock exchange are still predominantly family controlled enterprises. Family ownership of 25% of the shares is often sufficient to control the company, especially if some form of pyramiding is used. Management and major shareholders are usually the same persons.

Table 6. Ownership and management control pre-1996 and post crisis (2005)

	Ownership Change		Control Change	
Absolute Level of % Change	**No. of Firms**	**% of Total**	**No. of Firms**	**% of Firms**
<25%	**32**	**46**	**3**	**17**
25< x< 50%	**8**	**12**	**0**	**0**
50<x<75%	**11**	**16**	**4**	**22**
<75%	**18**	**26**	**11**	**61**
Total	**69**	**100**	**18**	**100**

Table7. Ownership and control (55 listed firms under rehabilitation)

	No. of Firms	% of Firms
Ownership and control are similar to 1996	**51**	**93**
Ownership and control separate	**4**	**7**
Inside Management (Management control is held by major shareholders) in 1996	**40**	**73**
Outside Management	**15**	**27**

Table 8. Shareholding of controlling shareholders in percent (55 listed firms under rehabilitation)

1996 Pre-crisis	**65**
2005 Post-crisis	**24**

Source: Pairoj and Nuttanan (December 2005)

Several major conclusions can be drawn from the Thai experience. First, in general, significant changes in the absolute level of ownership (50 to 75% and more) is needed for the original owners to lose control of companies. Moderate changes in ownership allow previous owners to bargain and negotiate with creditors. Second, in the Thai context, a change in ownership does not necessarily imply loss of control. Creditors are often willing to let original owners run the reorganised firm if the firm has future value and the original owners are honest and co-operative with major creditors.

5) Institutional changes in the last two years (2004-2006)

Some observations on institutional changes

Institutional changes viewed either from the supply or demand side can be of revolutionary or evolutionary types. Evolutionary processes probably dominate since it is difficult to overhaul or uproot embedded cultural behaviour. Even legal changes, in most instances, follow rather than lead societal demands. The development of Thailand's insolvency system can be considered evolutionary in this sense. When there is no real need, institutions do not emerge. Legal experts, especially from the government sector, tried to introduce reorganisation procedures in the bankruptcy law prior to the 1997 crisis. However, it took the 1997 crisis to trigger real changes in the supply of various institutions (formal and informal), ranging from a new bankruptcy law to new and more efficient approaches to legal execution (civil or bankruptcy cases), civil procedures etc. Meanwhile, society is looking forward to further reforms in business and corporate law such as the use of security as collateral, reform of the bankruptcy law to allow debtors to voluntarily file for bankruptcy, and reform of the reorganisation part of the bankruptcy code. On court-based reorganisation, debates abound regarding the role of official receivers (too much power and too little expertise?). Meanwhile CDRAC (under the Bank of Thailand) has already accomplished its major goals. The division will therefore be closed.

Developments and major changes in the appeals procedure of Thai corporate reorganisation in bankruptcy

According to some legal scholars, a milestone in legal practice took place in October 2004 when the Act of Establishment of the Bankruptcy Court and Bankruptcy Procedure 1999 (No.2) as amended in 2004 was implemented. This is considered a historical change since it is the first time that an appeal by leave, considered by a meeting of all judges in the Bankruptcy Division of the Supreme Court, will be made possible and complement an appeal by right as presently stipulated in the law. Instead of the lower court or court of first instance being an active part in the process (as far as the right to appeal is concerned), the Supreme Court will also actively deliberate the approval of an appeal requested by legal parties when the usual right to appeal is prohibited.

Prior to its total abrogation in 2004, section 90/79 of the Bankruptcy Act (No.6) as amended in 2000, stipulated that an interlocutory order, or a court order giving a decision concerning business reorganisation, cannot be appealed except for:

1. An order dismissing the petition;
2. An order allowing or disallowing a creditor from receiving payment in reorganisation either in whole or in part;
3. An order to place the debtor under absolute receivership; and
4. An order that the chief judge of the Court of First Instance or the chief judge of the region having jurisdiction (as the case may be), deems appropriate in the interests of justice, and the judge permits a filing of written appeal.

Permission for an appeal against an interlocutory order may be given only after a decision of the case has been made, and such decision has been appealed. Because of appeal restrictions, anything that is not covered by items 1-3, according to section 90/70, require the permission to appeal to be approved by the chief judge of the Bankruptcy Court or the chief judge of the region. The practical consequence of 90/79 is that appeals are being closed or not granted by the chief judge, thus causing complaints of injustice in court decisions. Many court decisions that stir up controversy, beg for greater transparency, yet are not subject to check or scrutiny since the right to appeal is barred.

One of the important restrictions to appeal is the court's decision to approve or disapprove the plan, and the plan administrator. Such decisions, if incorrect, unsound, or unaccountable can cause great harm to affected parties.

Due to the inherent weakness of section 90/79 and the social costs that resulted, major changes in the appeals processes were made in 2004. Civil and criminal offences in bankruptcy are now handled by the Central Bankruptcy Court. With respect to the appeals process, section 90/79, which dealt with reorganisation issues, was abrogated. In its place is the Bankruptcy Court and Bankruptcy Act, 1999, No. 2, which was amended in 2004. The law is being enforced for an appeal to court verdict or order of a former bankruptcy case, reorganisation cases or related civil cases. This is an appeal to court verdict or order as stipulated in section 24 of the 1999 Bankruptcy Court Act (No.2 amended 2004). As for the time requirement, section 24 utilises two systems within one month from the date the court issues its verdict. Cases for appeal to the Supreme Court fall into two categories: 1) appeal by right; and 2) appeal by leave.

Cases where legal parties have an automatic right to appeal

Section 24 of the 1999 Bankruptcy Court and Procedure Act and Section 3 of the Amended 2004 Act, stipulate that:

1. Appeal from the Bankruptcy Court to the Supreme Court must occur within one month;
2. Right to appeal automatically applies to five court verdicts or orders, three of which are mentioned above. The additional two are orders for dismissing the reorganisation order, and court orders on civil cases related to bankruptcy. This right to appeal is not to be in violation of legal rules regarding civil procedures to appeal.

Cases where legal parties have no right to appeal but the Supreme Court may grant permission

This is the new principle whereby the former prohibition of appeal to the Supreme Court according to section 24 of Bankruptcy Court Act is being exempted by the new provision. According to section 24, two categories of cases are prohibited from appeal. The first category is bankruptcy cases. Apart from the five cases mentioned in section 24, no appeal is allowed for bankruptcy cases that are related to court orders of approval for composition, court adjudication of bankruptcy, and court adjudication for discharge from bankruptcy. Further, no appeal is allowed for reorganisation cases that are related to court orders for reorganisation to proceed, and court orders to terminate reorganisation. The second category applies to court orders that are not allowed to be appealed according to the appeal procedure as stipulated in the statutory act concerning civil procedure.

Section 26 of Bankruptcy Court and Procedure Act allows legal parties to request an appeal to the Supreme Court concurrently. The Bankruptcy Court may, upon examining the appeal, reject it due to the fact that it falls into prohibited categories under Section 24. In such case, the Bankruptcy Court shall send the appeal to the Supreme Court. Alternatively, upon being rejected by the Bankruptcy Court, the legal parties can submit a request for appeal directly to the Supreme Court within 15 days after the rejection.

The Supreme Court, in deliberating the permission to appeal, will base its decision on the following reasons. The court verdict or order is in conflict with the verdict of another high court, or the court verdict is inconsistent or in conflict with the Supreme Court verdict. The decision to grant an appeal shall be made by a simple majority of the judges in the Bankruptcy Department of the Supreme Court.

6) Judicial cases: What have we learned?

Thai Petrochemical Industry Public Company (TPI)

The last two years have witnessed an incessant and furious legal battle between Mr. Prachai Leoprairat, the former executive and original major shareholder of TPI, and the Ministry of Finance, the appointed planner or plan administrator.

In order to provide a brief background, the court order to remove the creditor appointed plan administrator, Effective Planner Ltd., in early 2003 was controversial enough. Many legal scholars doubt the authenticity and transparency of the court's reasoning. There seems to be lack of solid evidence of either fraud, mismanagement or incompetence on the part of Effective Planners Ltd., even if TPI's progress on the plan

was not satisfactory. Even so, the creditors were not alarmed by TPI's performance and were content with Effective Planners.

The logic is that creditors insist on nominating their own plan administrator at the creditors meeting for court approval. However, in mid-2003, not only did the court unexpectedly take the unprecedented step of rejecting the creditors' meeting's decisions, but ordered the future creditors meeting to nominate the government or Ministry of Finance appointed plan administrator. Until then, this was the most contentions legal dispute in Thai business history and caused TPI creditors great anxiety and consternation. Most legal scholars thought the court decision was legally unprincipled and arbitrary, but have yet to venture to write about the decision.

The TPI judges might have thought that a neutral disinterested government-appointed plan administrator would end the protracted in and out of court quarrel between the debtor executive, Mr. Prachai and creditors. They were wrong.

Outside of the legal arena, periodic clashes between workers and the labour unions of two factions on the TPI factory site in Rayong province ensued. As a pre-emptive strategy to prevent labour militancy, the chairman of the plan administration committee (a former military commander) brought in military personnel to manage the TPI factory in the provincial area. As time went on, the Ministry of Finance plan administrator, however, was able to win the heart of the majority of workers using the carrot rather than the stick. The improved performance of TPI, the industry and the economy made it possible for the plan administrator to increase incentives for workers in the form of bonuses and other benefits.

Between 2004 and 2005, when the new plan administrator managed the company, there was no peace for any party. Court battles continued and the original fundamental conflict prevailed. Having accepted the loss of privilege in managing the debtor company, Mr. Prachai continued to voice his complaints through litigation about the excessive salaries that he thought were being paid to the plan administrators and unnecessary expenses. Mr. Prachai himself was accused in court by several government agencies, including the Division of Secret Intelligence (DSI). This forced the Security Exchange Commission (SEC) to seek a Bankruptcy Court order to remove him from his executive position in listed companies. According to the SEC and stock market rules, an executive cannot hold a position in a listed companies if he or she is under prosecution. The Bankruptcy Court, however, rule in his favour since he was a debtor executive in a company under court-based reorganisation.

Mr. Prachai insisted on the proper valuation of the company and the share price when the court approved the change in the plan, and the subsequent change in the financial and ownership structure of TPI. From the beginning, when the first plan was approved in 1999 and conflict with creditors emerged, Mr. Prachai always claimed that his company and the share price were worth several times more than stated in the creditor plan. Therefore, when creditors converted the debt (mostly unpaid interest into equity with practically no haircut), such that creditors owned 75% of the equity, he bore a considerable grudge against them and accused them of wanting to take over his company.

The same problems were repeated again in 2005 subsequent to the court approval of a major plan revision for TPI. Matters were eventually taken to the Supreme Court. In the end, however, Prachai lost. The court did not seem convinced by his reasoning that previous shareholders, like himself, were treated unfairly.

As it is, the current financial structure after the capital change of TPI has improved. At the end of 2005, USD 2 700 million (United States dollars) in outstanding debt were reduced to USD 1 800 million to be rescheduled and paid over the next 12 years.

About 19.5 billion shares at THD 3.30 baht per share will be issued to existing shareholders, creditors, new strategic and non-strategic investors that are quasi-governmental enterprises (the government Mutual Fund (10%), the Government Provident Fund (10%), creditors (8.5%), the Government Savings Bank (10%); Thai Petroleum Public Co. or TPP (31.5%) and the original shareholder (30%)). Mr. Prachai will own less than 10% of the shares of TPI after the subscription.

Through government intervention, TPI became a quasi-government enterprise since government and quasi-governmental agencies hold 60% of its shares. It is not a full-fledged state enterprises since 51% is not directly owned by government agencies. The consequence of the court decision in 2003 to order management to be under a government directed plan administrator has resulted, two years later, in converting a purely private company into quasi state-owned enterprises. This took place and was made possible by changes to the framework and implementation of the corporate reorganisation law, which had been acrimoniously fought and opposed by former major shareholders.

Is this fair? This is debatable. Is it viable? It seem to be. But it cannot be compared to the alternative plan of Mr. Prachai who come up with a much higher share price than THD 3.30. He proposed bringing in new foreign private investors from China. The alternative remains only hypothetical. No one can say which outcome would have been better.

Natural Park

Natural Park, a publicly listed company that went through court-based reorganisation received less public or media attention than TPI. Yet this case is no less scandalous. It was very politicised because the parties involved ranged from businessmen to politicians of the highest rank. From a policy standpoint, the judicial contest and the court verdict yield important lessons. Legal professionals doubt the integrity of the judge panellists. At issue is the approval of the plan by the Bankruptcy Court. Most people who read the plan thought that it was a pure lemon, and that the plan should not be passed. The plan forced creditors to receive less than 5% of the debt owed. Without dishonesty, liquidation of the company would have enabled creditors to receive a larger payment than by going through reorganisation.

There was a serious cram down on some creditors while the Asset Management Company and other new investors benefited more. Creditors, according to the plan received 0.5-2% of their money because the debtor company, Natural Park, crazily sold its claims on its subsidiaries (worth THD 3.7 billion) for just THD 1 million and incurred substantial losses. Debtors claims worth THD 8.3 billion were not included in the plan. The creditors, naturally, appealed to the Supreme Court. Justice seemed to work at the Supreme Court since it deemed the plan invalid.

However, the tragic part relates to section 90/76 of the Bankruptcy Code. When the Supreme Court order came down to the Bankruptcy Court, the plan administrator (who was paid a meagre THD 1 million/month) had already implemented the plan and paid creditors. Section 90/76 legally protects any actions done since the plan approval, and the case was closed. Frustrated creditors have had to resort to traumatic civil and criminal proceedings.

State-owned Krung Thai Bank was charged with political favouritism in making reckless loans to the company. When the loans went sour, the SEC charged its executives with neglecting their fiduciary duties. This charge emerged because one of the company directors permitted abusive related-party transactions and failed to protect the interests of shareholders. The Securities Exchange Commission pressed criminal charges on this executive. However, the SEC's efforts were ineffectual since special prosecutors refused to press charges in court. Many lawyers were suspicious of political interference, since the company is known to be intimate with higher echelons in the present government.

Prasit Pattana (Phaya Thai Group Hospital)

This case might not have captured the public's attention if not for the fact that the debtor executive and the original major shareholder, Dr. Arthit Urairart, was a famous politician. There was also a widely held belief that a major shareholder (Mr. Vichai Thongtaen, former legal counsel of Prime Minister Taksin), is the nominee for the Prime Minister's Chinnavart family. Some insiders deny the Prime Minister's involvement. They believe that Mr. Vichai's family was genuinely interested in the Phaya Thai Hospital Group.

The basic problem in this case is that under court-supervised reorganisation, the creditors (who comprised several Thai banks) did not allow (for unknown reasons) Dr. Arthit, the previous major shareholder, to run the company. Instead, PricewaterhouseCoopers (PWC) was picked as the plan administrator. Subsequent to the restructuring, Dr. Arthit's family became a minor shareholder. When the plan administrator requested the court to terminate the reorganisation, Dr. Arthit submitted a petition to the Supreme Court to annul the bankruptcy court decision on the grounds that PWC acted fraudulently. The Supreme Court has issued the order that the Bankruptcy Court take the complaint into consideration. The issues are currently pending.

LESSONS LEARNED: BANKRUPTCY REFORM IN THAILAND

by
Wisit Wisitsora-At

The objective of this paper is to explain how Thailand, after being hit by the economic crisis in 1997, reformed the bankruptcy system in order to deal with the subsequent growth of non-performing loans. This paper shows how the changes were made and the reasons behind the changes. It is now possible to see if they were beneficial and, most important, if they contributed to an appropriate and sustainable bankruptcy system. The paper also identifies the advantages and disadvantages of the system and suggests ways forward both for Thailand and other countries in the region. Finally, it illustrates the ongoing process of change in Thailand.

1) How to swiftly change a bankruptcy system

After the crisis hit Thailand, bankruptcy law was seen as a mechanism to deal with bad debts. It was clear at the time, that during the systemic bankruptcy of a country, that no law in general is capable of dealing with such a situation. In spite of this, attempts were made to reform the debt collection laws (such as the Civil Procedure Code and the Bankruptcy Act) on the grounds that they, at least, should be able to help clear up debts more swiftly than agencies set up to deal with the assets and liabilities of financial companies.

The Thai Ministry of Justice was given the task of reforming the bankruptcy law and the Civil Procedure Code. This task was neither innovative nor difficult since both society and the ministry had already attempted to initiate change. The Ministry of Justice took the opportunity to push for its own draft legislation on the amendment of the Thai bankruptcy law and the Civil Procedure Code. These were then given priority to be submitted to parliament.

It was accepted at the time that had there been no such drafts, it would have taken the government longer to react to the problem and that there would have, perhaps, been greater overseas influence on the drafting process. Although foreign influence is not necessarily detrimental, internally-based changes implemented with a true understanding of a country are more likely to meet with acceptance.

2) An existing system is a crucial support of change

It should be understood that prior to the reform of the country's bankruptcy system, Thailand already had a long history of bankruptcy law. It had both relevant laws and institutions. The existing law was the Bankruptcy Act of 1940, with bankruptcy issues being heard by courts with civil jurisdiction throughout the country. In terms of the management of the estate of bankrupts, the official receiver's office (or the Legal Execution

Department as it is called in Thailand) was active. This existing system eased the task of reform substantially, since the only crucial matter was to modify rather than to build anew.

With respect to changes in the law, since Thai law already allowed for liquidation procedures, the challenge was to modify the law so as to allow reorganisation procedures. It was agreed that the draft legislation on the matter was almost adequate. After some minor changes were made, the draft was submitted to parliament and subsequently became the Bankruptcy Act (4th Issue) of 1998. The law allowed companies to undergo reorganisation with the protection of stay and subject to the process of the court's supervision. This could either be done voluntarily (with the debtor's application), or involuntarily (with the creditor's application). In short, if the plan was approved by the creditors' meeting and confirmed by the civil court, it would then bind all the parties involved.

3) The reality of legal and institutional reform

Given the fact that the existing system helped to ease the task of legal reform considerably, genuine reform was still the predominant issue. Changing the law might be seen as adequate in itself, but the Ministry of Justice was well aware that such an approach without genuine changes to support the implementation of the system would lead to failure.

The reorganisation procedure was regarded as a new mechanism, the most difficult part being to allow judges and official receivers to play a role in dealing with the survival of business units. Some court decisions might therefore involve the sphere of day-to-day management. They could include decisions taken in the ordinary course of business or on transactions outside the ordinary course of business.

The level of control by official receivers over the transparency of companies necessitated a highly competent group of receivers. Initially, many people considered shifting this responsibility to a new agency consisting of persons with a strong commercial background, though it ultimately became the challenge of the judiciary system.

4) Courts versus tribunals

Critics did not really believe that the judiciary and official receivers would be able to adapt to the changes in the bankruptcy system. It was widely accepted that, without changes in the judiciary itself, the burden would be too great to bear. Although many people suggested that a somewhat neutral organisation set up by law might be able to tackle the problem more quickly and easily, it was agreed that such a move would not be sustainable and that it might damage the country in the long run if the judiciary were given the task.

It was, instead considered wiser to improve the existing system rather than create a new one simply for a particular purpose. Another prime reason was that even if a new agency was established, under the constitution, disputes appertaining to its management could still go to the court. It was also agreed that the trust of the people in the integrity of the judiciary was instrumental in the decision to give it the task. Ultimately, the Ministry of Justice insisted that the court be assigned the task and matters were implemented accordingly.

5) How to strengthen the court and its supporting agencies

In order to help the court prepare itself for the task, it was accepted that the extant court system for dealing with bankruptcy cases would be unsuitable since reorganisation cases could involve large numbers of both companies and debts. In addition, bankruptcy

cases were treated as civil matters and had to be filed with courts with civil jurisdiction, including provincial courts throughout the country. It would have required an enormous effort by the judiciary to prepare judges all over the country to react quickly and appropriately in every case. Judges would also have needed training in the new law in addition to the understanding of business.

It was accepted also that due to the urgency of the issue, these reorganisation cases had to be dealt with swiftly. If they were to be heard in these courts, the backlog of other cases would cause considerable delay. Furthermore, to have implemented training for all judges in a short period of time would have been neither easy nor economical, while lack of expertise could have undermined the system as a whole.

One solution to the problem was to establish a specialised court for bankruptcy cases, an approach that had already been implemented in Thailand with a number of other specialised courts (such as Labour, Tax, Intellectual Property and International Trade courts). Such a system allows a specialised court of first instance to be set up for a particular type of case, benefiting the recruitment of judges and being a more economical way to arrange training for them. Appeals against decisions made in these specialised courts go directly to the Supreme Court.

Specialised courts are not suited for all countries. Even in Thailand, the attempt to set up the first such court was not without criticism. Opponents generally raised the issue of the principle of equality before the law and the effectiveness of the system in addition to arguing that these types of specialised court cases could just as well be heard in civil courts. It was also argued that if there were relatively few cases, it would not be cost-efficient to set up a specialised court. In some countries, judges would be regularly transferred to other courts and it would be difficult to keep judges in one place since the reason behind the move was the need for judges to gain experience in different types of cases.

Since the specialised court system was already in existence in Thailand, it was not difficult to convince the parliament to pass a law on the establishment of the bankruptcy court. The act was passed in 1999. After that, it was not permitted to hear bankruptcy cases involving either liquidation or reorganisation in other courts. Judges with bankruptcy experience were recruited and placed on the court. Training sessions in the required areas were held specifically for them.

With respect to the official receiver, the Legal Execution Department set up the Business Reorganisation Office to take responsibility for the new law regarding reorganisation cases. All the officers involved had to undergo special training. The Ministry of Justice worked in co-ordination with lawyers to ensure that those concerned were given adequate training.

6) Outcomes

After the changes were introduced, no doubts remained that the system could carry out its task as intended. Reorganisation cases reached a peak in 2000, when more than 100 cases were filed with the bankruptcy court and the amount of debts being restructured went up to around THB 4 billion (Thai baht). The judiciary ensured that all cases were heard in a speedy manner and most of the major cases were dealt with successfully in due course.

Inevitably, some problems emerged during implementation, leading to calls for additional changes. The bankruptcy court was entrusted by parliament to have jurisdiction

over criminal matters arising out of bankruptcy practice, this being envisaged as an efficient way to prevent fraud within the system.

When the system is evaluated, there is always the question of whether or not it is sustainable. The figures in Table 1 show that although there was a reduction in the number of reorganisation cases after the crisis in 2001, a steady number of such cases still enters the bankruptcy court.

Table 1. Number of new reorganisation cases

	2001	2002	2003	2004	2005
Number of new reorganisation cases filed with the court	79	61	52	50	30

Table 2 shows the numbers of filings for bankruptcy with the court. The increase in 2003 was caused by a change in the bankruptcy law to allow an easier method of discharge.

Table 2. Number of bankruptcy filings

	1999	2000	2001	2002	2003	2004
Individual bankruptcy	1 118	835	968	1 591	2 209	4 778
Juristic persons' liquidation	549	604	746	922	657	965

The regular use of bankruptcy was not possible in the past, when the associated stigma was regarded as a big issue. However, the recent increase in the number of cases can be seen as an indicator that bankruptcy is now more socially acceptable and is also an indicator of the need to improve the system to help steer the management of bad debts in the proper direction.

7) The ongoing business of reform

Bankruptcy reform is not an easy matter. After the economic crisis in Asia, a number of international institutions (like the IMF, the World Bank, UNCITRAL, the OECD and development banks in the various regions) decided to pursue the same goal, which is to say, the installation of a proper bankruptcy system in each country.

In Thailand, there are many issues which are now pending consideration. Many proposals have been made to the Ministry of Justice to change or even overhaul the whole system for bankruptcy. Such a task is for long-term development, and the government has assigned it to the Bankruptcy Law Amendment Commission, in co-ordination with the Ministry of Justice. It is envisaged that the whole law will be replaced by a new one. Even though no deadline has been set, the Ministry of Justice hopes that draft legislation will be presented to the government in 2006.

It has been suggested that the UN Legislative Guide on Bankruptcy Law and the work of the World Bank should be used as the basis for considering proposed changes.

Interestingly, none of the recommendations put to the commission so far involve changing the role of judges in bankruptcy cases. This could be an indicator of the effectiveness of judges in their handling of bankruptcy cases after the crisis.

The new issue to emerge in Thailand is consumer bankruptcy. Some institutions suggest the abolishment of consumer bankruptcy. This issue is still under discussion.

8) Lessons to be learned

Even though Thailand has opted for the use of a specialised bench to react quickly to problems, the same approach may not work for other countries. As was previously stated, the success of the Thai approach was based on an existing infrastructure that supported changes. It was also regarded as a change from within, since most of the draft legislation already existed at the time of crisis.

However, the stance on letting the judiciary have jurisdiction over bankruptcy cases was admirable. It was in line with the constitution and was supported by the people who believed that the courts could handle the cases. Obviously, the task would be easier if there were no need for swift change; for those who have time to reform, more investment should be made in the judiciary. Integrity is also essential. A profound knowledge of business affairs among judges is another prerequisite for a reliable system. A key lesson is that changing the law is only the first step, and that without genuine change in implementation, the reform will not work.

Another lesson to be learned is that a bankruptcy system is one of debt collection laws. Enforcement of security and civil judgments is another important factor. Each country needs to have all the systems working efficiently in order to ensure proper functioning of the whole. It is advisable to lay the fundamental groundwork by ensuring that a proper system of civil procedural law exists. An overall legal and institutional framework is likewise needed.

To strengthen a country's bankruptcy system, transnational aspects of trade need to be taken into consideration. Cross-border insolvency issues are becoming important. Some advances are being made within the ASEAN community. During the last Law Ministers' Meeting in Ha Noi, Viet Nam, ASEAN member countries expressed both the need and willingness to expand their co-operation on civil law matters.

This was followed by a seminar held jointly between Thailand and UNCITRAL on bankruptcy and secured transaction laws. It is noteworthy that participating countries were interested in the improvement of their legal infrastructure (especially secured transaction law), with Viet Nam having already established a legal framework and Cambodia in the process of drafting one. This has resulted in further co-operation between Thailand and the Lao PDR on training programmes.

In conclusion, those countries that form a group or region tend to find it easier to co-operate. It is a great deal easier to do this than having to rely excessively on the programmes of international organisations. However, a synergy of global and regional approaches can be created with international organisations finding a role through which they can support regional approaches.

AN UPDATE ON NON-PERFORMING LOANS RESOLUTION AND BANKING REFORM IN VIET NAM

by
Hoang Tien Loi*

1) Introduction and summary

Over the past few years, the Vietnamese economy has enjoyed impressive growth rates. The country issued its first sovereign bond in 2005 with a total face value of USD (United States dollars) 750 million (which was sold out in the US, having been over-subscribed by a factor of four times). The investment environment has been good with increasing interest in both direct and indirect foreign investment. This positive picture seems to have made people overly optimistic and insufficiently cautious about the risk of a potential downturn in the economy. A number of factors are possible causes for concern:

External debt now stands at about USD 20 billion, and Viet Nam is servicing this debt at a rate of USD 2 billion each year. Some analysts view the debt as controllable but, for a small economy like Viet Nam, there is rising concern. Moreover, the recent discovery of a scandal at one of the largest official development assistance (ODA) project management units (PMU 18) has placed the efficiency of ODA utilisation under heightened scrutiny. Inefficiency in the utilisation of ODA may end up burdening future generations with huge debts.

Furthermore, the burden of non-performing loans (NPLs) has slowed the reform process in Viet Nam and hampered the further expansion of the economy. At the end of 2005, Viet Nam's state-owned commercial banks (SOCBs) reported low levels of NPLs. NPLs incurred before 2000 (largely related to state-owned enterprises) were said to have been nearly completely resolved. However, stagnation in the real estate market is posing a problem in the banking sector that is being felt in the industrial sector, which still uses banks as its main source of funds. Finally, directed lending in several government programmes would appear to be raising NPLs again.

The efforts of the Vietnamese government in recent years have significantly improved the economy in general and the banking system in particular. The State Bank of Viet Nam is preparing a new banking reform programme for submission to the government by June 2006. Efforts are needed in Viet Nam to develop the insolvency system in order to facilitate the reform of the banking system as well as to maximise the value of non-performing assets (NPAs) by transferring capital and assets to more efficient users.

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2) Non-performing loans in Viet Nam

The banking system is the main source of funding in the Vietnamese economy. The commercial banking system comprises five SOCBs; 34 joint-stock commercial banks; four joint venture banks (between SOCBs and foreign banks); and 27 foreign bank branches. The banking system manages total assets equivalent to 80% of Viet Nam's GDP. The SOCBs currently hold the lion's share (70%) of the credit market. Joint-stock banks, foreign bank branches and joint venture banks hold 12%, 15% and 3% respectively. SOCBs also have the highest NPL ratio.

Over the past decade, SOCBs have evolved from specialised policy-driven lending vehicles to more commercially oriented financial intermediaries. However, policy-driven lending practices throughout the 1990s, and limited credit assessment skills in the wake of rapid credit growth, led to the accumulation of NPLs. To address this concern, the Vietnamese government embarked on an important overhaul of the banking system through a multi-year restructuring and recapitalisation programme in 2001. Resolving NPLs is an important part of this banking reform.

SOCBs hold most of the NPLs in the economy. The pressure on SOCBs to resolve their NPLs was not been strong enough since the government placed a higher priority on the stability of the banking and financial system, and gave support to ensure that there would be no run on banks. The main obstacles to NPL resolution in Viet Nam are:

- The lack of reliable information on the level, size, structure and characteristics of NPLs;
- The methods allowed for resolving NPLs are limited. NPLs are being resolved on an individual basis. There are no regulations or guidance on bulk sales of NPLs.
- The NPL market is underdeveloped. There is no regulation on the possible involvement of foreign investors. The Debts and Assets Trading Company, the national asset management company (AMC), is the only organisation that can buy NPLs from banks. There are no secondary buyers, which means there are few participants in the NPL market.
- The legal framework for the NPL market is inadequate. There is no comprehensive law dealing with insolvency in Viet Nam. Insolvency and creditor rights are set by many regulations, including the Law on Bankruptcy, civil law, the Ordinance on Economic Contract, etc. Since the new law on bankruptcy came into effect in October 2004, there has been no evidence to show that bankruptcy procedures contribute to NPL resolution. Court orders have not been enforced, creditor rights have not always been respected, and there are long delays in resolving debts. The use of bankruptcy procedures has, thus, been limited.

Different forms of AMCs were studied by the Vietnamese government since 1998 with the assistance of international consultants. Currently, there are 10 bank AMCs (belonging to commercial banks) and a national AMC (the Debts and Assets Trading Company) that adheres to the Ministry of Finance.

The bank AMCs were established according to a decision of the government in 2000, that provided the regulations regarding the establishment and operation of bank AMCs. Bank AMCs focus mainly on dealing, exploring, managing the mortgaging assets that are transferred from their parent entities (commercial banks) in order to recover the long-outstanding NPLs of the mother bank. With low capital and a lack of power, these AMCs are really only vehicles to collect the NPLs of the mother banks, and to consolidate paperwork with government support.

In addition to bank AMCs, in June 2003, the Vietnamese government established the national Debts and Assets Trading Company (DATC) under the management of the Ministry of Finance. The DATC has chartered capital of VND (Viet Nam dong) 2 000 billion (USD 127 million), which is considerably more than that of the commercial banks. It is the government's ambition to use the DATC as an important means to help enterprises resolve their long outstanding loans and distressed assets, and improve their financial health. At present, the DATC focuses on resolving the NPLs and NPAs of state-owned enterprises. The lifetime of the DATC is undefined.

In reality, the DATC is the only organisation allowed to buy NPLs in Viet Nam. It started its operations officially in 2004, though the NPLs resolved through the national AMC are still very limited.

By the end of 2005, it was reported that the SOCBs had resolved 92% of their NPLs that were incurred before 2000, and had successfully attained a new low. According to central bank sources, NPL levels at the SOCBs went from 7.6% in June 2005 to 4.7% in December of the same year. This reduction coincided with the application of a new loan classification system required by the State Bank of Viet Nam in May. Clearly, experts were surprised with the reduction since earlier discussions had raised concerns regarding bank NPL levels, which were expected to increase dramatically as the result of a new more stringent loan classification system. Suspicions, thus, arose regarding the reliability of the information and whether the NPLs were really resolved.

To accelerate the resolution of NPLs, the DATC recently signed a co-operation agreement with all five SOCBs to resolve their NPLs. The DATC is working together with the SOCBs to formulate a more comprehensive plan to solve the problem. The plan is expected to include the introduction of more sophisticated approaches such as bulk sales, joint ventures with foreign investors, etc. It is too early to comment on whether this approach will help resolve NPLs more quickly.

The State Bank of Viet Nam (SBV) is in the process of drafting a new banking reform programme to submit to the government by June 2006. Measures to continue improving the credit management system, resolve NPLs and prevent new NPLs from being incurred are expected to be high on the agenda of this second banking reform programme.

3) Recent legal and institutional developments in risk management and the banking sector

Continued efforts have been made to separate policy-based and directed lending from commercial lending. A bank called Viet Nam Bank for Social Policy (VBSP) was established to undertake directed and policy lending activities, to promote poverty reduction and to pursue other social purposes.

In addition, SOCBs are now given more autonomy in lending. They are now allowed to reject projects that they believe are not commercially viable. Evidence of this has been the recent denial of lending by SOCBs to a few large projects that were proposed by state-owned corporations. The change is reflective of a more conservative credit policy and should help prevent the recurrence of some bad debts.

Another proposal that is being considered by the government is to transform the Development Assistance Fund (DAF) into the Development Bank of Viet Nam. The DAF is a kind of development finance institution that is wholly owned by the state, and under the supervision of the Ministry of Finance. The DAF provides development investment credit,

post investment interest subsidies, export support credit, ODA on-lending, investment trust funds and disbursement trust funds. Under current banking laws and regulations, the DAF is not considered a credit institution and is not under the supervision of the central bank. The DAF manages total assets equal to 14% of Viet Nam's GDP. The transformation of the DAF is expected to take place in the second half of 2006, which will turn the organisation into a more transparent and effective policy lending institution, thus fulfilling one of Viet Nam's obligations in the World Trade Organization (WTO) accession process.

The DAF is working on a number of initiatives to improve its credit risk management system, which currently lags far behind those of Vietnamese commercial banks. They include: setting up a new loan classification system; designing an internal credit rating system that places more emphasis on the creditworthiness of borrowers instead of merely the feasibility of projects; human resource development; improving accounting practice; etc.

Last year also witnessed two remarkable changes in banking regulations pertaining to: i) capital adequacy and safety requirements; and ii) loan classifications and loan loss provisioning. The central bank now stipulates[1] capital adequacy ratios in banking businesses and for credit institutions operating in Viet Nam:

- *Minimum capital adequacy ratio (capital safety ratio):* Credit institutions, excluding foreign bank branches, shall maintain a minimum ratio of 8% between owners' capital and total risk bearing assets;
- *Credit limits to customers:* The regulation requires credit institutions to formulate internal policies with criteria to determine credit limits applicable to a single customer and groups of related customers. The total loan balance of a credit institution to a single customer shall not exceed 15% of its own capital. The total loan and guarantee balance of a credit institution to a single customer shall not exceed 25% of its own capital. The total balance of loans, and combined loans and guarantees to a group of related customers shall not exceed 50% and 60% respectively. It also stipulates that the total financial leasing amount for a single customer shall not exceed 30% of the own capital of a financial leasing company.
- *Liquidity ratio:* The regulation requires credit institutions to formulate a liquidity plan to ensure their liquidity and solvency. Credit institutions shall ensure a ratio of 25% between quick assets and liabilities due within the following month, and a ratio of 100% between quick assets and quick liabilities due within seven working days.
- *Maximum ratio of short-term mobilised funds used to finance medium and long-term loans:* The ratio for commercial banks is 40%, and 30% for other credit institutions.
- *Limits on capital contributions and share purchases:* Credit institutions may use their charter capital and reserve funds for investment in enterprises, investment funds, projects and other credit institutions in the form of contributions of capital, joint ventures, and share purchases. The investment in a credit institution shall not exceed 11% of the enterprise's or fund's charter capital, or of the project value. And, total investments shall not exceed 40% of the credit institution's charter capital and reserve fund.

There have been significant improvements in the methodology to calculate the above ratios, especially the capital adequacy ratio. This new regulation reflects a step forward for the Vietnamese banking sector towards international standards and best practices in banking operations.

The governor of the SBV has also promulgated a decision[2] on loan classifications and provisioning for bad debts of credit institutions. Under this regulation, a loan portfolio is to be classified into five groups as follows:

- *Group 1 (standard debts):* includes undue debt, whose principal and interest are assessed by credit institutions to be fully recoverable when they become due. Debts under this category are not subject to provisioning (0% rate of provisioning);
- *Group 2 (debts to which attention shall be paid):* includes debts overdue for less than 90 days and rescheduled debts that are now no longer due according to rescheduled terms. This group shall be provisioned at the rate of 5%;
- *Group 3 (sub-standard):* includes debts overdue between 90 and 180 days and rescheduled debts overdue for less than 90 days according to the rescheduled terms. This group shall be provisioned at the rate of 20%;
- *Group 4 (doubtful debts):* includes debts overdue for between 181 and 360 days and rescheduled debts that are overdue for between 90 and 180 days according to the rescheduled terms. This group is subject to a provisioning rate of 50%;
- *Group 5 (debts with potentially irrecoverable principal):* includes debts overdue for more than 360 days, debts frozen pending the government's handling, and rescheduled debts that are now overdue for more than 180 days according to the rescheduled terms. This group shall be provisioned at 100%. With respect to debt frozen by the government, specific provisions shall be set up according to the financial capability of the credit institution.

Debts can be upgraded or downgraded based on the assessment of the credit institution of the ability of the borrower to pay, and its risk profile. A non-performing loan is defined as a loan classified under group 3, 4 or 5.

One of the new requirements of this decision relates to setting up a general provision. A general provision is the amount provisioned for handling non-measurable losses in the course of loan classification, and in cases where credit institutions meet with financial difficulties attributable to the declining quality of debts. Credit institutions shall make general provisions equal to 0.75% of the total value of the debts in groups 1 to 4 within five years of the date that the regulation takes effect (*i.e.* before 15 May 2010).

This new regulation is believed to be more in line with international best practices, but remains a challenge to apply fully in practice. As required by the central bank, all SOCBs have developed comprehensive credit manuals that take into account international practices in risk management. The banks are also designing and implementing new internal credit rating systems.

Notes

1. Decision No 457/2005/QD-NHNN dated 19 April 2005.
2. Decision 493/2005/QD-NHNN dated 22 April 2005.

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ASIAN INSOLVENCY SYSTEMS:
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Part II

TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS IN CHINA AND HONG KONG, CHINA

THE COURT'S ROLE IN ENTERPRISE BANKRUPTCY PROCEEDINGS AND RESTRUCTURING IN CHINA

by
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Bankruptcy is a final stage where a market subject exits the market due to its business failure. From a court's point of view, a bankruptcy law is actually the procedural and substantive law applied by the court while liquidating debtors. Courts pay great attention to the legislation and reform of bankruptcy laws. The Supreme People's Court of China participated actively in the formulation of the Enterprise Bankruptcy Law and uses its practical experience to perfect the current bankruptcy system by adopting methods of judicial interpretation and case guidance.

Modern bankruptcy laws focus on reviving enterprises that fail or that may lose their ability to service their obligations. The conciliation and reorganisation proceedings under the current bankruptcy system of China are similar to a restructuring system. Provisions for conciliation and reorganisation under the current bankruptcy law are found in the Bankruptcy Law of China (For Trial Implementation) (hereinafter, the Trial Bankruptcy Law), the Procedure for Bankruptcy and Debt Repayment of Legal Person Enterprises under the Civil Procedure Law of China, and the Opinions of the Supreme People's Court on Several Issues Concerning the Implementation of the Law of China on Enterprise Bankruptcy (For Trial Implementation), (hereinafter, Opinions), the Opinions of the Supreme People's Court on Several Issues Concerning the Application of the Civil Procedure Law of China, and the Provisions by the Supreme People's Court on Some Issues Concerning the Trial of Enterprise Bankruptcy Cases (hereinafter, Provisions).

A comprehensive analysis of the provisions of the above-mentioned laws and judicial interpretations, and the systems of conciliation and reorganisation within the framework of the current bankruptcy law shows the following:

1. Conciliation and reorganisation shall be applied for by a debtor or the authority in charge of the debtor after the creditors file a bankruptcy petition;
2. Conciliation and reorganisation are closely linked, and are actually the same procedure;
3. The supreme authority in charge of the enterprise or the person appointed at the shareholders' meeting of the enterprise shall be responsible for the reorganisation;
4. The conciliation agreement is enforceable under some conditions; and
5. Conciliation and reorganisation are only applicable to the debtors' liabilities, not including the capital reorganisations of the debtors.

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Systems of conciliation and reorganisation play an important role in a bankruptcy law. However, only six articles in the Trial Bankruptcy Law provide them. Although eight articles in the Opinions and six articles in the Provisions of 2002 make supplementary provisions, many important problems (such as the lack of rules concerning the supervision of reorganisation, the application for withdrawal of bankruptcy declarations, and on the formation of voting groups), remain unsolved. Furthermore, the provisions concerning the withdrawal of proceedings of conciliation and restructuring have not been perfected, and other provisions, such as those concerning the administration of reorganisation procedures, are insufficiently rational.

The provisions concerning conciliation and reorganisation in the bankruptcy law of China are too theoretical and insufficiently operational. For example, prior to the successful conciliation of Ningcheng Laojiao Company Limited, no other listed company had been successfully reorganised through conciliation.

It was the case of ST ZhengBaiWen Capital that prompted the systems of conciliation and reorganisation to be applied to listed companies. The biggest problem in the ZhengBaiWen case concerned the distribution of equity among new investors and the original shareholders. Because a large number of shareholders were involved, and the reorganisation agreement was outside of the bankruptcy proceedings, the opinions of all shareholders were sought through the application of the principle that "objection shall be lodged explicitly and approval may be made tacitly". The result was the consent of a majority of the shareholders. As for the dissenting minority shareholders, their shares were repurchased at a fair price calculated by making reference to international practices. The reorganisation was finally completed, and the Zhengzhou Municipal Intermediate People's Court made a judgment to confirm the result.

Although the judgment by the Zhengzhou court conformed substantively to the regulations generally recognised by the restructuring legislation of other countries, and complied procedurally with the international trend for public authorities, represented by courts, to intervene in restructuring proceedings, there are still legislative lacunae that have caused disputes to arise in jurisprudential circle. The case has also caused people to think about the impact that restructuring proceedings, delisting and bankruptcy can have on the equity markets.

The Supreme People's Court of the People's Republic of China also paid attention to the restructuring of listed companies by means of the conciliation mechanism, and explicitly indicated that, for the purpose of reorganisation through conciliation, the bankruptcy petitions filed by listed companies may be accepted where conditions are appropriate. Three listed companies (Ningcheng Laojiao, Jinan Qingqi, and Jilin Paper Manufacturing), were successfully reorganised through the conciliation mechanism. The reorganisation of listed companies such as Shengfang Technik and Shenzhen China are currently being considered.

Prolonged weakness in the securities market has heightened liquidity risk in quite a number of stock companies. As a consequence, regulators have become interested in their reorganisation through conciliation. However, the restructuring process is beset with difficulties because legal resources are insufficient. Nevertheless, attempts to ensure that small and medium-sized shareholders of listed companies do not completely lose their original capital due to delisting, have helped financial institutions avoid systemic risks, have attenuated the effects on social stability, and have provided cases for reference in the formulation of restructuring proceedings under the new Bankruptcy Law.

The Bankruptcy Law of China, which is currently under review, provides for a classified voting system for secured and unsecured creditors and some special claims during the bankruptcy restructuring of an enterprise, but fails to make provisions concerning voting groups of shareholders. If no provisions concerning the acceptance or rejection of shareholders' equity in the restructuring proceedings are made in the Bankruptcy Law, problems similar to those encountered in the reorganisation of ZhengBaiWen will remain unsolved. As a result, a remedy needs to be specified for when groups of reference shareholders do not approve the restructuring scheme in order to prevent the failure of restructuring due to shareholders' refusal to co-operate.

A way of doing this may be to increase the groups of voting investors in the classification of voting groups for the restructuring plan, that is, "while the matters concerning the adjustment of equities of investors are involved in the draft restructuring plan, the people's courts shall make a decision to establish groups of investors for voting." When a court approves a restructuring plan, even though the group of voting shareholders fails to approve the restructuring plan, "the distribution proportions enjoyed by shareholders according to the draft restructuring plan shall be no lower than the distribution proportions that can be enjoyed according to bankruptcy proceedings when the draft restructuring plan is submitted for approval", and the people's court may approve the restructuring plan.

Such provisions play a positive role in the restructuring of public companies, and are of help in attracting third party investors and prompting the revival of enterprises. Attention also needs to be devoted to the protection of the shareholdings of small and medium-sized investors during the adjustment of stock equities that results from the compulsory approval of the restructuring plans of listed companies. Even if such shareholders gain nothing from the bankruptcy proceedings, a certain proportion of stock should be reserved for them in the restructuring plan so that (while protecting the best interests of creditors), the restructuring proceedings can perform the function of maintaining social stability, and benefit the long-term development of the securities market.

China is finding its way forward in the judicial practice of enterprise restructuring. The most important goal at present is to perfect the legislation for enterprise restructuring, and to create the conditions for restructuring proceedings to play a more significant role.

ISSUES IN THE ACCEPTANCE OF BANKRUPTCY CASES BY CHINESE COURTS

by
Yu Junfu and Chen Dong*

Bankruptcy occurs when a debtor is unable to repay debts due, according to the original intent of bankruptcy legislation, and in accordance with the provisions of Article XXXI of the Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases (the Regulations). The "inability to repay the debts due" means that the time limit for the debtor to perform on debts has expired and the debtor is unable to repay.

In the practice of bankruptcy liquidation, "bankruptcy" is often mixed up with "bankruptcy proceedings". Bankruptcy proceedings take place when the debtor is unable to repay the debts due. Their objective is to safeguard a majority of the creditors' interests while giving due consideration to the debtor's interests. The court distributes the debtor's properties upon application of the parties concerned.

The application and acceptance of a bankruptcy case is an important phase in bankruptcy proceedings, and covers such issues as which civil subject can become bankrupt, the conditions under which the bankrupt can enter into a proceeding, and how the people's court is to exercise jurisdiction and examine the issues, and make a final decision to start the proceedings. This article discusses the legal issues concerning the application and acceptance of bankruptcy cases from an attorney's viewpoint.

1) The debtor's bankruptcy ability

a) The debtor's bankruptcy ability under Chinese law and regulation

The debtor's bankruptcy ability means the debtor's competency for applying bankruptcy proceedings to solve the problem of debt service, that is, the civil subject's competency for being declared bankrupt. In view of the applicability principle, there exist two legislative doctrines in the provisions of every country's bankruptcy laws on the debtor's bankruptcy ability: the businessman bankruptcy doctrine, and the general bankruptcy doctrine. The difference between the businessman bankruptcy doctrine and the general bankruptcy doctrine is shown mainly in the applicability of bankruptcy laws to natural persons.

Chinese bankruptcy legislation is thought to adopt the businessman bankruptcy doctrine, and also the business corporation bankruptcy doctrine. Only a businessman with

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corporate capacity has bankruptcy competency (the new draft bankruptcy law will extend to natural persons).

According to the provisions of Article ILV of the General Principles of the Civil Law, a business corporation shall terminate upon being declared bankrupt in accordance with the law. In addition, it is provided under Article II of the Enterprise Bankruptcy Law (Trial) and according to the provisions of Article 199 of the Civil Procedural Law that this is applicable to people's enterprises.

In any case, when a business corporation is unable to repay its debts due to losses, both its creditors and the debtor may apply to the people's court to declare it bankrupt for liquidation. Thus, the subject of bankruptcy must first be a corporate organisation with independent capacity for civil liability, and next, a for-profit organisation engaged in productive operations. Only a business corporation and no other civil subject has bankruptcy ability for the moment.

In particular, any business corporation (owned by the people, or not), including collective enterprises with corporate capacity, affiliated enterprises, private enterprises, contractual joint ventures, co-operative ventures, solely foreign-funded enterprises set up within the territory of China, general joint-stock enterprises, etc. have bankruptcy competency. Article IV of the regulations also enumerates civil subjects without bankruptcy ability (including enterprises without corporate capacity, other organisations, non-corporate public institutions, small industrial or commercial businesses, lease holding rural households, individual partnerships, natural persons, etc.)

b) Several classes of bankruptcy subjects

1. Pro forma going concern business corporations

The so-called pro forma going concern business corporation is a business corporation that is already set up, does not go out of business or have its license revoked, and is legally regarded as a going concern. According to Chinese legislation and regulations, any business corporation that is legally a going concern may submit a bankruptcy application to the court in accordance with the law when there is a reason (such as the inability to repay debts and the inability to arrange a settlement with creditors).

The concept of "pro forma" going concern is raised here because the following issues may appear in practice. In one case, the so-called pro forma going concern means that the debtor may start bankruptcy proceedings once bankruptcy conditions are met, if the business license has not been revoked and the business continues to operate. In another case, the debtor is not able to pursue bankruptcy proceedings (even if the business license has not been revoked) because the business continues to operate only nominally. In another case, the debtor goes out of business for various reasons, has its business license revoked, and continues to operate or have its whereabouts unknown. It is questionable whether this type of enterprise is able to enter into bankruptcy proceedings in theory or in practice.

2. Enterprises going out of business, or with revoked licenses

In practice, more and more enterprises are going out of business or having their business licenses revoked. Most are not liquidated. They leave a considerable amount of outstanding debt, and thus make it hard to safeguard creditor interests. Regulations on enterprises that go out of business or that have revoked licenses are incomplete. Law and

practice should specify how to deal with such enterprises, especially with respect to whether they can use bankruptcy proceedings to distribute assets.

There have always been different theories on the legal nature of business corporations going out of business and on the revocation of licenses. One theory is the "personality elimination theory", which denies that a liquidated legal person has an independent personality. Other theories include the "personality discontinuance theory", the "personality semi-continuance theory" and the "personality continuance theory". These theories recognise the liquidated legal person's personality, but have different opinions on the basis of the origin of such personality.

Among them, the "personality continuance theory" is used in practice, and is recognised by most scholars and in most countries' legislation. According to this theory, a business corporation's personality is not eliminated until the liquidation is completed and the enterprise is terminated. The enterprise continues to have personality as the original business corporation during the period of liquidation, but with a different purpose. A business corporation at this time is called a "liquidated legal person".

We agree with the "personality continuance theory" for the following reasons: 1) if one does not recognise that enterprises going out of business or with revoked licenses have corporate personality, it would be hard to explain how these enterprises have the rights and powers to carry out liquidation activities, and dispose of credits and debts before they close; and 2) it is of significance for the settlement of legacy debts and the prevention of debt vacancy to recognise that business corporations going out of business or with revoked licenses have bankruptcy competency.

Because laws and regulations lack definitive provisions on these exit and liquidation issues, a large number of enterprises have appeared that are not liquidated (even though they have gone out of business or have had their licenses revoked,) or are terminated without liquidation. If these enterprises are not recognised as having corporate personality, barriers will be created for proceeding against these enterprises. It follows that evading liquidation has become a means for enterprises and shareholders to evade paying debts, or for shareholders to evade capital contributions, or for enterprise managers to appropriate the enterprises' properties.

The formulation of liquidation rules and other rules on the premise of recognising that enterprises have corporate capacity is helpful for preventing debt suspension. The Supreme People's Court acknowledges that business corporations going out of business with revoked licenses have corporate capacity in its judicial interpretations. In its reply No. (2000)24, the Supreme People's Court provides that:

> *…a business corporation, after having its business license revoked, shall carry out liquidation in accordance with the law, and will not be eliminated until the liquidation proceeding is completed and the business registration is cancelled. As a result, a business corporation shall still be regarded as a going concern after having its business license revoked until its registration is cancelled and may carry out the proceedings activities in its own name.*

After going out of business and the revocation of its business license, the enterprise continues to maintain corporate capacity, with its rights and powers restricted to the extent of liquidation. It can engage in civil activities only to the extent of liquidation. In principle, the enterprise shall not have legal relations as before winding up, but still have a direct repayment liability. The liquidators, at the time of performing the liquidation liability, shall assume the repayment liability for debts, but only subject to the liquidated

properties of the enterprises. Since these enterprises have corporate capacity, they also have bankruptcy competency. When their properties are insufficient to repay their debts, enterprises may apply for bankruptcy liquidation proceedings. The bankruptcy petition of these enterprises can be submitted in the liquidation process, or submitted without a liquidation process. Creditors may also submit bankruptcy applications directly.

3. Branches of foreign companies

Transnational bankruptcy cases are increasing with increasing globalisation and the development of transnational corporations and overseas investments. A number of issues arise with cross-border bankruptcies.

China has adopted the "doctrine of territoriality" in cross-border bankruptcies, that is, the force of the home country's bankruptcy declaration is limited to the home country, and does not extend to the debtor's properties abroad. At the same time, a foreign country's bankruptcy declaration only comes into force in the foreign country, and has no force on the debtor's properties in other countries. In judicial practice, China does not acknowledge that foreign parent companies have recourse to their properties within the borders of China after being declared bankrupt abroad. It holds that branches of foreign companies in China have an independent bankruptcy ability, and are not directly subject to the influence of their foreign parent companies.

In recent judicial practice, this doctrine of territoriality has been refined further. Article 73(4) of the regulations provides that "any bankrupt enterprise's properties abroad shall be reclaimed by the liquidation group". China's legislation and judicial practices thus try to assure the maximisation of Chinese creditors' interests.

c) The applicability of the corporate personality disclaim principle in the acceptance of bankruptcy cases

Although the corporate personality disclaim principle has taken a place in the two main legal systems, China's phased market development meant that the corporate personality disclaim principle developed late in China and is still in its early days. It meets with difficulties in practice, especially in bankruptcy cases, since definitive laws and regulations are still lacking.

i) Related regulations and judicial interpretations

On the legislative horizon, the Bankruptcy Law (Trial) does not have related laws and regulations on personality disclaim, nor does the Company Law have an exception clause for the corporate limited liability principle. But, on 27 October 2005, the 18th Session of the 10th Standing Committee of the National People's Congress amended the Company Law. Article XX of the new Company Law provides that any company's shareholders shall not abuse their shareholder rights to impair the interests of the company or other shareholders, or abuse the company's independent corporate status and the shareholders' limited liability to impair the interests of the company's creditors. If the company's shareholders abuse their rights and inflict losses upon the company or other shareholders, they become liable for compensation under the law. And, if the company's shareholders abuse the company's independent corporate status and the shareholders' limited liability to evade debts and impair the interests of creditors, they assume joint and several liability with the company. It is the first time that Chinese authorities develop a regulation deriving from the principle of corporate personality disclaim.

In judicial practice there are widely divergent attitudes towards the corporate personality disclaim principle. On the one hand, it is provided for in Article IV of the Notice on Settlement and Rectification of the Torts and Debts of Companies Which are Terminated and/or Merged issued by the State Council on 12 December 1990 (hereafter referred to as the State Council's Notice) that for any company that was registered and incorporated at the administration for industry and commerce, that does not actually have any self-owned capital, or has paid-up capital out of line with the registered capital (except otherwise provided by the state), the governing authority directly approving the establishment of the company, or the applicant for the establishment of the company, or its investors shall assume the repayment liability for the company's debts to the extent of the registered capital. Any party providing a guarantee for the registered capital shall assume joint and several liability to the extent of the guaranteed capital.

It is also provided for in Article V that registered capital is a currency representation for any business corporation's properties under operation and management, or any business corporation's self-owned properties granted by the state. The capital contributed by each level of institution and organisation to the company can never be reclaimed. If the company's governing authority or sponsor organisation withdraws or transfers capital, conceals properties or evades debts, it shall refund all the withdrawn or transferred capital or the concealed properties, and repay the company's debts due. If there is something left, then anything falling under the investments of the Party and government organisations shall be taken as state-owned assets, and directly reclaimed by the investment organisations. Anything falling under the investments of collective enterprises shall be returned to the original investment organisations.

The provisions above are special regulations on the settlement issue of the terminated companies' credits and debts and, obviously, break the principle of shareholder limited liability (that shareholders are not liable to company creditors, and are liable only to the extent of their investment.) This is mainly shown in: 1) investors are required to repay the company's debts; and 2) investors are required under some regulations to assume the repayment liability of the company's debts to the extent of the amount of profit-making or to the extent of the company's misappropriated properties, but not subject to the limit of the amount of investment.

It is provided under Article (II) of the Reply on the Assumption of Civil Liability for an Enterprise Established by Enterprises after Being Terminated or Going out of Business made by the Supreme People's Court on 30 March 1994 (hereafter referred to as the Supreme Court's Reply) that any other enterprise sponsored by enterprises obtaining a corporate business license, having a paid-up self-owned capital in the amount provided under Article XV(7) of the Implementation Rules for the Registration Management Regulations of Business Corporations of China or other relevant regulations, (though out of line with the registered capital, and meeting other conditions for a business corporation) shall be recognised as having corporate capacity and shall independently assume a civil liability to the extent of its properties. But, if this enterprise does not have sufficient property to repay the debts after being terminated or going out of business, the sponsor enterprises shall assume a civil liability to the extent of the difference between the paid-up self-owned capital and the registered capital.

It can be seen from this clause that this reply acknowledges the following two principles in the case that the investment of a business corporation fails to reach its registered capital: 1) that when the enterprise's assets are insufficient to repay the debts, the investors assume a joint and several liability with the enterprise; and 2) that the joint

and several liability assumed by the investors has the nature of a supplementary liability and is subject to the extent of the difference between the self-owned capital and the registered capital that occurred as a result of underinvestment.

It is also provided in Article 3 that any other enterprise sponsored by enterprises obtaining a corporate business license, (but having no paid-up self-owned capital or having a paid-up self-owned capital lower than the amount as provided under Article XV(7) of the Implementation Rules for the Registration Management Regulations of Business Corporations of China or other relevant regulations), and not meeting other conditions for a business corporation, shall be recognised as not having corporate capacity, and have its civil liability assumed by the business corporations sponsoring this enterprise. This clause provides that investors failing to contribute or fully contribute the registered capital shall assume an obligation of unlimited repayment liability to balance the creditors' interests.

This document represents the spirit of the corporate personality disclaim principle to a certain extent, and makes certain regulations on the abuse of corporate personality, underinvestment, failure to contribute or fully contribute, the registered capital and other acts.

In contrast, it is provided under Article I of the Guiding Opinion **of Guangdong Senior People's Court on Several Issues Concerning the Trial of Bankruptcy Cases of** June 2003, that for any business corporation applying for, or being applied for bankruptcy, the court shall not reject the bankruptcy application because the debtor's shareholders or investment organisations owe or withdraw the registered capital. After the court declares it bankrupt, any person liable for owing or withdrawing the registered capital shall supplement or return the owed or withdrawn registered capital, which shall be taken as part of the bankrupt enterprise's bankruptcy properties.

This local senior court's judicial guiding document is vindication for the corporate limited liability principle. The opinion emphasises that in any bankruptcy case, if a company's shareholders owe or withdraw the registered capital, this will not affect the independence of corporate personality, and the company will still assume the debt service liability to the extent of the registered capital, while any person liable for owing or withdrawing the registered capital only needs to supplement or return the owed or withdrawn registered capital. In other words, shareholders still assume a limited liability to the extent of the amount of their investment.

ii) Problems faced by courts at the time of applying the corporate personality disclaim principle

Since there are no definitive regulations on the corporate personality disclaim principle under Chinese law, several documents provide specific operating bases for applying the corporate personality disclaim principle to the enterprises' registered capital deficiency in Chinese judicial practice, and also make instructive explorations for the establishment of the principle. These documents make regulations similar to the corporate personality disclaim principle in particular cases, and have the following common points: 1) all of them take the lawful and valid establishment of corporate legal personality as a premise; 2) the investors' false investment is taken as one of the constitutive requirements for liability assumption; and 3) the investors directly assume the enterprises' debts.[1]

These standards not only show the direction for the local courts' judicial trials, but also provide legal bases for the local courts to "pierce the corporate veil", and safeguard

creditors' interests. This is also represented in Article XLVIII of the Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Dispute Cases (I) (Exposure Draft), which provides that:

> *…the people's courts shall strictly follow the corporate independent personality and shareholder limited liability principle specified in the Company Law, and only order the controlling shareholder to directly assume a civil liability for the company's creditors if there exist particular causes for abusing corporate personality in specific legal relations provided in these regulations.*

Articles 50 and 51 of these regulations of the Supreme Court also have specific provisions on the corporate personality disclaim under the circumstance that the company has ill-defined accounts or funds merged with its shareholder, or the company's business is confused with that of its shareholders or dominated by its controlling shareholder, or the company has in nature only one shareholder, etc.[2]

However, in the trial of bankruptcy cases, (since there is no regulation on the corporate personality disclaim principle in the Chinese Bankruptcy Law and its judicial interpretations), according to law applicability rules, any court, at the time of hearing any bankruptcy case, shall in principle apply the provisions of notice and reply once finding that the bankrupt debtor has a false registration, withdrawn capital or committed any other act abusing the independence of the corporate legal person. Although this is true in theory, problems may occur in judicial practice.

First, according to the provisions of the Guangdong Senior People's Court's Guiding Opinions, a court shall not reject a bankruptcy application at the time of hearing the application for the reason that the debtor's shareholders or investment organisations owe or withdraw the registered capital, but shall require any person liable for the owed or withdrawn registered capital to supplement or return the owed or withdrawn part after the bankruptcy declaration and put it into the bankruptcy properties. That is, when the debtor submits an application for bankruptcy, the court shall not reject corporate personality by reason that the shareholders owe or withdraw the registered capital, but shall still follow the corporate independent personality and shareholder limited liability principle, and have it assume the repayment liability to the extent of the amount of the investment. This is inconsistent with the State Council's notice and the Supreme Court's reply.

Guangdong Senior Court's Guiding Opinion is not legally binding, however, its influence and significance should not be underestimated. One is a judicial interpretation with legally binding force, and the other is a guiding opinion of a superior court on the inferior courts. The contradiction makes regulations more ambiguous and renders the work of the courts more difficult when applying the laws. On the one hand, judges will be exposed to the awkward situation of balancing the judicial interpretation against the guiding opinion in the trial of individual cases and, on the other hand, the confusion will allow some parties and their attorneys to pursue vested interests and evade the laws.

The ambiguity of the prevailing legislation also facilitates the abuse of the corporate personality independence principle, the evasion of the laws, and the impairment of creditors' interests. Since the corporate personality disclaim principle is still at the phase of judicial practice in China, judges have adequate discretion. In specific cases, if the courts find that investors withdraw capital or fail to fully contribute the capital when hearing bankruptcy cases, in terms of legal applicability, creditors and investors will make different choices to safeguard their own interests. If the investors apply the Guangdong Senior Court's Guiding Opinion, then the investors only need to make up for

the capital fund without assuming an unlimited liability to the creditors. Creditors will persist in applying the Supreme Court's notice, whereby investors still need to assume an unlimited repayment liability for outstanding debts as well as liability for the amount of underinvestment.

If judges are partial to investors when exercising discretion, false investors will evade liability, and creditors will be unable to get relief. This facilitates phenomena such as multiform "briefcase companies" or "government bodies turned companies". As far as the creditors are concerned, if they are unable to predict the economic outcome of activities, or have their interests reasonably safeguarded or their impaired interests relieved, they will distrust the law and lose confidence in the existing economic order. This will reduce confidence in the credit markets and affect overall social and economic development.

In bankruptcy practice, the courts may also meet with inconsistent standards for accepting bankruptcy applications. Since the standards for accepting bankruptcy cases in legislation lack operability, there is no consistent standard for whether the debtor has bankruptcy competency in practice. The Civil Procedural Law and the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases both provide that[3] "any bankrupt debtor shall have a corporate capacity, and any enterprise without corporate capacity, small industrial or commercial business, partnership organisation, or lease holding rural household does not have the competency to be the subject of bankruptcy."

However, there are neither definitive regulations nor consistent trial practices to determine whether an enterprise with a business license (but failing to meet the essential conditions for a business corporation), is able to apply for bankruptcy or be applied for bankruptcy. Under one opinion, the judgment on whether an enterprise has corporate capacity can only be based on the enterprise's registration. Any registered enterprise can be subject to bankruptcy, even if the registered capital has not been contributed or is only partially contributed. This then becomes a problem of ordering the enterprise's investors or sponsors to supplement or make up the registered capital.

For instance, the Guangdong Senior People's Court emphasises that the competency for being subject to bankruptcy shall be acknowledged for any enterprise with a corporate business license (even if the registered capital fails to reach the minimum required), as long as its corporate capacity is not revoked by the administration for industry or business.[4]

Another opinion holds that the judgment should be based on whether the enterprise meets essential conditions for a business corporation at the time of establishment. For any licensed enterprise, (with unpaid or insufficient registered capital), the court should reject its competency as a subject of bankruptcy in accordance with the provisions of the Supreme Court's Reply. This is the opinion of the authors for three reasons:

First, as far as Guangdong Senior Court's guiding opinion is concerned, its goal is to: strike a balance between the interests of bankrupt debtors and creditors; close obviously insolvent enterprises in a timely fashion, and exit the market through bankruptcy liquidation; and maintain the stability and safety of the social and economic order. This will, however: indirectly protect some malicious investors in the market; facilitate abuse of the independence of corporate personality; impair the independence of corporate personality, and the authority and rationality of the limited liability principle; and lead to distrust of the market order and market credit.

Second, it goes against notions of fairness and justice if interests gained through unlawful acts are protected by law, while the losses caused by unlawful acts cannot be relieved.

Third, as far as current judicial practice is concerned, when creditors find that the debtor lacks assets to repay debts (or has no assets at all when proceeding against the debtor or applying for forcible execution), the creditors' attorney will first consider the condition of the contributions of the debtor's shareholders. If it is found that the shareholders underinvested or withdrew an investment, they will suggest that creditors join shareholders as co-defendants, and have them assume a joint and several repayment liability. In practice, this is the last and also the best legal relief for creditors.

In December 2002, the vice president of the Supreme Court, Mr. Li Guoguang, made a speech at the National Court Civil and Commercial Trial Working Conference and pointed out that:

> *...when a company's creditors proceed against the company's shareholders because the company's shareholders have any unfaithful act abusing corporate personality and thus making the company unable to perform or fully perform the repayment obligation, the people's courts shall accept. ...and when hearing this type of case, shall decide the shareholders' liabilities according to the specific circumstances, and have the shareholders assume a joint and several repayment liability for the company's debts to the extent of the amount of underinvestment if the shareholders have any underinvestment; have the shareholders assume an unlimited joint and several liability for the company's debts if their underinvestment makes the company's registered capital lower than the minimum standard provided in the Company Law, and the company's legal personality unable to be lawfully created; or have the shareholders assume a joint and several liability for the company's debts to the extent of the company's withdrawn assets if the shareholders withdraw the company's assets and thus result in the company's insufficient performance capacity. If the shareholders' assets are merged with the company's assets, or the shareholders' business is merged with the company's business, the company's personality will be absorbed by the shareholders' personality and become not independent, the shareholder shall assume an unlimited joint and several liability for the company's debts.*[5]

In conclusion, defects in the corporate limited liability system have emerged with the development of the Chinese market economy. These include false investment by shareholders, withdrawal of investment, and underinvestment, along with acts such as nominal parent and subsidiary companies, and the application of the corporate limited liability principle to deceitfully impair creditor interests. This damages the relationship between the company's shareholders and its creditors, and other stakeholders, and impairs the authority and predictability of law. The improvement of the Chinese corporate personality disclaim principle and the further development of the corporate limited liability system are urgent.

In the authors' opinion, it is necessary for judicial authorities to conduct further study in order to draw on the corporate personality disclaim principle in the company laws of other countries. It is even more necessary for legislative authorities to increase the force of standard documents, and improve the corporate personality disclaim principle on the horizon of legislation. The reason for the current disorder in China with respect to the application of the corporate personality disclaim principle is slow and confusing

legislation. There are no laws or rules to go by due to the lack of detail and the roughness of prevailing legislation. In addition, there are inconsistent voices in judicial practice.

The most important step is, therefore, to build the authority and the integrity of the present laws. On the one hand, one should insist on the good faith principle of the General Principles of the Civil Law in the market economy, and prevent fraudulent acts and abuses of rights. On the other hand, legislative authorities may consider supplementing the exception clause for corporate limited liability to specify the corporate personality disclaim principle in the amendment to the Company Law. At the same time, corresponding supporting provisions should be made in the Bankruptcy Law, and the Civil Procedural Law.

First, it is necessary to specify the competency for the subject of bankrupt legal persons. Once the court finds that an enterprise applying (or being applied) for bankruptcy has a personality defect, the court should reject the application. Second, in the case of the debtor's applying for bankruptcy, it should be provided that creditors have the right to oppose the corporate personality disclaim in the process of the court's acceptance of the bankruptcy case, and that the court has an obligation to hear and give a verdict on such an opposition.

2) Essentials of bankruptcy

The essentials of bankruptcy describe the conditions under which the debtor with bankruptcy ability (a business corporation) can apply for (or be applied for) bankruptcy, and start the bankruptcy proceedings. It also describes the essential conditions for the court to accept the bankruptcy case. In other countries, these matters are grouped by scholars into the essentials of bankruptcy. These include: the debtor has reasons for bankruptcy; there is no barrier to bankruptcy; and a majority of creditors exists; etc. On the problem of which matters fall under the essentials of bankruptcy, since all countries have different legislative backgrounds, social and national situations, there are also differences between laws and the opinions of scholars.

According to Chinese bankruptcy legislation, any business corporation entering bankruptcy proceedings shall meet the following conditions:

a) The debtor reaches the bankruptcy limits

The bankruptcy limits (also called bankruptcy reason), are the legal factual basis for the parties concerned to submit a bankruptcy application, and for the court to start bankruptcy proceedings, and declare the debtor bankrupt.

It is provided under Article III of the Chinese Enterprise Bankruptcy Law (Trial) that any enterprise that suffers heavy losses due to poor operations and management, and is unable to repay its due debts may be declared bankrupt in accordance with the provisions of this law. It is provided under Article 199 of the Civil Procedural Law that (for any business corporation unable to repay its debts due to heavy losses), either the creditors or the debtor may apply to the people's courts to declare the debtor bankrupt for liquidation.

This is provided for in both the Enterprise Bankruptcy Law (Trial) and the Civil Procedural Law under the conditions of "inability to repay the debts due", and "incapacity to repay the debts due". Under these laws a "heavy loss" means insolvency. The focus of inability to repay the debts due is on whether the debt relationship can be maintained as normal. The insolvency focuses on asset/liability ratios and the repayment

risk incurred, studies the debtor's repayment ability (only subject to the limit of physical properties but without consideration of credit, capability and other possible repayment factors), and calculates the amount of debts without consideration of whether they fall due, and includes all of them into the gross amount. The debtor usually has become insolvent by the time it is unable to repay the debts due. But, even if the book value of assets still exceeds the liabilities, the debtor may also be unable to realise unreasonably structured assets, or may be unable to repay debts because of poor operations and management.

On the other hand, if the debtor is able to repay debts using properties, loans and other credit means at the time of becoming insolvent, it is not sure to lose the ability to repay debts. There are, therefore, not only conceptual differences between insolvency and inability to repay, but also differences in the definition of bankruptcy limits in practice. Accordingly, taking the inability to repay the debts due as the bankruptcy reason is called a cash flow standard, while taking insolvency as the bankruptcy reason is called an assets/liabilities standard. Taking the inability to repay as the bankruptcy reason is mainly to maintain the existing economic order and debt relationships, while taking insolvency as the bankruptcy reason emphasises safeguarding creditor interests from the angle of property repayment ability.

According to other countries' and Chinese bankruptcy liquidation practices, we shall focus the enterprise bankruptcy reason on "inability to repay the debts due", and "incapability to repay the debts due". The Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases provides a clearer definition of an enterprise's inability to repay the debts due in Article XXXI. The "inability to repay the debts due", and "incapability to repay the debts due" are again emphasised as the focus of bankruptcy reasons. This is because Chinese bankruptcy law was still in the era of the planned economy, and "heavy loss" was taken as the reason for bankruptcy with a view to the condition of people's enterprises.

This gives rise to problems as follows: 1) creditors will find it hard to lodge a proof when submitting a bankruptcy application. There is no way for the creditors to know whether the debtor is insolvent or demonstrate proof. Taking this as the bankruptcy reason, if strictly implemented, is sure to restrict or even deprive creditors of the bankruptcy application right. However, if the creditors are not required to provide proof, it may also occur that a bankruptcy application could be submitted without proof of the bankruptcy reason; 2) the court will have no way to conduct a timely investigation and ascertain at the time of checking whether to accept a case. Firstly, the debtor's financial accounts cannot be taken as a basis for the decision. Debtors on the verge of bankruptcy always have chaotic bookkeeping, and asset records are inconsistent with reality. They fail to book and settle various properties, (such as impairments of commodity stocks, raw materials, doubtful accounts receivable, etc.). As a consequence, there is no way to prove whether the debtor is insolvent by book assets. Even the existence of worthless unfinished buildings may become a reason for the debtor to defend itself against a bankruptcy application. Second, in order to prove whether the debtor is insolvent, it is necessary to make an asset appraisal and financial audit, which takes time, or is impractical during the period provided by the law for the court to decide whether to accept the case. Third, when the inability to repay is taken as the only bankruptcy reason, suspended payments of debts due in a continuous state may be inferred and judged as inability to repay. The suspended payment can be proved at the time of bankruptcy application as *prima facie* evidence and can be investigated and ascertained on a timely basis when the court examines and

accepts the case. But, the court can not ascertain insolvency without material proceedings. Furthermore, legislation can not find a solution by means of presumption.

The inability to repay debts due should focus on whether the debt relationship can be maintained as normal. We think it should be grasped in the following aspects: 1) the debtor loses the ability to repay, that is, the ability to repay debts through property, credit, capacity or any other means. Repaying debts by means of credit refers mainly to the conversion or extension of debts, and repaying debts by capacity refers mainly to repayment of debts by labour, services, etc.; 2) what the debtor is not able to repay are debts that fall due, and are claimed, undisputable or determined in name. If before the maturity of the debts, the creditors believe that the debtor will be unable to repay them after maturity, or the debtor files a request for extension of debts undue, it will not be taken as inability to repay, because the repayment obligation has not come into existence at that time. If the creditors fail to claim the debts due, it will be taken as an implied consent to extension. Even if the debtor is already incapable of repaying these debts, it cannot be taken as a reason for bankruptcy because the condition of inability to repay did not actually occur. If, for a claimed debt, both parties dispute whether it exists or dispute the amount, etc., it comes to the question of whether the debtor shall (and is able to repay) if a court or an arbitral authority give an effective verdict, acknowledge the right and obligation, and determine the debt in legal name; 3) the debts are not limited to objects payable by money, but must be valuable in monetary terms, or else declaring bankrupt will become meaningless because debt cannot be repaid in the bankruptcy proceedings; and 4) it means the debtor's continuous inability to repay all or most debts during a certain or a predictable period, but not suspension of payment for temporary fund turnover problems. Here the debtor's long-term continuous inability to repay the debts will not be taken as a necessary condition: only if there are other facts proving that the debtor will be continuously unable to repay the debts during a predictable period.

b) Absence of barriers to bankruptcy

If a bankruptcy proceeding is not started, or is terminated for a legal cause that prevents the starting or continuation of bankruptcy proceedings, the legal cause is referred to as a bankruptcy barrier. According to regulations in different countries, bankruptcy barriers are classified into: barriers that prevent the start of bankruptcy proceedings; and barriers that prevent bankruptcy declarations. Only the barriers preventing the start of proceedings are discussed below:

i) Legal barriers

A legal barrier means that the court has the right to reject the bankruptcy case for certain reasons in law and regulation. According to the provisions of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases, legal bankruptcy barriers include:

(1) The claimant fails to pay the court a case acceptance fee

Any debtor or its creditors, when submitting a bankruptcy application, shall pay the court a bankruptcy case acceptance fee. If the fee is not paid, the court may not accept the bankruptcy application.

(2) The debtor's bankruptcy application fails to get approved by the competent authority

It is provided under Article V of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases that any state-owned enterprise applying to a people's court for bankruptcy shall submit a document from the superior governing authority approving its bankruptcy. Any other enterprise shall provide a document of its sponsors' or shareholders' resolution on the enterprise's bankruptcy.

(3) The claimant submits a hostile application

Article XII of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases provides that:

> *...if the people's courts finds any of the following circumstances upon examination, the bankruptcy application will not be accepted: (I) the debtor has such acts as concealment or transfer of properties etc., and applies for bankruptcy in order to evade the debts; (II) The creditors use the bankruptcy application to deface the debtor's business reputation, and intend to impair fair competition.*

According to these regulations, the court (if finding that the purpose of the debtor's bankruptcy application is to evade its debts or the purpose of the creditors' bankruptcy application is to defame the debtor, or impair fair competition) shall reject the bankruptcy application. As a result, if the claimant submits a hostile application, it will also constitute a bankruptcy barrier.

(4) The debtor's objection to the claimant's credits is tenable

It is provided under Article IX of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases that if the debtor lodges an objection to the creditors' rights when the creditors apply for the debtor to go into bankruptcy, the court, if considering that the objection is tenable, shall advise the creditors to lodge civil proceedings first, and reject the bankruptcy application.

ii) De facto bankruptcy barriers

De facto bankruptcy barriers mean that some de facto reasons exist for making it inadvisable or impossible to start a bankruptcy proceeding. These de facto bankruptcy barriers include:

(1) Whereabouts unknown

The whereabouts of the debtor's staff or properties are unknown, in which case the debtor is of de facto inexistence, and no bankruptcy proceedings can be carried out;

(2) Serious disorder

The debtor's financial and property are seriously disordered, and most business materials are lost and cannot be investigated and ascertained; and

(3) Social turbulence

For certain reasons, the debtor's bankruptcy may give rise to serious social turbulence, making it inadvisable to accept the bankruptcy case for the moment.

As regards "having a majority of creditors" as a pre-requisite for bankruptcy, there is no definite regulation in Chinese bankruptcy legislation and judicial interpretations. Considering that the function of the bankruptcy proceedings is to fairly distribute the debtor's properties to a majority of creditors, if multiple creditors do not exist, then bankruptcy proceedings have no practical meanings, and bankruptcy proceedings cannot be organised (since it is not possible to organise a creditors' meeting).

3) The jurisdiction and acceptance of bankruptcy cases

a) The jurisdiction of bankruptcy cases

Jurisdiction means the right and power to interpret and apply bankruptcy law and regulation, that is, the division of authority among different courts.

i) Territorial jurisdiction

Both Article V of the Enterprise Bankruptcy Law (Trial) and Article I of the Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases provide that enterprise bankruptcy cases shall be under the jurisdiction of the people's court in the debtor's place of residence. The debtor's residence means the location of its main office. If the debtor has no office, the people's court at its place of registration has jurisdiction. In practice, the location of an enterprise's main office is generally determined according to the following rules: 1) the head office is the location of the main office (such as the location of the president and the financial staff); and 2) if the head office has several locations, the main office is determined by the number of executives, business volume, length of office time, and other factors. If the location of the main office cannot be determined, then multiple territories can be the location of the main office, and all relevant local courts will have jurisdiction.

ii) Hierarchical jurisdiction

Jurisdiction by hierarchy means that the scope for accepting bankruptcy cases between superior and inferior people's courts is divided according to certain standards. Jurisdiction by hierarchy is provided under Article II of the Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Bankruptcy Cases. The article states that the grassroots people's courts generally have jurisdiction over the bankruptcy cases of enterprises authorised and registered by the county, or county-level city or district administration for industry and commerce. The intermediate people's courts generally have jurisdiction over bankruptcy cases of enterprises authorised and registered by the district (or district level or above) administration for industry and commerce. Bankruptcy cases of enterprises included in the national plan for regulation are subject to the jurisdiction of an intermediate people's court. According to this judicial interpretation, bankruptcy cases are generally subject to the jurisdiction of the grassroots and intermediate people's courts. The senior people's courts and the Supreme People's Court do not directly handle bankruptcy cases.

iii) Central jurisdiction in practice

In Shanghai, Shenzhen and other cities with concentrated bankruptcy cases, the people's courts generally take a mode of central jurisdiction, which means to say that all bankruptcy cases in the region are subject to the uniform jurisdiction of the intermediate people's court. For instance, it is provided under Article V of the Shenzhen intermediate people's court's Procedures for Hearing Enterprise Bankruptcy Cases, that the bankruptcy of any corporation registered in Shenzhen shall be heard by the Shenzhen intermediate people's court.

Specialised proceedings for bankruptcy cases have become a universal trend. In the United States, France and other countries, bankruptcy cases are accepted by special courts. For instance, in the United States, bankruptcy cases are accepted by the federal district bankruptcy courts, the federal bankruptcy appeals courts, or the Federal Supreme Court. In France, bankruptcy cases are accepted by commercial courts. In countries without special courts, bankruptcy cases are also heard in a specialised way.

There is a limited number of judges who are specialised to hear bankruptcy cases. Since bankruptcy laws are different from general civil laws, there are many special arrangements in judicial proceedings. Bankruptcy affairs demand considerable knowledge and professional experience in law, business management, etc. and judges need to expend considerable time and effort to supervise and guide liquidation. Bankruptcy trials are, therefore, characterised by their degree of specialisation, and also the need for judges to pay attention to their whole course from acceptance to termination. The jurisdiction and trial of bankruptcy cases is decided by the particular details of the proceeding.

b) The acceptance of bankruptcy cases

After the people's court accepts a case, the debtor will be put into protection, and the execution proceedings on the debtor's properties will be suspended. It also means that the debtor starts to be terminated as a business corporation. The people's courts take special care in examining and accepting cases in which the interests of creditors, the rights and interests of investors, the interests of employees, social stability and other factors are involved.

i) Case acceptance and hearing proceedings

The acceptance and hearing proceedings are provided in the judicial practice of many cities and districts. Whether to accept a bankruptcy application is determined by giving full public audience to each party's positions. First, the provisions on hearing proceedings itemise the written materials to be submitted by the bankruptcy claimants. This helps the people's courts conduct the examination of materials. Next, all bankruptcy hearing proceedings provide for public summons of the concerned parties to make statements in the courts and respond to inquiries. Article V of the Rules of Shenzhen Intermediate People's Courts on Accepting and Hearing Bankruptcy Cases provides that the participants in bankruptcy hearing proceedings shall include the bankruptcy claimant, known creditors with a large amount of credits, the enterprise's legal representative, financial staff and employee representatives, the enterprise's top governing authority, intermediary institutions issuing the enterprise's assets appraisal and audit reports etc. Last, the hearing proceedings generally require that: the bankruptcy claimant state the cause for the bankruptcy application and present relevant proofs; the proposed bankrupt enterprise's legal representative or person in charge state the condition of the enterprise or raise a plea; the intermediary institutions comment on the audit and appraisal reports; the

collegial panel make a survey; concerned persons make inquiries, etc. Accepting the case based on full information makes the court better acquainted with the relevant issues and lays a solid foundation for progress. It also helps reveal hostile bankruptcy acts and prevent ethical risks in the examination and hearing process.

ii) Examining bankruptcy cases for acceptance

In practice, the people's courts examines bankruptcy applications in the following aspects:

(1) Whether the debtor is unable to repay due debts

The debtor's inability to repay debts is a legal bankruptcy limit. In practice it is generally shown by the facts that debtors are not able to perform on a large number of verdicts because its main assets have been seized by the people's court upon application of the creditors, or it has broken faith for an extended time.

(2) Whether the debtor continues to exist

Whether the debtor continues to exist, and whether its principal assets, financial accounts, or staff still exist. It will not meet the conditions for bankruptcy proceedings if nothing is left. In addition, the debtor's asset condition shall also be taken into account. If it is insufficient for payment of bankruptcy expenses, bankruptcy proceedings will not be started.

(3) Whether the debtor is a special enterprises

It is provided under Article III(2) of the Enterprise Bankruptcy Law (Trial) that no bankruptcy declaration will be made for: any utility or any enterprise materially impacting the national economy and the people's livelihood; or an enterprise given supports by governmental authorities to repay debts or by other measures. A utility or an enterprise impacting the national economy and the people's livelihood (such as traffic, energy, infrastructure enterprises), have a direct impact on the macro economy and the people's livelihood. Since such an enterprise's bankruptcy affects the economy of some regions or even the country, it is necessary for laws to protect them. This does not mean that these enterprises cannot be declared bankrupt, or that these enterprises do not have a bankruptcy ability (bankruptcy competency), but that the courts shall take care in examining and deciding to accept bankruptcy cases, and shall consider whether governmental authorities give support to these enterprises or could take other measures to help them repay their debts. If the government supports the enterprise or takes other measures to help it repay debts, bankruptcy cases shall not be accepted.

(4) Social security

A basic condition that makes China different from developed western countries is that China does not have a social security system. Neither the rural nor the urban population is covered by social security. In addition, the vested social security obtained by urban residents is limited. The incomplete social security system and the low level of security constrain the normal operation of bankruptcy proceedings.

Bankruptcies put pressure on social stability due to the cancellation of labour contracts and the unemployment of workers without adequate security. As a result, it is necessary to examine the conditions of employees, and whether a bankruptcy gives rise to

social problems. If a case falls under those included in the enterprise bankruptcy plan of the State Council, employee placement expenses will be paid to employees from the transfer fees of land use rights.

If a bankruptcy case is a general bankruptcy case (not included in the bankruptcy cases planned and regulated by the State Council), it will not apply the employee placement policy. Legal provisions and related judicial interpretations state that the wages of employees and compensation for the cancellation of labour contracts shall be repaid in the first order of bankruptcy distribution, and that employee medical and living expenses may be firstly appropriated from the bankruptcy properties during the liquidation period. In these cases, the court shall take care to examine the impact of bankruptcy on employees, since the amount of compensation obtained by employees is less than that obtained from bankruptcy cases within the plan. If the enterprise has many employees, bankruptcy will have a significant impact on their lives, and the court will accept the case on the condition that the relevant government departments give support.

(5) Trading before the enterprise's bankruptcy application

Article IIIV of the Enterprise Bankruptcy Law (Trial) provides that during the six months before the court accepts the bankruptcy case to the day of the bankruptcy declaration, the enterprise's concealment, partition without permission or free transfer of properties, abnormal underselling of properties, provision of property security for debts, advance repayment of debts, abandonment of own credits and other acts are of no effect. When examining and accepting bankruptcy cases, the court shall focus on material trading acts within the six months before the bankruptcy application and, if it finds any of the above acts, shall correct them immediately.

In addition, the court shall examine whether the debtor has concealed or transferred assets, or if the purpose of the bankruptcy application is to evade debt repayment. The Regulations of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases provide that people's courts shall not accept bankruptcy applications under these circumstances. Hostile bankruptcy applications (in order to evade debt repayment) are a bankruptcy barrier for the debtor. The people's court shall exclude the claimant's hostile action and take care to examine transfers of material properties and material investments at the time of examination.

(6) Impact on the social and economic order

There are two broad considerations. One is the impact of bankruptcy on financial stability, and the other is its impact on social stability.

Bankrupt enterprises may have enormous debts. If numerous debtors enter bankruptcy proceedings concurrently, the non-performing bank loans may impact the banking system. The court should, therefore, take care to examine the impact of enterprise bankruptcy on systemic stability.

Bankruptcy may also damage social stability. In addition to labour creditor's rights and social security issues, bankruptcy may impact the repayment of raised funds, the personal injury insurance and housing purchases of consumers, small creditors with limited risk tolerance, equity investors, the stability of the securities markets, etc. The court should make an informed evaluation and consider the trade-offs when accepting applications.

Notes

1. Zhu, Ciyun (1998), "Study on the Corporate Personality Disclaim Principle", Law Press, 1st Issue, November 1998, pp. 356-357.
2. Peoples Court (2003), Regulations of the Supreme People's Court on Several Issues Concerning the Trial of Enterprise Dispute Cases (I) (Exposure Draft) (N), People's Court Daily, 5 November 2003.
3. See Article of Civil Procedural Law, and Article IV of the Supreme People's Court on Several Issues Concerning the Trials of Enterprise Bankruptcy Cases.
4. The Task Force of the Second Civil Tribunal of the Provincial Senior Court (2005), "Survey Report on Regulating the Bankruptcy Trial Work and Improving the Bankruptcy Trial Mechanism", excerpted from Tribunal, 4th Issue, 2005, p.56.
5. Wang Yan, "Corporate Liquidation System and its Value Study", Journal of the University of Yunnan, law edition, 5th Issue, p.83.

THE ESTABLISHMENT OF LIMITED PRIORITY OF WORKERS' CLAIMS IN THE ENTERPRISE BANKRUPTCY LAW OF CHINA

by
Li Guoqiang*

The order of payments against all property (including secured property, owned by an enterprise when its bankruptcy is declared), is a major issue in the Enterprise Bankruptcy Law. This paper makes a relatively thorough analysis of relevant situations, and proposes that the principle of limited priority of workers' claims should be established in the Enterprise Bankruptcy Law to fully and correctly deal with the relation between the payment of workers' claims and the payment of security interests. "Limited priority" means that limitations on scope, time and the amount of preferential payments of workers' claims are imposed. Furthermore, the State Council may, in accordance with the basic principles and conditions of the Enterprise Bankruptcy Law, separately work out specific measures for implementing the Enterprise Bankruptcy Law.

China is formulating an Enterprise Bankruptcy Law that is consistent with a market economy. In the law, the order of payments of workers' claims and security interests is a relatively important issue. The observations and recommendations found in this paper were developed based upon the assessment of surveys, discussions with scholars and enterprises, and after consulting and analysing relevant international legal writings.

1) The principle of limited priority of workers' claims should be established in the Enterprise Bankruptcy Law

Currently, two different opinions are held towards the priority of workers' claims (such as wages in arrears and social security premiums in arrears) over the payment of security interests in the event of enterprise bankruptcy.

There are a number of arguments that support the priority of workers' claims: it is people oriented; it conforms to the spirit of the Constitution; failure to pay wages and social security premiums due violates laws such as the Labour Law; it does not conflict with Security Law; it supports social stability; and banks are more capable of identifying and bearing risks than workers.

At the same time, there are arguments against the priority of workers' claims: wages and social security premiums in arrears should be regulated in accordance with the

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Labour Law; the Bankruptcy Law can not violate the principle of priority of security interests; some enterprises are more likely to infringe upon the rights and interests of workers; banks will be forced to increase interest rates and will be reluctant to lend, resulting in an eventual loss of employment opportunities; and workers' priority will cause an increase in bad loans and, in turn, increase financial risks.

The essence of the controversy is how to balance the interest relation among creditors based on the national conditions of China in order to properly protect the rights and interests of creditors, and to establish and develop an efficient and fiduciary economic order. Why this question is so controversial is mainly because China is in a period of systemic transformation, and many people view the system design mainly from the perspective of solving practical short-term issues.

This paper argues that the design of the Enterprise Bankruptcy Law should deal with the current interests and difficulties of worker/creditors, consider the long-term interests of worker/creditors and enterprises, and be linked to the establishment of the basic property system of a market economy. Workers' claims should be given priority only if certain conditions are satisfied (*e.g.* limited priority), in accordance with the following suggestions:

1. The Enterprise Bankruptcy Law should deal with relevant issues according to the principle of limited priority of workers' claims. It should permit workers' claims satisfying certain conditions to be preferentially paid through specific provisions concerning scope, time, and amount. Limited priority workers' claims should maintain the priority of security, and help address problems related to wages and social security premiums in arrears, thereby promoting social harmony.
2. In consideration of the complexity of limited priority workers' claims, some problems require further study so that the State Council can formulate specific measures according to the basic principles and conditions specified in the Enterprise Bankruptcy Law.
3. Measures should be adopted to address problems related to wages and social security premiums unpaid by bankrupt enterprises at the same time as the promulgation of the Enterprise Bankruptcy Law. Such measures should include: a) perfecting the Labour Law and the social security system, strengthening enforcement of labour security supervision, establishing a wage monitoring system, and establishing an early warning mechanism for wage disputes that will correct problems related to wage and social security premium arrears at the earliest opportunity; b) establishing enterprise wage protection funds or similar systems; and c) providing government relief to those suffering hardship due to lost wages and social security premiums owed by bankrupt enterprises. In this respect, it is worth drawing on the experience of France, Korea and other countries who withhold 0.2% to 0.25% of wages to maintain wage protection funds that are used in the event of bankruptcy.

The core of these three measures is that governments must bear the responsibility for social stability and for establishing a social security system.

2) The need for and feasibility of the limited priority of workers' claims

Limited priority workers' claims embody people-oriented values. It is a good thing to meet the daily needs of workers in bankrupt enterprises. They embody, in the form of a

law, the provisions of the Constitution concerning the protection of labour rights, including the right to enjoy social security benefits.

Limited priority workers' claims are a practical choice in response to current conditions in China. They help maintain social stability. The Enterprise Bankruptcy Law should resolve both procedural problems and practical problems, and should be operable. Where the relief system for workers whose wages are in arrears is imperfect, courts will become the focus of conflict, and it will be hard to make judgments.

The limited priority of workers' claims is linked to the Civil Procedure Law, the Security Law, the Law on Commercial Banks, Contract Law and other laws. Limited priority is beneficial to establishing a property rights system and a credit system. With respect to preferential payment of ordinary claims, the security interests system constitutes the basic principle recognised by the property system in a market economy, and reflects the function of the property system to support the credit system. The security interests system is a social transaction system which has functioned effectively at home and abroad for thousands of years. Denial of, and damage to the system will have harmful consequences.

Limited priority workers' claims comply with actual legal practice in China that gives priority to workers' claims. The Bankruptcy Law and the Civil Procedure Law of China provide that secured claims be paid preferentially. However, in practice, in most cases priority is given to the payment of a part of wages and social security premiums in arrears. In fact, the principle of priority of workers' claims has, to some extent, already been accepted by society.

Practice proves that the limited priority of workers' claims is feasible. Emerging investigations on the claims of industrial and commercial banks show that, in fact, not all workers' claims under policy-based bankruptcy are paid in full. For policy-based bankrupt enterprises, the proportion of payments of wages and social security premiums in arrears in 2004 was 76% and 87% respectively. For law-based bankrupt enterprises, the proportion was 63% and 61% respectively. In our opinion, failure to pay is acceptable because it reflects the changes in ideas of enterprise workers and the relief arrangements by governments.

The absolute priority of workers' claims, on the other hand, might force financial institutions to increase their interest rates and to withhold lending. The difference between the interest rate on secured versus unsecured loans is a few percentage points. The amount of loans granted by financial institutions in China exceeds CNY (Chinese Yuan renminbi) 15 thousand billion, more than one-third of which is secured loans. The difference resulting from a small percentage point increase will raise enterprise costs by tens of billions of Yuan. This will hurt struggling enterprises, and affect, directly or indirectly, the long-term interests of workers.

It may prevent minority enterprises from maliciously defaulting or forging workers' claims, dodging repayments, or gaining by cheating on secured claims. This is not a theoretical, but a practical problem. Surveys have found that credit co-operatives in Foshan City have lent to bankrupt enterprises who forged labour affiliations and dodged their debts to a credit co-operative. A US scholar and a Hong Kong, China employer both happened to hold the same point of view that should absolute priority be given to workers' claims, labour costs would be reduced by enterprises. It is obvious that with the launch of the new bankruptcy mechanism, additional potentially bankrupt enterprises will

arise; gaining secured claims by forging workers' claims maliciously and cheating will become a new hotbed for bad debts.

Limited priority workers' claims comply with principles and provisions recognised in the bankruptcy laws of a majority of other countries. A comparative study of the order of payments under the enterprise bankruptcy laws of twenty-seven countries has shown that the priority of secured claims is a basic characteristic of bankruptcy law. In sixteen countries, including Australia, Austria, Bermuda, Canada, the Czech Republic, Finland Germany, Israel, Malaysia, Norway, Poland, Romania, Singapore, South Africa, the UK and the US, the payment of secured claims, (including fixed and floating charges) ranked first.

The payment of a part of workers' claims ranks first in France where wages in arrears (to which absolute priority is given) is limited to the wages for the two months immediately before the bankruptcy proceedings start. In Brazil, workers' claims have priority over floating claims, and relevant provisions are under revision. In Russia the priority is only limited to personal injuries and relevant claims. In Columbia and Indonesia taxes and workers' claims. Taxes rank first in Indonesia and Japan. Wages payable to the administrator rank first in New Zealand. These examples show that security interests rank first in a majority of foreign bankruptcy laws and that workers' claims rank first in a minority of bankruptcy laws with certain limitations based on time and amount.

3) The significance of the limited priority of workers' claims

Workers may be trained to identify market risks, to improve awareness, and to tackle problems as soon as possible in case of default on their wages and social security premiums.

Local governments need to strengthen the enforcement of labour security, and urge governments to pay more attention to and tackle problems related to wages in arrears and social security premiums in arrears.

Limited priority workers' claims may balance bank interests, and help reduce overall financial risk and the level of bad debts in financial institutions. For example, ICBC's ratios of payment of secured claims of policy-based bankrupt enterprises in 2003 and in 2004 were 0.5% and 0.8%, respectively. However, the ratios for law-based bankrupt enterprises were 20% and 21.8%, respectively.

Financial institutions need to prevent and avoid the risk of workers' claims. Banks can play a role in preventing enterprises from defaulting on wages and social security premiums. They may be cautioned to strengthen loan risk controls by drawing a certain proportion of secured claims to subsidise workers. Currently, banks do not evaluate the enterprises' risk of wage default and social security premiums when lending. And, only a few banks prohibit lending to enterprises who have defaulted on more than a certain amount of wages. Of course, the provisions concerning limited priority can go too far, because banks are not labour supervisors and cannot replace workers and trade unions.

4) The limits

Scope limitations

Almost all countries have provisions concerning the scope of workers' claims that shall be paid preferentially. A majority of countries list wages, medical expenses, pensions and limited severance pay as items that receive preferential treatment. Some countries find it prudent to compensate for holiday bonuses, labour protection pay, and sick leave. The scope of preferential payments in case of enterprise bankruptcy in China includes: wages; medical expenses; support for the disabled; consolation money; basic pension and medical insurance premiums in arrears; and compensation payable to workers according to the law. These items cover the daily needs of workers. This coverage is wider than that provided by a majority of countries, which reflects the socialist nature of China and corresponds to current national circumstances.

Different opinions are still held regarding whether worker compensation should be paid preferentially. In the opinion of the authors, it is inadvisable to pay all worker compensation in arrears preferentially because worker compensation has various meanings (it may be regarded as severance pay or as an "identity transfer fee"), as specified by eight ministries and commissions (including the former State Economic and Trade Commission). In the case of the latter, for ordinary enterprises, it is difficult to determine whether worker compensation should be paid preferentially because not all enterprises are owned by the state, and many major policies are involved. The Enterprise Bankruptcy Law is a commercial law, so it is advisable to pay only severance pay of a general nature which, generally, is equivalent to one to two months' wages.

Time limitations

Different countries have different provisions, but almost all countries provide for some sort of time limitation. As for wages in arrears, developed countries generally provide for the payment of one to six months' wages. In France, which gives absolute priority to the payment of wages in arrears, the time limitation is two months. For wages in arrears, China may provide a longer period for preferential payment, *e.g.* 6-12 months' wages in arrears immediately before the enterprise bankruptcy. China may provide that the time limitation for social insurance premiums, disability compensation, and consolation money in arrears may be extended up to 18 months.

Amount limitations

A majority of countries limit the total amount of workers' claims that can be paid preferentially. The bankruptcy of an enterprise means that the enterprise's business operations fail, and workers' claims are paid only for the purpose of guaranteeing their basic needs. In the authors' view, the amount of wages in arrears that should be preferentially paid may be determined according to the local monthly average wages in the same industry. In practice, the local average "floating wages" in the same industry may be determined through consultation. It is important to define and differentiate the standards for, meanings of, scope of, and amount of wages, in order to avoid infringing upon other creditors' interests.

5) Other issues

Provisions concerning the preferential payment of expenses of bankruptcy proceedings should be adjusted or restricted. Surveys show that the expenses of enterprise administrators are too high to protect workers' claims. Authorities in Foshan found that the high cost of bankruptcy proceedings had become a way for some institutions to enrich themselves. A literature surveys of 27 countries shows that the payment of the expenses of bankruptcy proceedings ranks first only in: Belgium; China; Hong Kong, China; Latvia; and Mexico. It is, therefore, suggested that only the payment of wages to administrators and routine administrative expenses be ranked first, and that the other expenses of bankruptcy proceedings, (especially expenses charged as a proportion of assets or the excess over a certain amount) be paid after the payment of security interests.

The solution of the workers' claims issue depends mainly on labour law and social security regulations, and the effective implementation thereof. The Enterprise Bankruptcy Law should complement, be linked to, and correspond to the labour law and other laws to help solve the workers' claims issue. However, the basic functions of different laws cannot be altered. Different laws have their respective responsibilities and may give consideration to two or more things. The key to the workers' claims issue is the effective implementation of the labour law and social security regulations.

In the order of payments against insolvent properties, whether priority is given to the payment of workers' claims does not vary from market to non-market economies. China should base its policies on national conditions after considering foreign practices. It should near its practices to those of market economies in order to reduce unnecessary international frictions.

The limited priority of workers' claims has a limited impact on social stability. It is necessary to conduct a socioeconomic analysis of the issue of wage and social insurance premium defaults. Under market economy conditions, a situation where people work without pay for a long period (and do not resign) is unusual. The issue of default on wages and social insurance premiums has two characteristics.

First, is the issue of state-owned enterprises. This issue involves enterprises who operate improperly for a long period and should (but fail) to go into bankruptcy. In such enterprises, workers are unwilling to leave because policies are not clear. The number of such enterprises is decreasing. From the viewpoint of society, the estimated proportion of wages in arrears to the total amount of wages does not exceed 2%. The Enterprise Bankruptcy Law has provided for the bankruptcy of state-owned enterprises and may tackle this issue.

Second, is the issue of farm workers' wage arrears. This issue cannot be tackled according to the absolute priority of workers' claims. Farm workers provide labour services mainly through a "trustworthy fellow villager" who acts as a labour contractor. But the majority of such labour contractors have no valuable assets to mortgage for borrowing loans. So the farm workers' wage arrears issue can only be tackled by improving labour wage regulatory measures.

The provisions in international conventions concerning the priority relation between workers' claims and secured claims are illustrative. The European Convention on Insolvency Proceedings and the Protection of Wages Convention No. 95 do not clearly provide for the priority of workers' claims. Each member state may, at its discretion, make such provisions in its domestic law. The 28th paragraph of the preamble of the

European Convention on Insolvency Proceedings provides that "Any other insolvency law questions, such as whether the employees' claims are protected by preferential rights and what status such preferential rights may have, should be determined by the law of the opening State." The third paragraph of Article 11 of Convention No. 95 provides that "…the relative priority of wages constituting a privileged debt and other privileged debts shall be determined by national laws or regulations." Paragraph B of Article 16 of the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems provides that the bankruptcy law should recognise the priority of secured creditors in their collateral, but the guidelines do not directly refer to the relation with workers' claims.

THE ORDER OF PAYMENT OF WORKERS' CLAIMS AND SECURITY INTERESTS UNDER CHINA'S NEW BANKRUPTCY LAW

by
Wang Weiguo*

1) Current legal provisions

Article 32 of the Enterprise Bankruptcy Law for Trial Implementation provides that:

With respect to claims secured with property that are established before bankruptcy is declared, the creditors enjoy the right to receive repayment with priority with respect to such security. With respect to claims that are secured with property whose amount exceeds the value of the security collateral, the part that is not repaid constitutes a bankruptcy claim, and will be repaid in accordance with the bankruptcy proceedings.

Article 37 of the Enterprise Bankruptcy Law for Trial Implementation provides that:

After the prior deduction of bankruptcy expenses from the bankruptcy property, repayment shall be made in the following order: 1) wages of staff and workers and labour insurance expenses that are owed by the bankrupt enterprise; 2) taxes that are owed by the bankrupt enterprise; and 3) bankruptcy claims.

Article 203 of the Civil Procedure Law provides that:

With respect to the property mortgaged or otherwise used as security for bank loans or other obligations, the bank and other creditors shall have priority in the repayment of debts as regards the property mortgaged or used as security for other kinds of obligations.

Article 204 of the Civil Procedure Law provides that:

After the prior deduction of bankruptcy expenses from the bankruptcy property, repayment shall be made in the following order: 1) wages of staff and workers and labour insurance expenses that are owed by the bankrupt enterprise; 2) taxes that are owed by the bankrupt enterprise; and 3) bankruptcy claims.

In accordance with these provisions, among all the properties of a debtor, secured claims enjoy the status of being paid with first priority with respect to the security. Unsecured properties and remaining properties shall be paid after secured claims and expenses associated with the bankruptcy proceedings. As for bankruptcy distribution, workers' wages, labour insurance premiums and other workers' claims shall be paid with first priority.

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2) Provisions of the International Convention

Article 5 of the Convention Concerning the Protection of Workers' Claims in the Event of the Insolvency of their Employer (passed at the International Labour Conference in 1992) provides that "In the event of an employer's insolvency, workers' claims arising out of their employment shall be protected by a privilege so that they are paid out of the assets of the insolvent employer before non-privileged creditors can be paid their share." Article 8 thereof provides that "National laws or regulations shall give workers' claims a higher rank of privilege than most other privileged claims, and in particular those of the [s]tate and the social security system." That is to say, the convention requires that workers' claims be paid prior to "non-privileged creditors", "privileged claims of the [s]tate and the social security system" and most other privileged claims. The provisions of the current bankruptcy legislation of China give priority to workers' claims over ordinary claims and tax claims, which satisfies the level of protection required by the convention.

3) Provisions concerning policy-based bankruptcy

As for the "policy-based bankruptcy" implemented since 1994, the worker arrangement issue for bankrupt enterprises has a prominent status. With respect to the status of secured claims, the Notice of Several Issues Concerning the Trial Implementation of Bankruptcy of State-owned Enterprises in Several Cities Document No. 59, issued by the State Council in 1994, also recognised the priority of secured creditors. However, Article 5 of the Notice of Several Issues Concerning the Trial Implementation of Merger and Bankruptcy of State-owned Enterprises Document No. 492, issued by SETC and the People's Bank of China in 1996, made a new provision that:

> *…during the implementation of enterprise bankruptcy, firstly, workers of bankrupt enterprises shall be properly arranged, for the purpose of maintaining social stability. Where an enterprise offers the land use right as a collateral, the revenues from the transfer of the land use right shall be first used for arrangement of workers of bankrupt enterprises, and the mortgagees shall enjoy the right to be paid with priority out of the remaining revenues if the revenues from the disposal of the land use right are insufficient for the arrangement of workers, the insufficient amount shall be paid successively out of the revenues from disposal of unsecured property or other secured property. The portion which fails to be preferentially paid to the mortgagees shall be paid as general claims.*

This provision was reaffirmed in the Supplementary Notice of Several Issues Concerning the Implementation of Merger and Bankruptcy of State-owned Enterprises and Workers' Reemployment in Several Cities Document No. 10, by the State Council in 1997. However, it is generally understood that this provision is only an expedient measure adopted during a special period in connection with special issues.

By the end of April 2004, the number of enterprise closings and bankruptcy projects arranged in China was 3 377. The total amount of bad accounts in state-owned banks and claim losses of financial asset management corporations that was cancelled after verification was CNY 224 billion (Chinese Yuan renminbi). The amount of eliminated source of losses was CNY 134 billion. Central Finance accumulatively appropriated CNY 49 billion as bankruptcy subsidies.[1] To some extent, the claim losses of banks were borne directly or indirectly by Central Finance, and were made up by financial resources saved due to the elimination of the source of losses. Generally speaking, this measure is a

strategic arrangement for the distribution of reform costs within the state-owned economy, instead of a systematic arrangement for establishing a market-based economic order.

4) Provisions of the draft new Bankruptcy Law

Provisions on secured claims

In the course of drafting the new Bankruptcy Law, NPC-FEC continues the current legislative plan regarding the payment of workers' claims and secured claims. The draft submitted by FEC to the standing committee in June of 2004, provided the right of exclusion status of secured claims. Article 121 of the draft provides that:

> *...the right of mortgage, the right of pledge, and the lien enjoyed on the property or rights of a bankrupt belongs to the rights of exclusion, and the holders of such rights of exclusion are referred to as exclusion right holders. An exclusion right holder shall enjoy the right to be paid with priority with respect to the subject matter of the right of exclusion.*

The right of exclusion refers to the "right to receive payment from special property of a bankrupt corporation with preference over creditors in the bankruptcy."[2] Specifically, the right of exclusion refers to the:

> *...right to receive payment separately from special property of a bankrupt corporation with priority. Such a right comes from the security interests existing on special property of a bankrupt prior to the bankruptcy declaration, and is not created due to bankruptcy proceedings.[3] A creditor who enjoys the right of exclusion shall not exercise its right according to liquidation proceedings. Not exercising "its right according to liquidation proceedings" means a creditor who enjoys the right of exclusion shall exercise its right out of bankruptcy proceedings according to the type of its right of exclusion and based on the force of its right of exclusion.[4]*

For example, Japanese Bankruptcy Law provides that, "those who have a special pre-emption, a right of pledge or a right of mortgage on the property belonging to a bankrupt corporation shall enjoy the right of exclusion with respect to the subject property." Under Article 92, the "right of exclusion shall not be exercised according to the bankruptcy proceedings." Article 95 of the US Bankruptcy Act states that claims in bankruptcy are divided into secured claims and unsecured claims: "A secured claim is a claim secured by special property, and an unsecured claim does not involve any special property and is paid from any other property of the debtor other than the collateral."[5] In accordance with the US Bankruptcy Act, workers' claims belong to unsecured claims, but have relative priority status among a series of unsecured claims.[6]

In a market economy the largest creditors of enterprises are banks and other financial institutions. With the credit of banks, enterprises produce, improve technology, introduce talent and smooth logistics for the purpose of exploiting markets, developing themselves and promoting economic prosperity for the whole society. In order to reduce their lending risks, banks typically grant loans to applicants with good credit standing. An important means for an enterprise to create comfort for the bank is to reinforce the enterprise's credit standing by offering a security. In this way, banks become major creditors of enterprises in the form of secured loans.[7]

It is definitely not viewed positively to give the right of exclusion status to secured claims. One reason is that the existence of a great deal of rights of exclusion causes the reduction of unsecured property, and the decrease of the ratio of payment of unsecured claims (including workers' claims) and, at the same time, results in the frustration of the collective payment principle of the Bankruptcy Law.

Provisions on workers' claims

Based on the observations of foreign scholars, there are four types of attitudes toward security in the legal systems of various countries: 1) very sympathetic countries such as Sweden and the UK; 2) sympathetic countries such as Germany, Japan, the Netherlands, Switzerland and the US; 3) ill-disposed countries such as Belgium, Spain, and the majority of countries in Latin America; and 4) very ill-disposed countries such as Austria, France, and Italy.[8]

The convention concerning the Protection of Workers' Claims in the Event of the Insolvency of their Employer provides for workers' claims. In 2004, the FEC's draft adopted the concept of workers' claims.[9] Workers' claims refers to the claims for payment enjoyed by workers against their employers based on their labour affiliations, that are embodied in Item 1 of the first paragraph of Article 137 of the draft, that is, "the wages owed to workers by and social insurance premiums in arrears payable by a bankrupt, and the compensation and other expenses payable by the bankrupt to workers in accordance with laws and administrative regulations." The first paragraph of the article provides that insolvent properties, after preferential payment of expenses of bankruptcy proceedings and common debts, shall be used first to pay workers' claims, then to pay the taxes in arrears and, finally, to pay general claims. This provision is consistent with current legislation.

The UNCITRAL draft Legislative Guide on Insolvency Law 2004 points out that:

> *In a majority of countries, workers' claims including claims for wages, leave or holiday pay, allowances for other paid absence, and severance pay constitute a class of priority claims, which in a number of cases ranks above tax and social security claims. This approach is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see chapter III.D.6), as well as with the approach of some international conventions. In some insolvency laws, the importance of maintaining continuity of employment in priority to other objectives of the insolvency process, such as maximisation of value of the estate for the benefit of all creditors, is evidenced by a focus on sale of the business as a going concern with the transfer of existing employment obligations, as opposed to liquidation or reorganisation where these obligations may be altered or terminated.*[10]

Following are the situations of several developed countries:

The United States

The US Bankruptcy Act provides that, workers' claims belong to unsecured claims and the portion below USD 2 000 (United States dollars) shall be protected with the third/fourth priority. Wages of no more than USD 2 000 earned within 90 days before the filing of the bankruptcy petition shall be regarded as wages with third priority. The welfare with fourth priority must be the welfare enjoyed by employees with respect to the work within 180 days before the bankruptcy petition is filed. The total amount of the two

priorities above may not exceed USD 2 000. For example, if an employee has been paid USD 2 000 with third priority, he may not be paid with fourth priority. If workers' claims exceed USD 2 000, the excess can only be paid as general unsecured claims.

The US provides that the priority of the payment of workers' claims is inferior to that of the payment of secured claims, mainly for the following reasons. First, maintaining economic growth is more important than relief to individual worker creditors. The secured creditors (mainly banks) can safely anticipate that claims will be effected within the framework of the Security Law, so that industrial and commercial enterprises may continue to obtain the bank funding they need for business operations. In a strong economic environment, even if an enterprise goes bankrupt, workers can find employment quickly, and the potential for civil strife is reduced. Second, the US Bankruptcy Act, to a great extent, reflects the interests of financial creditors, so secured claims are fully protected. Third, in the US, wages are usually paid once every two weeks. It is rare to see wages in arrears for three months; employees would probably quit before this point. As a result, there appears to be little probability of an employer defaulting on a large part of employee wages.

France

In order to keep workers from losing their claims due to a failure to declare them in a timely fashion, the law on the Judicial Rehabilitation and Liquidation of Enterprises of 1985 provides that the payment of workers' claims, (including all remuneration within the past 60 days and leave pay payable to employees and apprentices) established according to the Labour Code, are given first priority over secured claims. Such remuneration and compensation payable to employees and apprentices should be paid within 10 days after proceedings are declared.

The implementation of this system in France is based not only on political considerations, but also on special conditions in France. First, a wage protection system was established by law in 1973, whereby enterprises and employers pay the Association for Employment in Trade and Industry 0.25% of total wages as a guarantee for wages payable to employees in the event of a bankruptcy.[11] The impact of workers' claims on secured claims can, thus, be abated to some extent.

Second, in 1974, the government, in accordance with a decree passed by the congress, established an Inter-ministerial Committee for the Reorganisation of Industrial Structures. The fifteen members of the committee are the heads of ministries under the French government and are led by the Minister of Finance. The committee has a secretariat and is governed by the Ministry of Finance. Its main function is to help large private enterprises with more than 400 employees out of insolvency through co-ordination and proper financing. As for small private enterprises with less than 400 employees, regional and provincial governments carry out co-ordination and assistance. As for state-owned enterprises, the competent government ministries are responsible for handling their problems. As a result, when an enterprise falls into trouble, even if banks are unwilling to lend, the enterprise may be salvaged by resorting to the government.[12]

Japan

As for the secured claims mentioned above, the Japanese Bankruptcy Law has provided the right of exclusion as a guarantee. With respect to claims, the law provides that only the unpaid wage claims for the six months immediately before the bankruptcy declaration are recognised as general pre-emptions and priority claims in bankruptcy.

However, all of the wage claims unpaid by a limited joint-stock company, limited company or mutual insurance company prior to the bankruptcy declaration become general pre-emptions. Some scholars have criticised this differential treatment.[13] The claims after the bankruptcy declaration may be paid with priority as corporate common claims. In addition, it is generally understood that pension claims should apply the provisions concerning wage claims.

Although the Japanese Bankruptcy Law grants different priority to workers' claims, it still abides strictly by the civil theory that "property rights have priority over claims". Workers' claims do not encroach on secured claims as they do under French law.

Korea

Workers' claims refer to the claims on all pecuniary goods as defined under Article 18 Wages of the Labour Standards Law, including claims on basic wages, claims on various incomes, claims on severance pay, claims on savings, etc. As for the order of payments, the priority of workers' claims is inferior to the priority of claims secured by a pledge or mortgage, but the wages for the last three months and the pensions and disaster compensation for the last three years shall be paid with first priority over claims secured by a pledge or mortgage.

When an enterprise goes into bankruptcy, the order of payments against the property of the enterprise is as the follows: 1) the wages payable to workers for the last three months, and the pensions and disaster compensation payable to workers for the last three years; 2) land taxes and other levies and fees surcharged by public organs having priority over right of pledge and right of mortgage; 3) claims secured by a pledge or mortgage; 4) other claims based on labour affiliations other than the wages for the last three months; and 5) general claims.

In addition, the Korean government has realised that if an employer is insolvent, the priority of workers' claims is nothing but a theoretical right. In 1998, the Wage Claims Protection Law was formulated, and Korea decided to establish a wage claims protection fund for the purpose of guaranteeing the payment of wage claims in the event of the insolvency of the employer. The wage claims protection fund is funded by employers, and the contribution made is no more than 2‰ of the wages of workers for the current year. The amount of the contribution is determined by the Review Committee for Wage Claims Protection Fund. The ratio (as specified by the Minister of Labour) multiplied by this amount is the total.[14]

The relation between workers' and secured claims, and legal provisions in Korea are similar to those of France. However, Korea offers a fuller protection of workers than France does. Practices in Korea seem to be more socially orientated.

Chinese Taipei

Chinese Taipei's laws follow the civil law tradition. As for the issue of workers' and secured claims, the civil theory that property rights have priority over claims is followed:

> *The claims provided for in Article 38 of the Trade Union Law (in the event of bankruptcy of its debtor, a trade union has the right to be paid with priority against the debtor's property) Article 15 of the Law on Ore Yards (a mining right holder shall pay miners all wages in arrears with priority in the event of business discontinuance or bankruptcy) and the third item of Article 11 of this Law (the remunerations payable to administrators, as determined by courts, have the right*

to be paid with priority) shall get paid prior to general claims in bankruptcy… the priority of such priority claims is with respect to bankrupt corporations instead of special property, so such priority claims do not belong to rights of exclusion.[15]

In Chinese Taipei, special laws, including the Trade Union Law and the Law on Ore Yards, still give the payment of workers' claims against general property of debtors a priority over other claims, although the priority of workers' claims is inferior to that of secured claims.

5) The revised draft by the Law Committee

After the draft was submitted to the NPC standing committee for review, the Law Committee made major changes to the provisions of the draft concerning the status of the payment of secured claims and the priority of the payment of workers' claims. The basic intent of the changes is to give first priority to outstanding workers' claims. The second paragraph of Article 127 of the revised draft by the Law Committee provides that:

…the workers' wages and basic social insurance premiums payable by a bankrupt and the compensation payable to workers by the bankrupt according to laws and administrative regulations, which are not paid according to the previous paragraph, shall be paid with priority against the special property provided for in Article 113 hereof.

In practice, a major change occurs in this provision. The capitalisation of the collateral must be implemented by the administrator and the secured creditors can be paid only after the workers' claims are paid in full. During general bankruptcy liquidation proceedings, creditors with security rights on property shall have the right of exclusion. That is, after the bankruptcy declaration, the collateral shall be disposed of directly, and in a timely manner, in a usual way to realise the security right. In accordance with the Security Law, the pledge and lien of movable assets shall be subject to the handover of possession of the property. As a result, in the event of bankruptcy, the pledge or lien has actually been in the possession of the creditor.

The following questions arise: will all of the property be handed over to the administrator? How is it handed over? If the possessor refuses to hand it over, what is done? In case of the inability to hand over, the administrator can only use the income from the realisation of the collateral to arrange workers, which causes an unfair burden on mortgagees and pledges/lienors.

More important is that the priority of workers' claims over secured claims as provided for in the Bankruptcy Law will have a significant effect on the relationship between banks and enterprises, which can be deduced as follows:

1. The direct aftermath of this institutional arrangement is a decrease in public trust in security rights and the reduction of the expected payment ratio of secured claims. In the event of civil execution, a debtor may file a bankruptcy petition to keep creditors from exercising the security because, in the event of bankruptcy, collateral may be reserved through the priority of workers' claims.
2. Where the expected payment ratio decreases, a bank may adopt the following countermeasures: 1) to refuse to grant loans to enterprises that default on workers' wages and social insurance premiums, and who fail to participate in social insurance programmes. This means that such enterprises may go bankrupt or close due to lack of funding with the eventual result that their workers become

unemployed; and 2) in consideration of the reduction of the payment ratio of bank claims due to workers' claims, banks will increase the rebate rate for collateral when accepting enterprise collateral for loans. This means that the financing ability of the fixed assets of enterprises will decrease, which will cause a decrease in the volume of financial transactions and aggravate the financial difficulties of enterprises.

3. Under this system, banks will incorporate the payment of workers' wages and social insurance premiums by enterprises into the enterprise credit evaluation system. A solvent enterprise will make its best efforts to reduce workers' claims in arrears for the purpose of receiving loans.

4. A bank may insert articles into loan agreements that provide that if the enterprise is found to have workers' claims in arrears, the bank shall have the right to demand repayment in advance. If the enterprise is unable to repay loans, the bank will tend to start bankruptcy procedures. In this case, the probable results are: 1) through restructuring or conciliation, the enterprise and its workers make a compromise to provide a favourable guarantee for bank claims; and 2) the enterprise goes into liquidation and is closed, and its workers become unemployed.

5. The improvement in the priority of workers' claims will probably become another way for enterprises to evade paying debts through bankruptcy. Especially state-owned enterprises that have not been transformed may adopt the following sequence of actions in order to evade paying debts through bankruptcy: increasing workers' claims; filing of a bankruptcy petition; workers obtain the main assets of the enterprise based on priority; workers use such assets for funding; the enterprise is revived after a change of ownership; and the enterprise's debts to banks are cancelled. The results are as follows: 1) worsening bank assets; 2) deteriorating the bank-enterprise relation; and 3) worsening credit markets. The concurrent occurrence of the three means the worsening of China's business environment.

It appears that worker interests are not merely limited to the payment of claims. The following two points are worth consideration:

1. Employment is the fundamental long-term interest of workers. If the institutional arrangements under the Bankruptcy Law cause the deterioration of the existing business environment, the deterioration will necessarily result in a great deal of unemployment. This is not in workers' interests.

2. A nation's economic development is in the long-term interest of society as a whole. If the institutional arrangements under the Bankruptcy Law cause a deterioration in the Chinese economy, the final result will be a decrease in social welfare, including a decrease in workers' welfare. Nor is this in the interest of workers.

6) Recommendations

The following recommendations are made to tackle the problems above:

1. With respect to the institutional design of the priority of payment of secured claims and the priority of payment of workers' claims, the plan in the FEC Draft should be adopted. The priority of secured claims should be recognised and, in

the liquidation and distribution of unsecured property, first priority is given to workers' claims.

If there are sufficient reasons for the reinforcement of the protection of workers' claims, special limited priority may be given to workers' claims. That is to say, it may be provided that workers' wages owed by a bankrupt for a half year or one year, shall be paid with the same priority as that of the expenses of bankruptcy proceedings.

Limited priority means satisfying workers' basic needs during the bankruptcy procedures, thus showing basic concern for human needs. As for the workers' other claims, the current legislation and the plan in the FEC draft should be abided by. Workers' claims should be paid with first priority out of the income from the realisation of unsecured property. This arrangement has the advantage that the risk of losing secured claims are limited and easily grasped, and that it maintains the credit of the commercial banks of China in the world.

2. Provide for joint and several liability borne by enterprise operators and investors for workers' claims. This helps urge enterprises to reduce the amount of workers' claims in arrears and keeps enterprises from evading debts through bankruptcy.
3. Establish a compulsory liability insurance system for payment of workers' claims, whereby the premiums are collected at an agreed ratio of enterprise profits and dividends paid to shareholders, and handed over to a social insurance institution for trust administration.
4. Establish a worker security fund that will provide for the basic needs of workers in the event of an enterprise bankruptcy.

Notes

1. Source: Basic Situations on Policy-based Bankruptcy of State-owned Enterprises, 10 June 2004, issued by SASAC under the State Council, in Document (Ren-Cai-Wen (2004) No. 6) of NPC-FEC.
2. New Law Dictionary (1991), edited by Wagatsuma, Sakae, Chinese translation, China University of Political Science and Law Press, p. 855.
3. Chen Jinan (2002), Bankruptcy Law, Taiwan Sanmin Book, p. 196.
4. Id, p. 200.
5. Pan Qi (1999), US Bankruptcy Act, Law Press, p. 128.
6. The US Bankruptcy Act provides that eight types of unsecured creditors belong to unsecured priority creditors, and all others who do not have priority are referred to as general unsecured creditors. Among the nine types of creditors, creditors at a lower level may be paid only after creditors at the next higher level are fully paid. The priority of workers' claims is inferior to that of the first priority unsecured claims of

administrative expenses during the trial of the bankruptcy case, and is also inferior to that of the second priority unsecured claims formed by debtors during normal business operation from the time when the involuntary liquidation petition is filed to the time when the debtors are declared bankrupt. The "wages and other labour remunerations owed by debtors to their employees" in the workers' claims belong to third priority unsecured claims. The welfare funds, pension funds, medical insurance premiums, life insurance premiums, and other welfare items payable by employers belong to the fourth priority unsecured claims.

7. It was reported by relevant agencies that in 1982, 80% of the loans granted by US banks to large and small enterprises were secured claims. By 2001, the secured loans granted by US commercial banks to enterprises against real estate had reached USD 1 652 billion. See, Bebchuk, Lucian Arye and Jesse M. Fried (2001), "A New Approach to Valuing Secured Claims in Bankruptcy", 114 Harvard Law Review.

8. Wood, P.R. (1995), Principles of International Insolvency, p. 189.

9. Articles 46, 81, and 86 of the draft.

10. UNCITRAL Working Group V (Insolvency Law), Draft Legislative Guide on Insolvency Law, March 29-April 2, 2004, New York, paragraph 633.

11. Wang Yiyiug ed. (2001), Foreign Labor Laws and Social Security Laws, China Renmin University Press, pp. 233-234.

12. Wang Weiguo (1996), "Legislation and Practice on Regulation of Enterprise Plights in France", CASS Journal of Foreign Law.

13. 石川明, and translated by He Qinhua and Zhou Guiqiu (2001), Japanese Bankruptcy Law, China Legal Publishing House, p. 105.

14. Wang Yiyiug ed. (2001), Foreign Labor Laws and Social Security Laws, China Renmin University Press, pp. 545-546.

15. Chen Jinan, Bankruptcy Law, Taiwan Sanmin Book, p. 170.

CREDITOR PARTICIPATION IN CHINA AND HONG KONG, CHINA

by
Alan C.W. Tang

The theme of creditor participation can be looked at from two angles: the legal framework and the commercial realities. Focusing on China and Hong Kong, China, there are two questions to answer: 1) do creditors participate?; and 2) do creditors want to participate? The answer to both of these questions is: probably not.

1) The legal framework

Let us set the scene first by referring to the following table, which describes formal insolvency proceedings in Hong Kong, China and China:

Table 1. Participation in formal insolvency proceedings

Mode/Participation	HK–CVL	HK–Court	China– Now	China–2nd Draft
Appointment	Yes	Yes	No	Yes
Meetings	Yes	Yes	Yes	Yes
Committee of Inspection	Yes	Yes	No*	Yes
Reports	No	No	No	No
Complaints	Yes	Yes	Yes	Yes
Closing	Yes	Yes	No	No

Note: HK–CVL: Creditors' Voluntary Liquidation in Hong Kong, China; HK–Court: Compulsory Liquidation in Hong Kong, China; China–Now: Bankruptcy (Liquidation) under the 1986 Enterprise Bankruptcy Law; China–2nd Draft: Draft (Revised) Bankruptcy Law as at October 2004.

*Chairmen's Committee formed in GITIC bankruptcy, subsequently introduced in 2002 Supreme Court Rules on the interpretation of the 1986 Enterprise Bankruptcy Law.

Without going into an excessive discussion of procedural details, "Appointment" in the table above refers to the ability of creditors having any input or influence on the choice of the incumbent/replacement insolvency administrator. It should be noted that under "China–Now", the court has absolute power to appoint members to the bankruptcy/liquidation committee, which administers the bankruptcy proceedings; whereas under "China–2nd Draft", although the court makes the formal appointment of the administrator (which will replace the bankruptcy/liquidation committee), creditors at a meeting of creditors may object to the appointment and ask the court to appoint someone else.

With regard to creditors' meetings, there are large differences in their nature, powers and frequency, though creditors generally do have the right to attend and, where necessary, request the convening of such meetings. However, most creditors' meetings are not held on a scheduled or regular basis.

Again, where there are committees of inspection/creditors' committees, their powers and mode of operation are also quite different. Ironically, it is not uncommon for creditors to take the (incorrect) view that one of the incentives for joining these committees is to protect and pursue the creditor's own interest. Hence, related parties often compete and argue over appointments to the committee. The courts in Hong Kong, China have rejected the appointment of proposed members, resulting in no committee being formed.

Unfortunately, there are no formal requirements for formal written reports to be prepared or sent to creditors, although these are often provided during formal creditors' meetings as a matter of good professional practice by the insolvency practitioner. One exception is that of the "HK–Court", where reports of progress in a prescribed format are required to be filed with the court, and creditors may apply to inspect such reports.

In the event of disgruntled creditors, there are avenues for creditors to file their complaints with the relevant regulatory bodies and/or the court. These situations are rare, especially in China, where, effectively, the court would be dealing with complaints filed against the bankruptcy/liquidation committees that discharge their administrative duties under the direction of the court.

When an administration comes to a close, creditors are not necessarily being notified of any final meeting or the fact that the liquidation is about to close.

In a nutshell, the legal framework is such that creditors will have to make extra efforts to even have the opportunity to participate, whether in Hong Kong, China or in China. Take a typical Hong Kong, China court liquidation as an illustration: after the first creditors' meetings appoints the liquidators and a committee of inspection, creditors may not hear ever again from the liquidators if there are no dividends. Or they may simply receive a notice of dividend followed by a dividend cheque, if their claims are not subject to dispute. How can creditors participate?

2) The commercial reality

So, why are creditors not keen to participate? Much has been said regarding the changing of creditors profiles in insolvency situations these days. The increasingly significant hedge funds, distressed debt traders, and specialist investment vehicles often take a totally different view and approach to handling insolvency situations compared to traditional lenders and creditors.

The following discussion focuses more on Hong Kong, China than China:

1) Other than the change in creditor profile, which often comes together with a generally decreasing security cover for most creditors (secondary debt traders in particular), there is now much direct "zero-sum game" type of competition in multi-creditor situations. The chairman of a listed company in Hong Kong, China was heard to say that they purposely use over 20 bankers so that no one banker will have an overall understanding of exactly what they are doing, or not doing, as the case may be.

2) There is a jurisdictional mismatch. Whilst it is common that debtors maintain multi-jurisdictional operations these days, creditors are often bound by resources and other factors to taking a relatively simplistic view of matters, and looking at things predominantly from a local jurisdiction perspective.

3) There is an asset/liability mismatch. Here the debtors are organised in a way such that creditors have no direct control over the material assets and operations of a conglomerate. Listed companies, which often borrow funds for use in a group, do not have direct ownership of the operations or assets. For example, creditors who are owed more than HKD (Hong Kong dollar) 3 billion (over USD (United States dollars) 400 million) via lending in Hong Kong, China have no direct exposure to and control over a Chinese 5th tier subsidiary company of the group that directly controls some 40 joint ventures of the group in China.

4) A phenomenon that could be referred to as "ownership musical chairs" has emerged. Here, creditors do not know for sure who the true owners of an operation are, or for how long they will remain owners, as the majority ownership keeps changing hands every so often. A direct consequence is that there is no commitment by the owners to actually improving or even meaningfully running the operations. All they do is conduct financial manoeuvres to raise further funds from shareholders, or try to borrow more. All views are short term.

5) Sadly, most corporate failures these days have an element of irregularity if not outright fraud. What would one do if the chairman of a major listed company ran a parallel private office of not less than 10 people to work on a full-time basis producing falsified documents, or genuine documents for fake transactions, and in good anticipation of the queries and demands of the auditors during regular audits? In this regard, the common use of "local L/Cs" in Hong Kong, China for the sale and purchase of massive quantities of aluminium foil, or ingots, or other non-perishable goods from one end of Lockhart Road[1] to the other is not a welcoming sign. But, all parties to these transactions turn a blind eye towards them, at least until things go wrong.

Many creditors are fully aware of these risks when the lending is done, or the credit given (or soon thereafter). If and when things turn sour and insolvency problems arise, they tend to take a practical and bold view and almost immediately make a substantial if not full provisions, cut their losses, and hope that something might come back. However, they know the chances of any meaningful recovery are slim.

3) Creditor mentality

After a provision is made, the concern becomes the subsequent internal reporting and any need for further provisioning insofar as the creditor is concerned. The focus is no longer on any prospective absolute return, let alone the chances of any return. Hence, a rather negative mentality arises. The following are symptoms of this mentality:

- *No good money after bad:* creditors are most reluctant to spend, and will avoid spending an additional dollar to recover the bad debt;
- *Take the money and run:* where recoveries are imminent, or where there are already assets realised in an administration, creditors tend to prefer making an early distribution

1. Lockhart Road is a road of less than a mile long in the district of Wan Chai in Hong Kong.

from what is available, over investing the current realisations in further investigation and recovery actions;

- *Low/no risk acceptance level:* unlike when in lending mode, creditors now tend to be extremely risk adverse. They prefer actions only where there is absolute certainly of a positive outcome; and
- *Creditor funding is a near impossibility:* seeking and obtaining funding from traditional lenders and creditors is now almost an impossibility, unless major international issues and considerations (*e.g.* in a multi-creditor multi-jurisdiction situation) are involved.

Without funding, there is only so much (or so little) that any liquidator can do in terms of investigation and retrieval of assets to feed and support any further investigations and recovery proceedings.

4) Sure-win package for fraudsters

Unfortunately, in the course of the last 10 years or so, commercial fraudsters have learned through collective experience that they will do well by adopting the following simple steps:

1) Transfer out all assets;
2) Sack all employees but pay them well;
3) Burn all books and dump the computers; and
4) Resign as directors and leave the country (or just go into hiding).

Fraudsters know the tricks and the fact that most creditors will not and cannot pursue them. This process is self-feeding and a vicious circle is formed. More creditors are tricked and more losses are reported. One used to talk of losses in terms of millions, which have now become billions.

5) The way forward

Many parties have their ways of contributing to resolving the current awkward position of general creditor apathy. It is of paramount importance that the following factors be taken into account when one tries to consider one's own position and contribution:

1) *Break the vicious circle:* the self-feeding fraud circle must be broken. If not, the more let-offs there are, the more rampant the fraud is going to be;
2) *Macro considerations:* one should not consider only one's own position (although admittedly this is not easy in a pragmatic commercial environment). Unchecked commercial fraud will lead to higher costs of lending/providing credit, or a reluctance to provide credit generally, resulting in a sub-optimal use of economic resources in the capital market;
3) *Dollar return or take the moral high ground:* when situations of grave public interest are concerned, one should take the obvious moral high ground and consider any dollar return secondary. This is easier said than done and will require stamina and determination, as well as policy decisions at the highest level; and

4) *Establish a "Fight Fraud Fund":* a somewhat far-fetched proposition is for creditors and stakeholders to chip in to set up a general fund of some sort, on some local basis to combat/investigate/pursue fraudulent activities for the common good of the commercial fraternity. But, the practical approach is for creditors to be prepared to provide proper funding and support for investigation and litigation, and take a long-term view on case-specific matters. An alternative is to lend general support to the setup of litigation funding vehicles, and relax the legal niceties of champerty and maintenance.

Where situations of fraud are concerned, and where there are clear indications that the liquidators can at least take matters forward at a reasonable cost, creditors should provide support to liquidators.

6) Conclusion

Creditors generally do not wish to participate. The legal framework is not encouraging them to do so, and the practical commercial considerations dictate that they do not. But, creditors do have to take a macro and long-term view on the current unhealthy practices.

DEVELOPING A REGULATORY FRAMEWORK FOR OUTSOURCING OF INSOLVENCY WORK IN HONG KONG, CHINA

by
Xianchu Zhang*

In the course of the modernisation of the insolvency system in many jurisdictions, efficiency and effectiveness have been generally accepted as two basic principles. These principles are reflected in the recent World Bank Principles and Guidelines[1] and the Model Law on Cross-Border Insolvency.[2] The successful development of an insolvency regime depends crucially upon the competence and integrity of the appointed insolvency administrators.[3]

Against this background, a modern regulatory framework has been proposed to include requirements on qualifications/experience, professional/ethics standards, competence, independence, integrity, diligence and periodic training.[4] When considering the different legal, economic and political systems of different countries, it becomes apparent that the power to oversee such a regulatory framework may be given to either a government department or the judiciary.

A further choice may have to be made between a license-based model or a professional membership-based model.[5] For example, in Australia a reform has moved a court controlled regime of insolvency administration to one where it rests within a government agency.[6] This article highlights contracting-out practices and recent efforts to develop a regulatory framework in Hong Kong, China. For convenience, the outsourcing of corporate insolvency work under the Companies Ordinance of Hong Kong, China and personal bankruptcy work under the Bankruptcy Ordinance of Hong Kong, China may be referred to in this document as the contracting-out of insolvency cases or insolvency practice.

1) Contracting-out practices in Hong Kong, China

In Hong Kong, China the Official Receiver's Office (ORO) has traditionally been responsible for administrating most of the case work in respect of winding-up and bankruptcies under court orders, and engaging special managers in a limited number of larger cases demanding substantial resources. However, the substantial increase of the caseload led the ORO in consultation with the Hong Kong Society of Accounts (HKSA)[7] in 1996 to establish the Administrative Panel of Insolvency Practitioners for Court Winding-up (known as Panel A) to outsource some court-ordered compulsory insolvency

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case management with estimated realisation assets of more than HKD 200 000 (Hong Kong dollars).

As a result, non-summary insolvency liquidations were contracted out to private insolvency practitioners (PIPs). Panel A has worked on a roster system under which the ORO is required to convene a meeting of creditors to appoint the name of the next person on the roster as the liquidator, subject to the approval of the court, if the creditors have not nominated a liquidator of their own.[8] Only insolvency practitioners and professional firms that meet certain criteria may participate in the work of Panel A. One of the most important requirements is that a participating firm must have at least two PIPs who should be qualified members of the HKSA (and later, the Hong Kong Institute of Certified Public Accountants (HKICPA)) with experience equivalent to a minimum of 600 chargeable hours of insolvency work in the last three years, or 750 chargeable hours in the past five years.[9]

In 1998, the second scheme (known as Panel B), was set up with lower qualification requirements to allow PIPs to deal with smaller cases with estimated realisation assets of no more than HKD 200 000 in value (summary cases), as the agent of the ORO on a roster basis. However, the operation of Panel B did not last long after the court expressed concern about the wholesale contracting out by the ORO of its duties and responsibilities as the provisional liquidator under the law.[10]

In 2001, the original roster scheme of Panel A was changed into a tender system (commonly known as Panel T).[11] Under this scheme, PIPs are appointed by the ORO as provisional liquidators and their remuneration is subsidised by government funds up to the limits submitted in their tender.[12] The ORO sets out the terms and conditions of the work and invites PIPs to take up contracting-out appointments by making available a set of application forms and background materials on its website or in its office.[13]

In 2003, under the pressure of continuing personal bankruptcies, the ORO started to expand its outsourcing practice to self-petitioned bankruptcy cases. As an agent of the ORO, an appointee firm may conduct interviews with the bankrupt and complete and submit various documents to the ORO. In terms of qualifications, the ORO requires the firm concerned to have, among other things: a minimum of two "recognised professionals" (RPs), one of whom must be a certified accountant, a solicitor lawyer or a member of the Hong Kong Institute of Companies Secretaries; at least three years of post-qualification experience; and a minimum of 200 professional hours in the last three years relating to insolvency and bankruptcy work.[14]

According to the statistics of the ORO, in recent years, most of the court related winding-up work has been contracted out and performed by private practitioners. The winding-up orders made by the courts in each calendar year from 2001-2005 were: 1 066 (2001), 1 292 (2002), 1 248 (2003), 1 147 (2004) and 849 (2005);[15] whereas the cases allocated under the ORO's tender exercise in the period were: 809 (2001-2002), 1 231 (2002-2003), 1 116 (2003-2004), 1 009 (2004-2005) and 557 (first 8 months of 2005-2006).[16]

With the expansion of outsourcing practices, the ORO has broadened the qualification criteria for tender applicants. According to the contract conditions of the work under the Companies Ordinance, which stipulates the ORO's function of winding up companies under court order,[17] in order to qualify for the appointed work, a firm should, among other things, have: at least two "recognised professionals", one of whom must be a member of the HKICPA or the Hong Kong Institute of Companies Secretaries, or a member of the

Hong Kong Law Society. The recognised professionals further need to have at least three years of post-qualification experience and have a minimum of 300 chargeable hours over the past three years.[18] However, despite the existence of the different requirements for the experience of insolvency work for summary and preliminary examination of personal bankrupts on the one hand, and the practice under the Panel A scheme on the other, no formal registration or certification system for insolvency practitioners has been established so far.

2) Legislative amendments and consultation

Contracting out practices soon raised concerns with the regulatory framework. In 1999, the Law Reform Commission (LRC) published its Report on the Winding-Up Provisions of the Companies Ordinance, which recommended a license regime for contracting out insolvency work to private practitioners with the two panels at that time. The report held that "the winding up of companies and insolvency related appointments require high standards of liquidators and other insolvency practitioners as it is they who are charged with realising, managing or re-organising assets and with distributing assets to those entitled to them."[19] It also found that:

> *…there has been anecdotal evidence of abuse where assets in winding-up have been diverted by unscrupulous liquidators, usually by selling the assets at low prices to persons connected with the directors. In addition, there is also some evidence over the last several years of receivers and liquidators being appointed who have had only a vague idea of their functions and obligations.*[20]

Thus, the Law Reform Commission recommended, as the ultimate aim, to introduce a professional insolvency practitioner qualification based on an examination that would be established by the ORO and other related professional bodies at a later time.[21] It believed that to turn the current qualification (based on work experience) to a system of licensing would have the effect of enhancing the power of insolvency practitioners and reducing the potential for abuse.[22]

In designing the regulatory framework, the commission proposed a licensing system with two tiers, where the most difficult insolvency work should be performed by those best qualified to do it, namely licensed practitioners. This system aimed at separating less complex from more complex forms of insolvency, and ensuring that licensed practitioners carry out the most difficult work.[23]

However, before the recommendation was implemented, the Asian financial crisis created a dramatic increase in the workload of the ORO, which forced it to contract out more insolvency cases. In 2001 alone, 13 000 corporate liquidation and personal bankruptcy cases were recorded, representing a ten-fold increase over 1998. The situation even triggered the suspicion of abuse of the legal institution, and the ORO was criticised for its ineffective inspection and supervision of insolvency and bankruptcy cases.[24] According to Mr. E.T. O'Connell, the Official Receiver of Hong Kong, the number of court receiving/bankruptcy orders jumped from 1 179 in 1998-99 to 30 239 in 2002-03 and court-ordered winding-ups increased from 763 to 1 289.[25]

Against this background, the Companies Ordinance was amended in 2000 by inserting a new §194 (1A). The new rule provides that where the ORO is the provisional liquidator by virtue of the law, and is of the opinion that the property of the company concerned is not likely to exceed HKD 200 000 in value, it may, at any time, appoint one or more persons as provisional liquidators in its place.

Although the amendment enables the ORO to continue its contracting out practice in summary liquidations, the private practitioners under the new law will be appointed as provisional liquidators in place of the ORO, rather than its agent as under the old law. Consequently, in case of winding-up with assets of less than HKD 200 000 under a summary order, the insolvency practitioner may automatically become the liquidator.[26]

Given the increase of contracting-out cases, the different schemes created and different qualifying requirements, the landscape has changed significantly over the past years as regards the nature of the work being undertaken by PIPs in Hong Kong, China. The situation is still changing.[27]

3) The consultation paper of 2002

Facing this challenging situation, the Financial Service Bureau of Hong Kong appointed Arthur Andersen to carry out a study of ORO's role in handling liquidation and bankruptcy cases. The government (though it had no pre-determined position), had expressed its concern with the efficient functioning of the insolvency regime in Hong Kong, China as an international financial centre.[28] The consultation paper was published in June 2002.[29]

The consultation paper first affirmed the need to outsource insolvency work due to a major increase in the ORO caseload. It further noted that the trend towards a service-based economy (where tangible assets are often worth less than intangible assets) raised the risk that assets would be insufficient to meet the costs of administration. As a result, a more efficient insolvency regime should be developed.[30]

Having studied the role of the insolvency authority of other benchmark jurisdictions, the consultation paper identified the major functions that should be performed by the ORO: 1) administration of cases as the last resort where the assets in the case are insufficient to meet the administrative cost; [31] 2) enquiry and enforcement to deal with breach of the law and abuse of powers for the public interest; and 3) regulation and supervision, in particular of private insolvency practitioners.

In this regard the study found that although the ORO's responsibilities in regulation and supervision were not as wide as some other jurisdictions, it did "have some loosely defined responsibilities under the Companies Ordinance for PIPs conducting compulsory liquidation. The ORO's supervision of the Panel A and tender scheme, combined with the high proportion of court based insolvency, also gave the ORO extra-statutory authority and influence on the private practitioners."[32] Given that the private sector has been playing a greater role in insolvency proceeding, it should be a guiding principle to put stronger emphasis on the regulatory and supervisory functions of the ORO.[33]

According to government policy, the ORO would contract out work wherever appropriate so as to enable the ORO to concentrate on other services and responsibilities, including regulating and monitoring PIPs in outsourced cases. As a result, it proposed that certain new check and balance schemes be introduced and, conceivably, that all case administration and responsibility could eventually be contracted out through the panel schemes.[34]

The consultation paper recognised that there was no formal licensing and regulatory framework of private practitioners in contracting-out cases in Hong Kong, China. Currently, the ORO can only exercise its control on taking tenders, authorising panel participants, and allocating cases. Although this may have some significant impact on

private practitioners, neither the ORO nor the court has any authority over the right of the PIPs to carry out voluntary liquidation or other insolvency proceedings.[35] Moreover, the lack of a license system as an access control may be a potential risk to the credibility of the insolvency system.[36]

However, the study disagreed with the Law Reform Commission on the two tier regulatory framework and the immediate introduction of a licensing system on three grounds. First, the cost-benefit consideration: unlike the UK where a large base of insolvency professionals and a greater number of insolvency cases may spread the fixed costs of regulation and supervision, Hong Kong, China has a considerably smaller number of these practitioners. According to a study, all bankruptcy, administration, receivership, and liquidation work in the UK in 1998 was carried out by over 1 800 insolvency practitioners belonging to accountancy and law firms,[37] but in Hong Kong, China there were only 84 PIPs including 52 appointment tenders and 32 additional registered practitioners as of September 2001.[38] Thus, the high cost and threshold of a formal regulatory regime would discourage the entry of firms of practitioners into the market.[39]

Second, the track record of public confidence: in the UK there is a history of abuses by PIPS and "in contrast there is no record of abuse of the system by PIPs in Hong Kong, and the degree of public concern over the issue is therefore questionable."[40] For example, in the UK a series of high profile incidents resulted in the creation of a working party led by Mr. Justice Ferris on excessive remuneration.[41] In Hong Kong, China the court has been the arbiter in deciding fees and the ORO has taken some supervisory responsibility over compulsory liquidation. As a result the ORO's further involvement in fee supervision would render the regime redundant.

Third, a simple system based on authorisation as a policy consideration: given the two aforesaid grounds, the size of the market in Hong Kong may not justify the additional complexity and supervisory efforts based on a formal examination/license approach.[42] As such, the consultation paper recommended a single tier and a less formal scheme on the basis of authorisation where PIPs should be required to show satisfactory experience and staff resources to handle contracting-out insolvency work as a statutory condition. But, the legislation would be silent on the details of the mechanism, including the granting authority, formal audit and the supervision process.[43] This recommendation is clearly different from the suggestion of the Legal Reform Commission, which proposes formal licensing and regulation.

Both the report of the Legal Reform Commission and the ORO commissioned consultation paper focus on the cost-efficiency analysis and the needs to establish a regulatory framework on contracting-out insolvency work and PIPs in order to prevent potential abuse of powers or breach of duties. Both express different views. The differences may be interpreted in different ways. For one, the two studies hold different reviews on some basic facts. For instance, the report of the Legal Reform Commission concluded that the danger existing in practice demanded further regulation[44] whereas the consultation paper did not believe the current situation justified the introduction of a formal regulatory scheme.[45]

The issue has attracted judicial attention. One example is in Re Peregrine Investments Holding Ltd. & Ors,[46] where the parties disputed the fees and reimbursements for 63 days work sought by the private provisional liquidators between the commencement of the provisional supervision and the issuing of the winding-up order of HKD 76 million. According to the factors listed by the court to determine whether the fees could be

justified, some firms and PIPs have reviewed their internal billing and record keeping practices. Thus, the extent to which new rules need to be developed to deal with potential abuse should be studied further in order to accurately determine market conditions and identify the major concerns that should be addressed by possible regulation.

Moreover, the cost-justified basis, although agreed on by both studies, should be further clarified. For example, given the current market size and the number of participating PIPs, a careful assessment is needed to take all of the relevant factors into account. Otherwise, it would be difficult to develop an effective framework on a rational basis. Further, the different positions of the Law Reform Commission and Arthur Andersen as a professional firm may be viewed from another angle. The report of the Law Reform Commission takes a top-down approach with more emphasis on public policy and the integrity of outsourcing practices, whereas the consultation paper takes a bottom-up approach to reflect more practical issues and practitioners' concerns. In this context, a sound balance needs to be found between the public and private interests with updated information, and further study and consultation.

4) Recent developments

Since the publication of the consultation paper in 2002, the government of Hong Kong, China and the ORO have not taken any further reform measures, though new developments have again raised concerns regarding the current system.

It is reported that the increase of bankruptcy cases has attracted firms that were not qualified through the panel practice, and individuals who are not professionals to the insolvency business. In the peak time of bankruptcy in 2002, some individuals were even seen outside the ORO to solicit clients or to provide "services". Such unfair competition also drove fees to an unreasonably low level that could not sustain the quality of professional work.[47]

The bankruptcy contracting-out practice was further addressed in the Bankruptcy (Amendment) Ordinance 2005, which enables the ORO to appoint PIPs, without a creditors' meeting, to act as trustees in personal bankruptcy cases. The legislation confines the appointment to cases where individuals have filed for their own bankruptcy and where the anticipated value of the estate does not exceed HKD 200 000. However, the detailed qualification criteria for such contracting-out have not been set yet. The ORO is expected to submit its subsidiary legislative proposal in 2006.[48]

Although the Asia financial crisis is over, budget cuts and resource constraints have continued to challenge the effective function of the insolvency regime in Hong Kong, China. The most recent budgetary information of the ORO shows that its staff number would be reduced from 254 in 2002 to 227 in 2006, and further down to an estimated 223 in 2007, with its annual budget to be lowered from HKD 129 million in the 2003-2004 financial year to HKD 122 million in 2005-2006.[49] In a recent case, the ORO was openly criticised by the Office of the Ombudsman of the Hong Kong, China government for its negligence and inappropriate handling of a creditor's petition in 2002, and repeated complaints since then against a bankrupt for fraudulent borrowing during the uncharged bankruptcy period in 2004.[50] Although these may be isolated cases, they do show real apprehension with respect to ORO's efficiency.

A more recent development in this regard is the launch of Insolvency Guidance Notes (IGNs) by the HKICPA. In September 2005, it produced the first set of co-ordinated guidelines to provide its members with best practice standards for liquidation under the

Companies Ordinance. The guidance became effective for insolvency appointments made on or after 1 October 2005. According to Paul Chan, Vice President of the HKICPA, the IGNs represent a more regulated approach given that (unlike most other major jurisdictions) insolvency practice has been largely unregulated in Hong Kong, China.[51]

Despite the IGNs being expected to be observed under normal circumstances as "best practice", Mr. Alan Tang, Chairman of the Insolvency Practitioners Committee of the HKICPA, has further reminded people that the orderly administration of companies in financial difficulties and their winding up "is part of the rule of commercial law in Hong Kong. …we need to build up a body of high quality local insolvency practitioners and to strengthen the expertise and standards of the members of the Institute who want to specialise in this area."[52]

The IGNs are adapted from the UK Statements of Insolvency Practice (SIPs) issued by the UK Recognised Professional Bodies (RPB) and follows their broad thrust. The initial batch of IGNs covers three major fields: 1) the scope of the liquidator's investigation into the affairs of an insolvent company; 2) preparation of insolvency office holder's receipts and payments accounts; and 3) making statutory reports to the ORO on the conduct and disqualification of the directors of the bankrupt.[53] In these areas the duties and responsibilities of the liquidators are specifically outlined.

In terms of binding force, in the UK, departure from the standards set out in the SIPs is a matter that will be considered by the regulatory authority for the purposes of possible disciplinary or regulatory action,[54] whereas in Hong Kong, China the IGNs are issued for the purpose of guidance only and are not mandatory in nature. The HKICPA, however, reminds its members that failure to follow the IGNs may put a member at risk of having to justify their actions in answer to a complaint, and to explain and justify significant departures from the norms of the notes.[55]

Despite its similarities with the UK SIPs, the Hong Kong, China version of best practice is adopted by the HKICPA with the awareness of the differences between the regimes.[56] For example, some statutory rules have been set out in the Companies Ordinances in Hong Kong, China governing PIP remuneration. Where a PIP is appointed as the liquidator, their remuneration shall be determined either by the agreement between the liquidator and the committee of inspection, or by the court if there is no committee of inspection or the agreement cannot be reached.[57] The ORO may also apply to the court for an order confirming the remuneration of the PIP if it is of the opinion that the remuneration should be reviewed.[58] Under the Panel A scheme, the PIPs standard hourly rates had been approved by the ORO in consultation with the HKSA.[59]

Institutionally, the SIPs of the UK are issued under procedures agreed by the insolvency regulatory authorities acting through the Joint Insolvency Committee (JIC). Although they are produced by the Association of Business Recovery Professionals (R3) as the leading professional organisation for insolvency, business recovery and turnaround specialists in the UK, the subsequent approval by the JIC, and adoption by the RPBs (including the Association of Chartered Certified Accountants, the Law Society and the Insolvency Practitioners Association) render the SIPs applicable to PIPs of all professions.[60]

In contrast, the IGNs are guidelines adopted only by the HKICPA and may have limited applicability to accountants. Moreover, as compared with the SIPs, which cover at least 15 different aspects of insolvency work, the IGNs are much less sophisticated and comprehensive. It is envisaged that further guidelines will be issued in the future.

Currently, the HKICPA, with 25 000 members and nearly 10 000 registered students, is the only body authorised by law to register and grant certificates to qualified accountants in Hong Kong, China. As such, the IGNs will have important implications in insolvency practice. In addition to streamlining private practice, the promulgation may be taken as an indication of the future moves of the HKICPA. As Mr. Paul Chan stated, his institute, while having no fixed timetable, would not rule out the possibility of establishing a system to certify insolvency practitioners.[61]

As part of its efforts to develop an institutional framework for PIPs, the HKICPA has established an Insolvency Interest Group which is open to accountants, lawyers and other insolvency PIPs. In addition, the institute developed three training courses since 2001. The Diploma Course in Insolvency is recognised by the ORO as the equivalent of 50 hours towards the 600-hour requirement under the Panel A scheme.[62]

5) Future perspectives

Despite unsettled issues, the ORO has made it clear that it will continue its outsourcing practices. Mr. E.T. O'Connell predicted that in the period of 2004-2006 the ORO would contract out 1 140 cases,[63] including summary and non-remunerative liquidation with estimated realisable assets of less than HKD 200 000, the panel scheme for non-summary liquidation with estimated realisable assets of more than HKD 200 000, and preliminary examination of bankruptcy cases.

Against this background it seems increasingly necessary to develop a uniform and co-ordinated regulatory framework. Currently, contracting-out practices have involved public accountants, solicitors and company secretaries, who are subject to different professional institutes with different disciplinary standards and procedures. Moreover, the ORO's requirements as set out above, may involve senior and junior practitioners with unequal backgrounds and experience. Without a licensing or registration system and a scheme with different tiers, the current experience-based qualification may not adequately ensure the quality of work. As such, certain minimum thresholds on knowledge, ethics, and training requirements should be established. Further, given the different nature of outsourced work, uniform guidelines with general application need to be developed by the ORO or a joint committee of professionals (like the JIC in the UK), rather than individual institutes. Currently, it is not clear to what extent the IGNs adopted by the HKICPA would be recognised and observed by lawyers and company secretaries while performing their duties as PIPs.

In this regard, some measures are being taken by the ORO. It has committed "in the light of the consultation study to seek legislative amendments to the Bankruptcy Ordinance to provide a legal mechanism for outsourcing summary bankruptcy cases, and to consider the way forward for other recommendations of the study."[64] This is in addition to monitoring the administrative panel scheme. Mr. Frederick Ma, the Secretary for Financial Services and the Treasury of Hong Kong, China recently stated that the ORO should develop a more flexible approach to dealing with insolvency cases so that it would further strengthen its supervisory and regulatory functions. As such, he promised to adopt more measures to deal with the complaints against PIPs by the court and the ORO (including contract provisions, investigation, and legal liabilities), and carry out a review after 24 months of the implementation of the Bankruptcy (Amendment) Ordinance 2005 for further legislative deliberation.[65]

Despite this positive attitude, the timetable of the government seems to indicate that there is no urgency in establishing a uniform and formal regulatory framework in Hong Kong, China over PIPs and contracting-out cases. Indeed, the quality of the rule of law and the professionalism in Hong Kong, China have been well recognised worldwide. However, the environment itself may not necessarily prevent and deter all abuses and violations. A report by the US Securities and Exchanges Commission found that over two years, partners of PricewaterhouseCoopers violated the profession's ethical rules more than 8 000 times,[66] and certain practices in the UK were found by Mr. Justice Ferris to be "profoundly shocking" and "shameful".[67] In this context, a study by three professors of the US and the UK held that:

> *Evidence of conflict of interest and arbitrary abuse of power in UK bankruptcy practice belie the myth of "disinterested professionalism" and point to the danger of privatised governance.*[68] *...due to the autonomy and discretion exercised by professionals there are considerable differences between the insolvency "law on the book" and the insolvency "law in practice".*[69]

Another related issue is the regulatory model. In the UK the RPBs increasingly operate a so-called "private system of law" as a quasi-court or tribunal. But, their performance has been criticised for lack of duty of care to stakeholders and inefficient handling of complaints.[70] Here it is interesting to note that according to UK experience, the vast majority of insolvency practitioners themselves believed that most parties involved in insolvency would be far better served by one regulator.[71] But officials of professional organisations are keen to hang on to their powers and perks. They oppose the single regulation system on the ground of costs and disciplinary problems.[72] In designing the regulatory framework, the experience of the UK should be carefully studied.

Beyond the ethics and legal standards, other concerns may also be relevant. For example, a recent examination of all 170 active private insolvency trustees in their contracted-out work in over 700 administrations conducted by the Insolvency and Trustee Service Australia (ITSA) in 2003, found that in Australia, (a jurisdiction similar to Hong Kong, China in terms of its bankruptcy rate and rule of law environment), some 21% contained one or more material errors. ITSA followed up to ensure that remedial measures were taken.[73] Apparently, the real challenge in Hong Kong, China (as in Australia) may not be the abuse of power or breach of duties, but practical issues such as correct understanding, adequate knowledge, and sufficient experience of PIPs. For this reason, the simple absence of abuse under the current contracting-out system may not be sufficient to justify not introducing a regulatory framework with examination and licensing requirements.

With regard to the cost of developing a regulatory framework for outsourcing insolvency and bankruptcy cases, the experience of other jurisdictions should be taken as a reference. Using Australia as an example again, the ITSA licenses some 200 private administrators in relation to personal insolvency at a cost of AUD 50 000 (Australian dollars), which is fully recovered from application and re-registration fees paid by the administrators. The service also monitors the practitioners' handling of their cases through a programme of audits, investigation of complaints and decision reviews at a total cost of AUD 750 000, fully recovered from a percentage levied on asset realisation.[74] On the basis of comparative merits, the cost does not seem unreasonably high though, at the outset, some financial support from the government may be necessary.

6) Conclusion

In a highly competitive world, institutions have to develop and innovate constantly and proactively. Reputation alone may not guarantee future success. In line with the trend of other jurisdictions, Hong Kong, China has put great efforts into developing its outsourcing practices in both corporate insolvency and personal bankruptcy cases. However, the establishment of a uniform regulatory regime seems to be lagging. Despite the study commissioned by the HKICPA and other initiatives, some fundamental issues concerning the model to be used and the details of the rules that are needed remain unsettled. Although the government is endeavouring to adopt a timetable for the creation of a framework, budget pressures, the increase of contracting-out cases, and the lack of clear and uniform standards and rules will continue to challenge the current system in the near future.

Notes

1. The World Bank (2001), Principles and Guidelines for Effective Insolvency and Creditor Rights Systems.
2. The UNCITRAL Model Law on Cross-Border Insolvency, 1997.
3. Although different jurisdictions may use different titles for these insolvency appointments, the concept of insolvency administrator in general includes trustee, assignee, supervisor, liquidator, receiver, administrator, curator, official or judicial manager, commissioner, etc. Joyce, Peter (2003), "The Regulatory Gap: The Cost of Capacity Building", conference paper presented at The World Bank Global Forum on Insolvency Risk Management: Standards and Strategies, 28-29 January 2003, Washington DC, available at www.insolvencyreg.org.
4. The Principles and Guidelines of the World Bank, pp. 227-231.
5. Joyce, supra note 3.
6. Gallagher, Terry (2004), "The Role of Regulators in Insolvency Regimes", conference paper presented at the Colombo Conclave on Balancing Recovery, Restructuring and Liquidation–the Emerging Challenges in Asia, 13-15 February 2004, on file with the author.
7. The HKSA was established in 1973. Its name was changed to the Hong Kong Institute of Certified Public Accountants (HKICPA).
8. Smart, Philip, Charles Booth and Stephen Briscoe (2002), Hong Kong Corporate Insolvency Manual, Hong Kong Society of Accountants, Hong Kong, p. 61.
9. The Law Reform Commission of Hong Kong (Sub-Committee on Insolvency) (1998), "The Winding-up Provisions of the Companies Ordinance Consultation Paper", §26.7.
10. Philip, Booth, and Briscoe, supra note 8, p. 62.
11. Ibid.

12. The Yearbook of the Hong Kong Government 2002 (Chapter 4), available at http://www.info.gov.hk/yearbook/2002/ehtml/e04-09.htm.

13. Official Receiver's Office of the Hong Kong SAR, "Tender for Taking up of Appointment as Provisional Liquidator under Section 194 (1A) of the Companies Ordinance", available at http://www.oro.gov.hk/eng/tender/doc/annex1.pdf, modified on 16 December 2005.

14. See the website of the Hong Kong Institute of Certified Public Accountants at www.hkicpa.org.hk.

15. See the Statistics on Compulsory Winding-up and Bankruptcy Statistics Search, available at http://www.oro.gov.hk.

16. Official Receiver's Office, note supra 13, Terms of Tender, §12. The numbers are provided here on the basis of the financial year of Hong Kong, which runs from April 1 to March 31 of the following year.

17. §194 of the Companies Ordinance of Hong Kong.

18. Official Receiver's Office, note supra 13, Part II, Qualification Criteria.

19. The Law Reform Commission of Hong Kong (1999), "Report on the Winding-up Provisions of the Companies Ordinance", §3.11, available at www.hkreform.gov.hk/reports/rwind-e.pdf.

20. Ibid, §3.12

21. Ibid, §3.16.

22. Ibid, §3.13.

23. Ibid, §3.17.

24. See the reports of China Xinhua News Agency dated 3 August 2001 and 7 January 2002, available at: www.xaonline.com/news/gnxw/20010803/20022.htm; and http://news.xaonline.com/gnxw/20020107/119579.htm, respectively.

25. The reply of Mr. E.T. O'Connell as the Official Receiver to the question of Mr. Tsang Yok-Sing in the Finance Committee of the Legislative Council of Hong Kong on the meeting to review the expenditure budget of 2004-2005 (Question number 1313) dated 26 March 2004.

26. Philip, Booth and Briscoe, note supra 8, at 62.

27. Letter of the HKICPA dated 30 September 2004 inviting comments on its "Exposure Draft of Insolvency Notes", p. 3 (Background).

28. The news release of the Hong Kong Government dated 28 June 2002.

29. Arthur Anderson (2002), "Review of the Role of the Official Receiver's Office– Consultation Paper", Hong Kong.

30. Ibid, paragraph. 3.

31. The consultation paper found that in Australia and the US, private insolvency practitioners were extensively used to provide the last resort service, whereas in Hong Kong and the UK, the ORO body typically carried out such a function. Ibid, paragraph. 1.8.

32. Ibid, paragraphs 1.5 and 1.6.

33. Ibid, paragraph 1.9 (b).

34. Ibid., paragraph 2.4.

35. Ibid, paragraph 4.1.

36. Ibid., paragraph 4.2.

37. Cousins, Jim, Austin Mitchell, Prem Sikka, Christine Cooper, and Patricia Arnold (2000), Insolvency Abuse: Regulating the Insolvency Industry, Association for Accountancy and Business Affairs (AABA), London, p. 5.

38. Arthur Andersen, supra note 29, paragraph 4.12.

39. Ibid, paragraph 4.13.

40. Ibid, paragraphs. 4.2 and 4.18.

41. The report of Mr. Justice Ferris' Working Party on the Remuneration of Office-holders and Certain Related Matters (1998) is available at http://www.dca.gov.uk/civil/ferrisfr.htm. For a discussion of some of these cases, see Arnold Patricia, Christine Cooper, and Prem Sikka (2001), "Insolvency, Market Professionalism and the Commodification of Professional Expertise", working paper available at: http://www.essex.ac.uk/AFM/research/working_papers/wp03-01.pdf.

42. Arthur Andersen, supra note 29 paragraph 4.20.

43. Ibid, paragraphs 4.16 and 4. 21.

44. Supra note 19.

45. Supra note 29, chapter 4.

46. [1998] 3 HKC 1.

47. See the report of the Peopledaily Network dated 21 March 2002, available at www.china.com.cn/chinese/TCC/121818.htm (in Chinese).

48. Ibid.

49. The budget of ORO of 2005-06 and 2006-2007 (estimate) is available at http://www.budget.gov.hk.

50. See the report of the Sing Pao Daily News dated 21 January 2005, p. A15 (in Chinese).

51. HKICPA (2005), "Hong Kong Institute of CPAs Issues Guidance for Insolvency Practitioners", News release of the HKICPA, 14 September 2005, http://www.hkicpa.org.hk.

52. Ibid.

53. Insolvency Guidance Note (1), (2), (3) and (4) respectively.

54. Explanatory Foreword of the Statements of Insolvency Practice of the UK.

55. The News Release, supra note 51.

56. According to Mr. Darach Haughey, member of the Insolvency Committee of the HKICPA, the legal differences between two jurisdictions have been taken into account in formulating the IGNs of Hong Kong. Soo, Vanson (2005), "New Liquidation Guidelines Take Effect Next Month", The Standard, 20 September 2005.

57. §196 of the Companies Ordinance of Hong Kong.

58. Ibid, §196 (2A).

59. Booth and McBain (2004), "Insolvency Systems and Risk Management in Asia", conference paper presented at the Forum on Asian Insolvency Reform, New Delhi, India, 3-5 November 2004, http://www.oecd.org/dataoecd/1/56/33929417.pdf.

60. Explanatory Foreword, supra note 54.

61. See the website of the HKICPA, supra note 14 and the report of Wenwei Po (Hong Kong) of 15 September 2005, www.wenweipo.com/GB/?www.wenweipo.com/news_print.phtml?news_id=F10509150023.

62. Booth and McBain, supra note 59.

63. The reply of Mr. E.T. O'Connell to the question of Mr. Eric K.C. Li in the Finance Committee of the Legislative Council of Hong Kong on the meeting to review the budget 2004-2005 (Question number 0767) dated 25 March 2004.

64. See the 2005-2006 Government Budget, www.budget.gov.hk/2005/eng/head116.pdf.

65. See the report dated 7 July 2005, www.hbzq.com.cn/detail.asp?id=438453&db=TB0039.

66. Securities and Exchange Commission of the US (2000), "Report of the Internal Investigation of Independence Issues at PricewaterhouseCoopers LLP".

67. Mirror Group Newspapers plc. v. Maxwell and Others [1998] BCC 324.

68. Arnold, Cooper, and Sikka, supra note 41, p. 29.

69. Ibid, p. 17.

70. Cousins, Mitchell, Sikka, Cooper and Arnold, note supra 37, p. 16.

71. Insolvency Practitioners Association (IPA) of the UK (1997), IPA News, November 1997, p. 2.

72. Cousins, Mitchell, Sikka, Cooper and Arnold, supra note 37, p. 53.

73. Gallagher, supra note 6.

74. Joyce, supra note 3.

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Part III

INTERNATONAL TRENDS AND DEVELOPMENTS IN INSOLVENCY SYSTEMS

CREDITOR PARTICIPATION IN INSOLVENCY PROCEEDINGS

by
Roman Tomasic*

> *Unless creditors are involved in the insolvency process the law will seem irrelevant.*
>
> Ron Harmer, ADB[1]

> *[C]reditor participation is increasingly regarded as an important element of an insolvency law, especially as a counter-balance to the roles assigned to other participants under the law and as an important means of safeguarding creditor interests.*
>
> UNCITRAL[2]

Creditor participation in insolvency proceedings has been widely seen as an essential feature of any well-developed insolvency administration system. This notion has been expressed in different ways in national systems of insolvency law, ranging from principles such as the *pari passu* rule, to the holding of creditor meetings to decide matters of importance in the insolvency proceedings, to the role of insolvency representatives in such proceedings. Over the last decade we have seen the emergence of a number of multilateral efforts to more clearly articulate insolvency norms or "best practice" guidelines. These have included such outcomes as the Asian Development Bank's 2000 Good Practice Standards, the World Bank and IMF's 2005 draft Principles for Effective Insolvency and Creditor Rights Systems, and the monumental 2004 UNCITRAL Legislative Guide on Insolvency Law (the UNCITRAL Guide). The emergence of these multilateral statements witnesses the regional and global significance of insolvency laws and the role that they play in providing a foundation for a market economy. This paper will examine the creditor participation standards evident in this body of international best practice norms. Ultimately, it is argued that creditor participation in insolvency is an essential element in a rule of law based market economy.

1) Introduction

Creditor participation in insolvency proceedings has long been regarded as an important feature of any mature insolvency law system. The level and nature of such participation will vary depending upon the kind of insolvency proceeding that is involved.

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Such participation should be greater in situations of corporate rescue than in the winding up of companies with little remaining value. Such involvement may be seen to rest upon a number of widely accepted principles of insolvency law that seek to ensure that creditors are not unfairly prejudiced by the actions of corporate controllers, and that there is a fair and equitable system for the ranking of creditor claims.

Professor Roy Good of Oxford University has expressed this basic view as follows: "[I]t is a fundamental principle of insolvency law, and one which has many aspects, that the debtor's assets are to be distributed *pari passu*."[3] But, as many commentators have observed, exceptions to the centuries old *pari passu* rule are often as well known as applications of this rule.[4] Despite this basic principle, it is often the case that few assets remain for ordinary unsecured creditors or those who are not beneficiaries of a statutory exception to this principle. The good practice guideline that creditors should be involved in insolvency is an expression of the *pari passu* principle. The appointment of an insolvency representative has been one of a number of readily observable means of involving creditors in such insolvency proceedings.[5]

Ultimately, creditor participation is concerned with ensuring that justice is "seen to be done". In this regard, creditor participation may be seen as a reflection of a rule of law based system of insolvency administration. Where creditor participation is lacking or non-existent, confidence in the fairness of an insolvency system is called into question. This has been recognised in good practice standards that have been published by the Asian Development Bank and reflected in the statement that "[u]nless creditors are involved in the insolvency process the law will seem irrelevant."[6]

A notable feature of the international conversation with regard to insolvency law reform over the last decade or so has been the effort to draw upon a broad range of insolvency law practice and experience in an effort to develop generic principles and guidelines which may be readily adapted by individual countries to the task of fashioning their own insolvency laws. The World Bank and UNCITRAL have played an important role in this effort and have drawn heavily upon the collective experience of the wider insolvency practitioner community through the inputs of professional bodies such as INSOL International and individual insolvency consultants associated with such professional bodies.

2) The emergence of international insolvency law standards

Since the Asian financial crisis of the late 1990s, international efforts have been underway to fashion a comprehensive set of guidelines and principles that are applicable to a modern body of insolvency law and practice. Many of these principles and guidelines emerged from an earlier period of insolvency law reform that took place since the mid 1980s. These earlier insolvency reform efforts were reflected in official reports such as the 1982 Cork Report in the United Kingdom[7] and the 1988 Harmer Report in Australia.[8]

These reports led to the passage of subsequent landmark legislation, such as the 1986 Insolvency Act in the United Kingdom and amendments to the Australian Corporations Act[9] that came into effect in July 1993. Comparable reform legislation was enacted in the United States in the form of the 1978 Bankruptcy Reform Act. The experience gained from the enactment of these national bodies of law has been disseminated internationally and provided the basis for the development of global insolvency norms or benchmarks.

All of these laws contained corporate rescue provisions which emphasised the importance of creditor involvement. These included the corporate restructuring

provisions found in Chapter 11 of the US Bankruptcy Code, the voluntary administration procedures of Part 5.3A of the Australian Corporations Act and the Administration Order procedures of the 1986 UK Insolvency Act. Similar reform efforts were evident in other countries. The experience gained during these country based reform efforts provided insights that have facilitated the development of broader international guidelines or principles of insolvency law.

This paper looks at three such efforts and refers especially to what they have to say in regard to creditor involvement in insolvency. These three multilateral efforts are: 1) the Asian Development Bank's Good Practice Standards report[10] published in April 2000;[11] 2) the UNCITRAL 2004 Legislative Guide on Insolvency Law;[12] and 3) the World Bank/IMF 2005 revised Principles for Effective Insolvency and Creditor Rights Systems.[13]

At a different level, INSOL International has developed a statement of principles for a global approach to multi-creditor workouts that also emphasises creditor participation in such workouts.[14] Various principles and guidelines were developed following the financial crises that occurred in emerging markets in the late 1990s. For example, UNCITRAL's 2004 Legislative Guide on Insolvency Law was developed between 2001 and 2004. The World Bank has noted that these efforts sought to provide flexible: "[I]nternationally recognised benchmarks or standards to evaluate the effectiveness of domestic creditor rights and insolvency systems" and to provide "a broad-spectrum assessment tool to assist countries".[15] However, it has been recognised in all of these efforts that, ultimately, any insolvency law system must be based upon a particular country's own circumstances, culture and traditions. This requires some flexibility in the application of these principles and standards. As the World Bank has pointed out, effective insolvency systems:

> *...must be rooted in the country's broader cultural, economic, legal and social context…. The Principles are designed to be flexible in their application, and do not offer detailed prescriptions for national systems. The Principles embrace practices that have been widely recognised as good practices internationally.*[16]

Some such standards have focussed specifically upon particular regions, such as the Asian Development Bank's efforts under its Regional Technical Assistance for Insolvency Law Reform (RETA) which examined the insolvency laws of eleven Asian economies. It was recognised by the ADB that prior to the economic crisis of the late 1990s, insolvency laws in the Asian region were often "out of date and irrelevant to modern commercial needs."[17]

One solution to this problem was to compare local laws to broader global standards so as to assess the nature of the gap between local practice and international insolvency norms and practices. As one ADB report observed, "[a]n evaluation of a formal corporate law regime can be best approached by reference to comparative standards."[18] Similarly, the World Bank has noted that its principles "are a distillation of international best practice in the design of insolvency systems and creditor rights."[19] Of course, the use of standards and principles has long been seen as a valuable method of evaluating law reform efforts.[20]

3) New multilateral insolvency standards

The World Bank/IMF 2005 Revised Principles for Effective Creditor Rights and Insolvency Systems were based on the work of a task force of 70 international expert.

These principles are, however, still regarded as being draft principles although they have emerged through a process of extensive international discussion and feedback. The principles were vetted by regional roundtables involving over 700 participants from 75 countries and have drawn upon feedback from regional forums like the Forum for Asian Insolvency Reform (FAIR).

The World Bank principles are seen as facilitating "contextual, integrated solutions and the policy choices involved in developing these solutions." As we have seen, the principles urge adapting "international best practices to the realities of countries", especially in developing countries.[21] This is because there is a need to be sensitive to problems such as weak laws, unclear social protection mechanisms, weak financial institutions, poor corporate governance, and shortages of capacity and resources.

In regard to creditors and creditors committees, the World Bank principles C7.1 and C7.2 are relevant. Thus, principles C7.1 provides that:

> *The role, rights and governance of creditors in proceedings should be clearly defined. Creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by creation of a creditors' committee as a preferred mechanism, especially in cases involving numerous creditors.*

Principle C7.2 goes on to deal with the role and conduct of the committee of creditors. The World Bank principles can be compared to the General Practice Standards that were developed by the Asian Development Bank in 2000, which, among other things, urged that "[a]n insolvency law should make proper provision for the involvement of creditors as part of the liquidation or rescue process."[22] The involvement of creditors is especially important during the rescue proceedings as the "interests of creditors should prevail in decision making as part of the rescue process."[23] The influence of the ADB Standards and the World Bank principles is to be seen in the more detailed UNCITRAL Legislative Guide on Insolvency Law.

Ensuring complementarity between the UNCITRAL guidelines and the World Bank principles has been an important goal. The UNCITRAL Guide provides a much more detailed discussion of particular principles and provides lengthy discussion of the theme of creditor participation in insolvency proceedings. The 2004 UNCITRAL Guide drew upon inputs from experts in 87 states, 14 inter-governmental organisations and 13 non-governmental organisations.[24] It could, therefore, be seen to have considerable authority. As the preface to the guide notes:

> *The final negotiations on the draft legislative guide on insolvency law were held during the thirty-seventh session of UNCITRAL in New York from 14 to 21 June 2004 and the text was adopted by consensus on 25 June 2004.... Subsequently, the General Assembly [of the United Nations] adopted resolution 59/40 of 2 December 2004... in which it expressed its appreciation to UNCITRAL for completing and adopting the Legislative Guide.*[25]

It is appropriate to look more closely at the manner in which the issue of creditor participation has been dealt with in these multilateral statements.

4) The emerging consensus on the role of creditor participation

We have seen that there is an increasing consensus to the effect that creditor participation is vital to the integrity of insolvency proceedings. Thus, the World Bank has

urged (in principle C7.1) that "[t]he role, rights and governance of creditors in proceedings should be clearly defined." [26] The bank urged that creditor interests should be safeguarded by appropriate means that enable creditors to effectively monitor and participate in insolvency proceedings to ensure fairness and integrity, including by the creation of a creditors' committee as a preferred mechanism, especially in cases involving numerous creditors (principle C7.1).

Similar sentiments were expressed in the Asian Development Bank's Good Practice Standards and the accompanying text. This is reflected in the first quote at the head of this paper. Thus, the background discussion to the ADB Good Practice Standards argues that:

> *A rescue process is largely the province of creditors working, hopefully, in concert with the debtor. Creditors are vital to the process. They need to be organised, available and involved. A rescue or reorganisation process should, in effect, create a market place of its own where the bargaining, dealing and negotiation of people of commerce can be given full and fair effect.*[27]

On the subject of creditor participation, the UNCITRAL Legislative Guide on Insolvency Law has also urged that:

> *The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.*[28]

The justifications for the involvement of creditors in insolvency proceedings, whether formal or informal in nature, are based on the fact that they usually have a major interest in the business of the debtor and their financial interest will often be greater than that of most other stakeholders. This is especially so in rescue situations, as an ADB report has noted:

> *The interests of creditors should prevail in decision making as part of the rescue process. That is dictated by the fact that, because the corporation is insolvent or in extreme financial difficulty, the capital or equity of owners will have been severely depleted, if not completely lost and, although they have been affected, it is the creditors whose interests should become paramount. It should be the decision of the creditors that will determine whether a proposal of rescue is accepted or not (and, under some regimes, if it is not accepted, that the company be liquidated).*[29]

However, it should be remembered that the situation of unsecured creditors in a corporate insolvency is not a comfortable one given their "lowly status" in the context of secured creditors and other preferential claims.[30] The discomfort of unsecured creditors is even more serious where they are creditors of so-called "phoenix companies" (usually private companies) whose assets have been stripped by dishonest insiders, leaving only debt.[31]

Nevertheless, where creditors can be persuaded to take an interest in insolvency proceedings, it should be recognised that they may be in a good position to monitor the actions of the insolvency administrator because of the considerable expert knowledge that creditors will have of the workings of the debtor's business. Creditor participation may also provide a brake against abuses by corporate insiders who may seek to protect their own interests at the expense of the interests of creditors. As the UNCITRAL Guide points out:

> *…creditor participation is increasingly regarded as an important element of an insolvency law, especially as a counter-balance to the roles assigned to other participants under the law and as an important means of safeguarding creditor interests.*[32]

Nevertheless, corporate insiders may from time to time improperly seek to inhibit the capacity of creditors to be involved in such proceedings. Where this occurs, the confidence of creditors in the proceedings may be undermined. However, creditor participation should occur efficiently and not undermine the proceedings, such as by creating undue delay. This calls for an effective form of creditor representation in such proceedings.

Similarly, because disagreements between creditors are often inevitable, efforts need to be made to ensure that such disagreements do not undermine the efficiency and fairness of insolvency proceedings. It is important that key elements of the role of creditors are preserved as much as possible. These include their role in the selection, remuneration and oversight of insolvency representatives, their role in the sale of assets outside of the ordinary course of business, their role in approving reorganisation plans and their role in approving a committee(s) of creditors. As the UNCITRAL Guide points out:

> *The desirability of facilitating high levels of creditor participation must be balanced against the need to ensure that the creditor representation mechanism remains efficient and cost-effective and avoids creditors involving themselves in matters that will not have an impact on their interests….*[33]

The degree of creditor participation will be affected by the extent to which there is an adequate body of well-trained insolvency practitioners in an insolvency regime and the degree to which that regime has in place a well developed system of legal mechanisms and remedies. Consequently, creditor participation may need to be enhanced where there are inadequate numbers of well-trained insolvency practitioners and a lack of effective institutional infrastructure in a particular jurisdiction.

This is part of the balancing that occurs in regard to selecting the degree of creditor participation. The involvement of experienced insolvency representatives in insolvency proceedings should be encouraged as it is likely to reduce the delays and costs that may arise where a large number of individual creditors seek to monitor and regulate an insolvent debtor.

5) Forms of creditor participation in insolvency proceedings

The extent of creditor participation will vary in different legal systems. In part, this is a reflection of the absence of other monitoring and control mechanisms, although it may also reflect different models of participation. The UNCITRAL Guide, for example, distinguishes between the "low level of participation" approach (where insolvency practitioners fill the gap) and "greater participation" approaches where creditors assume an ongoing participatory role.[34]

These more participatory roles range from mere advisory functions performed by creditors, to the statutory provision of specific functions to creditors, such as the supervision of the insolvency representative, and requiring consultation between creditors and the insolvency representative, to creditors requesting or recommending action by the

courts. Participation may be by way of a creditors' committee or through the use of a creditors' representative to represent creditor interests.

The establishment of a creditors' committee may often be an effective means of articulating the views of creditors. In regard to the creditors' committee, the 2005 World Bank draft principles (principle C7.2) provide that:

> *Where a committee is established, its duties and functions, and the rules for the committee's membership, quorum and voting, and the conduct of meetings should be specified by the law. It should be consulted on non-routine matters in the case and have the ability to be heard on key decisions in the proceeding. The committee should have the right to request relevant and necessary information from the debtor. It should serve as a conduit for processing and distributing that information to other creditors and for organising creditors on critical issues. In reorganisation proceedings, creditors should be entitled to participate in the selection of the insolvency representative.*[35]

In regard to meetings of committees of creditors, standard 9.2 in the 2000 Asian Development Bank Good Practice Standards provides that "[a]n insolvency law should clearly define the voting rights of creditors and should prescribe minimum requirements for the approval of a plan of rescue." The ADB's supporting paper noted that meetings of creditors are important in this regard and observed:

> *Meetings of [creditors]… as a whole are obviously important. Also important is the selection, appointment and formation of a small committee of their number, which can take a more active and involved role in considering the adequacy or otherwise of information, the formulation of a plan and, possibly, the implementation of a plan. Meetings, to be effective, require organisation and control. Rules and procedures are required to deal with such things as the calling of meetings, the eligibility of persons to attend and participate in meetings (including voting rights and establishing quorum) and the chairing and general conduct of meetings.*[36]

These themes have been more fully articulated in the UNCITRAL Guide. The guide recommends that:

> *129. The insolvency law should facilitate the active participation of creditors in insolvency proceedings such as through a creditor committee, a special representative or other mechanism. The insolvency law should specify whether a committee or other representation is required in all insolvency proceedings. Where the interests and categories of creditors involved in insolvency proceedings are diverse and participation will not be facilitated by the appointment of a single committee or representative, the insolvency law may provide for the appointment of different creditor committees or representatives.*[37]

The UNCITRAL Guide also recommends that insolvency laws should specify how the costs of a creditors committee are to be met and should also specify the creditors who are entitled to be appointed to a committee of creditors (*e.g.* excluding related persons). In addition, the mechanisms for appointment of creditors to the committee should be identified by the law. In regard to the rights and functions of the creditor committee, UNCITRAL recommends that:

> *133. The insolvency law should specify the rights and functions of the creditor committee in insolvency proceedings, which may include:*

(a) Providing advice and assistance to the insolvency representative or the debtor-in-possession;

(b) Participation in development of the reorganisation plan;

(c) Receiving notice of and being consulted on matters in which their class has an interest, including the sale of assets outside the ordinary course of business;

(d) The right to hear the insolvency representative at any time; and

(e) The right to be heard in the proceedings."[38]

As the UNCITRAL Guide has also noted, creditors' committees are not always required, but are appropriate in cases where there are large numbers of creditors, where they have diverse interests, or where creditors may be geographically widely dispersed or where the case is such that costs and time may be saved by the appointment of a creditors' committee.[39] Creditors' committees usually only represent the interests of unsecured creditors, but there may be circumstances where the establishment of a committee of secured creditors may be justified. Sometimes it may be useful to include others (such as shareholders) on a creditors' committee, such as in a reorganisation.

Creditors' committees can be appointed in a number of ways, such as by the creditors themselves or by the court, but once appointed "the creditor committee should be able to act independently of the insolvency representative to ensure fair and unbiased representation of creditors' interests."[40]

The committee's role will generally be advisory in nature in that it will make recommendations to creditors as a whole in regard to how major issues (such as the sale of a substantial asset or the details of a reorganisation plan) are to be decided. The UNCITRAL Guide recommends that insolvency laws set out details of the types of matters that creditors should be required to vote on, such as the approval or rejection of a reorganisation plan.[41]

Meetings of creditors are clearly very important vehicles for creditor participation. As noted earlier, committees of creditors usually only represent the unsecured creditors (although some laws provide otherwise, *e.g.* where secured creditors are affected). In Australia, a secured creditor who votes at a meeting of creditors for the whole of their debt or claim is taken to have surrendered their security. The voting rights of creditors can be expressed by simple majority or by reference to the value of their debt and their number. Creditors should meet in different classes based on the nature of their security. A majority vote of creditors in a class is binding on all creditors in that class.

Local culture and tradition may affect the nature of creditor participation in insolvency proceedings. This may also be affected by other factors such as creditor expectations of such proceedings. The degree of creditor participation in insolvency proceedings will vary depending upon the nature and context of the proceedings.

For example, in a liquidation proceeding, the role of creditors will be more limited (although they can provide valuable advice to the administrator on the debtor's business). On the other hand, in a rescue situation, their role will be crucial and their interests should prevail over those of the owners of the company's equity or capital. However, to be effective, creditors need to be organised and controlled to efficiently express their views.

6) Encouraging greater creditor participation

Creditor participation is clearly a desirable feature of rule of law based insolvency systems. However, creditors are not always enthusiastic about participating in such proceedings due to the costs involved, or due to the low returns that are anticipated. A number of key concerns have been identified as affecting the level of creditor participation.

Four such concerns are worth mentioning: 1) the perception that proceedings are likely to be manipulated; 2) the transparency of insolvency proceedings; 3) a broader sense of creditor apathy; and 4) giving creditors a sense that their participation will have an effect at key stages of the insolvency decision making process. Personal liability fears may also be an issue.

Manipulation: It is necessary to avoid manipulation of voting in insolvency proceedings by insiders. Consequently, the law should include provisions that ensure that the rights of genuine creditors are not undermined. This is a concern that was evident in the 2000 Insolvency Law Reforms Report of the ADB when it noted:

> *Under any system of voting it is important to ensure that voting powers are not manipulated and that the interests of genuine creditors are not interfered with nor prejudiced by the voting powers of persons connected to the corporation. These are commonly referred to as "insiders"–persons who have some intimate connection or relationship with the debtor, its directors, managers, owners and shareholders. The law must ensure that the rights of commercial creditors are not abused [or] else they will be totally disaffected by the process.*[42]

Transparency: To ensure transparency and confidence in the insolvency administration, creditors should receive reports on the conduct of the proceedings. The UNCITRAL Guide notes that it "may also be desirable for creditors to receive reports on the conduct of the liquidation to ensure their confidence in the proceedings, as well as its transparency."[43] However, issues of confidentiality of information will also have to be addressed in this regard.

Creditor apathy: Creditor apathy is very real but this may be overcome by the careful selection of the members and the functions given to the creditors' committee, by use of electronic forms of voting, and by the provision of immunity from liability for creditor actions.

Making a difference: Participation by creditors may be encouraged by the law, providing that full meetings of creditors should be held at key points in the insolvency administration process. However, where the available asset pool of a company has been significantly reduced, such a participatory experience may be somewhat pyrrhic.

Liability concerns: Creditors may also be reluctant to participate in insolvency proceedings due to fears that they may incur additional liability through participation. This problem can be addressed by providing creditors with immunity from liability, except where they act fraudulently or wilfully.[44]**Secured creditors**

It is appropriate to refer briefly to the participation of secured creditors. It has already been noted that it is not generally the case that secured creditors form creditors committees. In many laws the rights of secured creditors are not affected by the commencement of insolvency proceedings and they are still in a position to enforce their rights. However, in other legal systems, once insolvency proceedings have begun, secured

creditors are prevented from enforcing their rights with the imposition of a stay on such enforcement action.[45]

A fuller discussion of the participation rights of secured creditors is beyond the scope of this short paper. However, the rights of secured creditors are important and an insolvency law need to have regard to these. As the ADB's 2000 Insolvency Law Reform Report notes:

> *The law should be sensitive to the position of secured creditors. If the rescue proposal is such that it might affect secured creditors (in the sense of reducing the value of their security or seriously impairing their rights to enforce a security), they should normally be afforded voting rights as a separate class.*[46]

The World Bank's Revised Principles also emphasise the importance of a robust legal system for protecting the rights of secured creditors, noting (in principle A2) that:

> *One of the pillars of a modern credit economy is the ability to own and freely transfer ownership interests in land and land use rights, and to grant a security interest (such as a mortgage or charge) to credit providers with respect to such interests and rights as a means of gaining access to credit at more affordable prices.*[47]

8) Employees as creditors

The protection of the interests of employees in a situation of corporate insolvency has increasingly been seen as an important concern. Of course, this has usually been dealt with in the past through the priority enjoyed by claims that may be made by employees for such things as the unpaid wages and superannuation contributions of employees. Increasingly, greater legislative attention is being given to protecting the entitlements of employees in an insolvency situation, such as by imposing liabilities upon a company's directors for knowingly failing to protect employee entitlements.

In some countries trade unions have become active and governments have intervened to protect employee interests and entitlements, as occurred in 2002 following the collapse of Ansett Airlines[48], at that time, Australia's second largest airline. This presents a new dimension to the idea of creditor participation.

9) Some conclusions

Creditor participation has been widely seen as a desirable feature of a modern insolvency law system. This is especially so in regard to corporate rescues. There are, however, considerable disincentives to participation and these need to be overcome. Some corporate law scholars would argue that participation is the basis for happiness upon the part of shareholders in companies. Whether this is also so with creditors is problematic and it therefore remains an open question.

But, as evident from the above survey of multilateral insolvency principles, guidelines and benchmarks, it is clear that international expert opinion favours greater participation in insolvency proceedings on the part of creditors. In the context of broader corporate governance concerns and international stakeholder debates, creditor participation is likely to become an increasingly important international concern in insolvency law and practice.

Notes

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2. UNCITRAL (2004), *UNCITRAL Legislative Guide on Insolvency Law*, p. 242.
3. Goode, R. (2005), *Principles of Corporate Insolvency Law: Student Edition*, London, Thompson–Sweet & Maxwell, p. 56.
4. See, for example, Duns, J. (2002), *Insolvency–Law and Policy*, Oxford University Press, South Melbourne, p. 319.
5. UNCITRAL (2004*), UNCITRAL Legislative Guide on Insolvency Law*, p. 241.
6. Above at note 1.
7. Report of the Insolvency Law Review Committee, chaired by Sir Kenneth Cork, Command Paper 855,1982. See further, the UK government's white paper, *A Revised Framework for Insolvency Law, Cmnd.* 9175 (1984).
8. Harmer, R.W. (1998), *General Insolvency Inquiry, Report No. 45,* Australian Law Reform Commission, Australian Government Publishing Service, Canberra.
9. The legislative background to these reforms can be found in the government's *Corporate Law Reform Bill 1992, Draft Legislation and Explanatory Paper*, prepared by the Commonwealth Attorney General's Department, Canberra, Australian Government Publishing Service, February 1992.
10. See generally, Ziegel, J.S. (1994), *Current Developments in International and Comparative Corporate Insolvency Law*, Clarendon Press, Canberra; and Wood, P.R. (1995), *Principles of International Insolvency*, Sweet & Maxwell, London.
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12. UNCITRAL (2004), UNCITRAL *Legislative Guide on Insolvency Law*.
13. For these draft World Bank Principles for Effective Insolvency & Creditor Rights Systems see: http://www.worldbank.org/ifa/rosc_icr.html.
14. INSOL International (2000), *Statement of Principles for a Global Approach to Multi-Creditor Workouts*, INSOL International, London, available at http://www.insol.org/pub.htm#statement.
15. *Draft World Bank Principles for Effective Insolvency & Creditor Rights Systems*, p. 1, see above.
16. Ibid, p. 2-3.

17. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", p. 11.

18. *Ibid,* p. 25.

19. *Draft World Bank Principles for Effective Insolvency & Creditor Rights Systems,* above, p. 2.

20. There is a large literature on the use of standards in legislation and law making; see generally, Tomasic, R. (1980), "The Sociology of Legislation", *Legislation and Society in Australia,* Allen & Unwin, Sydney, pp. 19-49.

21. Draft World Bank Principles **for Effective Insolvency & Creditor Rights Systems, above at pp. 2-3.**

22. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", above at p. 43.

23. *Ibid,* p. 42.

24. UNCITRAL (2004), UNCITRAL *Legislative Guide on Insolvency Law*.

25. *Ibid,* pp. 1-2.

26. *Draft World Bank Principles*, p. 17.

27. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", above at p. 42.

28. UNCITRAL (2004), *UNCITRAL Legislative Guide on Insolvency Law*, p. 258.

29. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", above, at p. 42.

30. See generally, Millman, D. and C. Durrant (1999), *Corporate Insolvency–Law and Practice*, Third Edition, Sweet & Maxwell, London, p. 135.

31. See generally, Coburn, N.F. (2003), *Coburn's Insolvent Trading: Global Investment Fraud and Corporate Investigations,* Law Book Co., Sydney, pp. 231-241.

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33. *Ibid,* p. 241.

34. *Ibid,* pp. 242-243.

35. *Draft World Bank Principles for Effective Insolvency & Creditor Rights Systems*, p. 26.

36. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", above, p. 42.

37. UNCITRAL (2004), *UNCITRAL Legislative Guide on Insolvency Law*, p. 259.

38. *Ibid,* p. 260.

39. *Ibid*, p. 250.

40. *Ibid*, p. 250.

41. *Ibid*, p. 258.

42. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", above, p. 43.

43. UNCITRAL (2004), *UNCITRAL Legislative Guide on Insolvency L*aw, p. 245.

44. *Ibid*.

45. These are matters that are dealt with more fully in the UNCITRAL Legislative Guide, see generally at p. 263.

46. Asian Development Bank, "Insolvency Law Reforms in the Asian and Pacific Region", above, p. 42.

47. The World Bank Principles for Effective Insolvency & Creditor Rights Systems (Revised), 21 December 2005, p. 11.

48. See generally, Easdown, G. and P. Wilms (2002), *Ansett–The Collapse*, Lothian Books, Melbourne.

INSOLVENCY AND SOCIAL PROTECTION: EMPLOYEE ENTITLEMENTS IN THE EVENT OF EMPLOYER INSOLVENCY

by
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1) Introduction

The most valuable assets of any country are its employees, and economic progress and development often hinge upon the degree to which the citizens of a country can be gainfully employed on a sustainable basis. In an increasingly global economy, businesses face enormous competitive pressures to minimise costs and maximise returns, often at the expense of domestic labour. Of course, there are winners and losers in this process, as jobs from one country are outsourced to another. Traumatic as this is, it is part of an inevitable cycle and is not nearly as traumatic as the more abrupt losses that befall employees when their employer files for bankruptcy.

The collapses in recent years of a number of mega-corporations (like Asia Pulp & Paper, Calpine, Collins & Aikman, Enron, Parmalat and WorldCom) represent only the latest casualties of competition, market volatility, poor management, or corporate demise by other forces that challenge business today. Enron's collapse, the largest corporate insolvency in United States history, placed the spotlight once more on the topic of employee's rights to entitlements in the event of corporate bankruptcy. The Enron catastrophe left over 4 500 staff unemployed and with uncertain ability to access entitlements owed to them under their work contracts. Even worse, employees and other investors who had invested their life's savings in Enron's stock and pension fund were left with nothing, while many of Enron's management and upper echelon walked away with large bonuses and severance packages, or managed to sell their own Enron stock before the real collapse. A tragedy of epic proportion, it led to a number of regulatory reforms in the areas of corporate governance, and accounting and auditing practices which, with hindsight, can be said to have had both positive and negative effects.

The real magnitude of these issues is difficult to measure in quantitative terms. In the context of systemic crises, such as the Asian financial crisis of 1997, the impact was so

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widespread that it led to civil unrest in some countries and threatened unrest in others. Argentina still has one of the highest unemployment rates in Latin America today (estimated at above 25%), three years after the crisis. At no time have we been more acutely aware of the challenges facing our oldest bedrock companies that have been the foundation of our economies (companies like Ford, General Motors, United Airlines and many others) who have either filed for bankruptcy or face the threat of insolvency due to unsustainable "legacy liabilities" that are impossible to satisfy in the competitive global markets of today. Some of these companies have successfully shed billions of dollars of liabilities to become more competitive and preserve thousands of jobs. Notable examples include United Airlines, which emerged from bankruptcy in June, having saved some USD 7 billion (United States dollars) in claims. More recently, GM announced savings of approximately USD 15 billion by renegotiating its labour and pension liabilities. This is a start, but it represents only the tip of the iceberg in our rapidly changing world.

The consequences of these failures, or the problems of financial distress, compel policy makers to re-examine systems that provide for employee protections in the event of their employer's financial demise.[1] Unfortunately, there are difficult choices that are not politically popular, as the road to salvation is often marked by sacrifice. Some jobs must be lost or claims reduced to return the business to financial health and thereby save as many jobs as possible, and provide an opportunity for the company's growth and expansion in the future.

2) Policy considerations and issues

Should employee rights receive special attention above and beyond that of other trade creditors? Employees sometimes possess a contractual right to entitlements accrued under their work contracts. In terms of relative priority, these entitlements and rights are no different than those of other unsecured creditors holding contractual rights and claims to payment. Both groups of creditors are on an even legal footing to be paid from the general assets of the company, as distinct from the rights of secured creditors whose *in rem* rights entitle them to satisfaction from specific assets in the event of a default.

Employees are commonly the silent or lost voice in bankruptcy proceedings, however, and often have little influence or bargaining power (outside the collective bargaining process). Yet, they stand to lose the most. Wages generally constitute a significant portion of employees' wealth, leaving them with few options to fall back on in the event of their employer's default.[2] Moreover, the overwhelming majority of employees have not intentionally assumed the risk that their employer might fail to pay them. Unlike creditors who can factor such defaults into their pricing or lending rates, employees typically are left with no recourse. They generally begin and maintain their course of employment without information as to the precise economic condition of their employer.[3] Even if such economic information were available and understandable by the staff member, under a standardised contract, there is little an employee can do to factor in the risk of insolvency. In the event that an employee does learn of the financial ill-being of his/her employer before a formal declaration of bankruptcy, that individual may still remain powerless, as job prospects and mobility tend to be limited.[4]

Regular trade creditors, on the other hand, have access to financial and economic data on the debtor and can (theoretically, if not realistically), set their terms of trade to reflect their assumed risk. So too, trade creditors will often have a variety of sources of income, whereas employees usually only work for a single organisation.

The financial security of employees in the event of employer insolvency is an issue capable of having a far-reaching societal affect. For example, employees holding pension benefits derived from their business' ongoing operations or stock, may discover that their pension plans have been tapped to cover expenses of the business or that their mutual funds (invested with the employer's stock) are now worthless as they face their retirement years. Thus, the insolvency of a company may cause workers to lose their retirement benefits, as in the case of Enron, placing them at the mercy of taxpayer-sponsored state support and forcing them to extend their employment well into the retirement years.

Unemployment and insolvency are an even worse combination in the context of troubled economies with high unemployment rates. Developing and transition economies typically have weak social protection systems for unemployed workers, whose numbers spiral when companies in financial distress downsize their workforce to rationalise their costs. In systemically affected countries, there is a greater potential for social unrest.

While employee entitlements clearly deserve special attention, numerous policy questions arise with regard to the treatment of these issues. For example, should general employee claims take precedence over claims of other unsecured creditors? If so, should the increase in risk to trade creditors be passed on to the debtor in the form of higher priced goods and services, putting labour intensive businesses at risk and inadvertently hindering job creation? If no, what other options are there to protect what is perhaps the most vulnerable of creditor groups?

This paper does not support a definitive model on legal treatment of employee entitlements in the case of insolvency. Rather, it examines some of the approaches currently adopted by different legal systems in order to protect employee entitlements in the event of employer insolvency. Section II briefly describes the position of two international bodies (the International Labour Organization and the European Union) on employee entitlements in insolvency, followed by a description of the four basic models in use around the world, with the aim of informing the debate on effective protection measures for a country's most important assets–its employees. Section III discusses a number of strategies and policy considerations in the establishment and use of insurance and guarantee fund systems. The paper recognises the need for more research and focus on this increasingly important issue in the current global analysis of insolvency principles and practice.[5]

It should be noted that there is a variety of treatments for employee contracts on the insolvency of a business. While some states, such as Russia, opt for the maintenance of work contracts through the long-term government administration of a failing business, unless otherwise indicated, this paper assumes the South African model of instantaneous termination of employee contracts in the event of bankruptcy. So too, many insolvency laws allow for a company suffering financial difficulties to be taken over or merged resulting in the downsizing or transfer of its workforce. While this process often results in large scale redundancies, and raises issues of whether a subsequent employer is liable for entitlements accrued under former employment, for the sake of simplicity in this paper, it has been assumed that all staff have been made redundant on the insolvency of the enterprise.

3) The international experience

The International Labour Organization

As early as 1949, the International Labour Organization (ILO), whose members include all the countries discussed in this paper, produced a Protection of Wages Convention in which it addressed the effect of insolvency on workers' wages.[6] Article 11.1 states:

> *In the event of the bankruptcy or judicial liquidation of an undertaking, the workers employed therein shall be treated as privileged creditors either as regards wages due to them for service rendered during such a period prior to the bankruptcy or judicial liquidation as may be prescribed by national laws or regulations, or as regards wages up to a prescribed amount as may be determined by national laws or regulations.*[7]

Nevertheless, Article 11.3 acknowledges that national laws and regulations are to determine *the relative priority of such debts*. If the workers' claims are protected by a guarantee institution, however, they may be relegated to a lower privileged status. By giving individual nations the right to limit the privileged nature of employee claims to a certain extent, the ILO may have surrendered a degree of its leverage regarding the rights of workers.

In 1982, the ILO issued a convention regarding the termination of employment.[8] Part II, Article 11, requires that employers provide employees on the verge of unemployment with either reasonable notice of such termination or compensation for the lack of reasonable notice. The ILO also seeks strong and direct participation by worker representatives in employment termination, particularly in light of major restructuring, downsizing or terminations due to employer insolvency.

European Union

In contrast to the ILO requirements, the European Union (EU) directives are binding on members. In 1980, the Council of the European Communities issued a directive regarding the protection of employees in the event of their employer's insolvency.[9] It was updated by the European Parliament in 2002.[10]

Section II, Article 3.1, requires that guarantee institutions secure employees' outstanding claims relating to their employment. Section II, Article 4.2, compels member states to ensure that outstanding claims from the last 18 months are paid. Nonetheless, Section II, Article 4.3, authorises member states to set limits on the liability for employees' outstanding claims as long as the states notify the Commission of the methods they used in order to reach those limits.[11]

Council Directive 98/59/EC requires that any employer considering collective dismissals consult with workers' representatives first, with a goal of reaching an agreement and thereby curtailing the need for such measures.[12]

Survey of country experience

The ILO and EU requirements have been interpreted and implemented in myriad ways. What follows below is a brief analysis of four different systems and variations on models used throughout the world in an attempt to address the social protection concerns raised by employer insolvency.

Model one: Pro-employee approach

China has implemented a very pro-employee approach to staff redundancies.[13] The Chinese model encompasses compulsory unemployment insurance that goes well beyond mere monetary compensation for entitlements owed, though not all workers are covered by it. The cost of the insurance is carried by both employers and employees. The system allows (in addition to receiving priority in insolvency to cover outstanding entitlements), for employees to be paid up to 80 percent of the national minimum wage for up to two years. It also aims to enhance the competitiveness and employability of the unemployed through training and job referrals in an attempt to speed their rejoining the workforce. Austria also has adopted a sector specific training programme financed by unemployment insurance, which has improved considerably the employment prospects for its participants.[14]

Critics have called for the transformation of the current Chinese insolvency system. The system is not always consistent in its effort to maximise pacification and settle affected worker claims.[15] Trade creditors' claims are often ignored due to the weak enforcement of contract law, and the employee rehabilitation fees paid out can vary between employees within the same company, creating further inequality.[16] Thus, there is a lack of consistency in the treatment of claims in bankruptcy. China has been rapidly moving to modernise its laws to embrace and enable the new market-oriented economy, including in the area of insolvency, where a new draft insolvency law is on the verge of being passed. The current insolvency law has often not been applied to its full and logical extent. In a climate of high unemployment and an unstable economic environment, state-run enterprises, in particular, are reluctant to declare bankruptcy, and employees themselves attempt to delay the onset of insolvency proceedings due to the loss of the security of what was once considered to be a job for life. The unfortunate result of this is that employees are often forced to work for a second enterprise while awaiting the uncertain enforcement of the right to the entitlements still owing from the first.[17] Under the new law, however, at the time of this writing, the author was informed that some difficult challenges have been taken to compromise between labour priorities and priorities for secured creditors. This marks a monumental achievement.

Model two: Bankruptcy priority–No insurance approach

At the other extreme is the Mexican system, which has no insurance scheme to cover the difference between the entitlements owed and the value of the assets realised.[18] Like a number of civil law systems, however, it does award first priority in bankruptcy to certain worker entitlements, such as payments of up to three months' wages in lieu of severance pay. Despite being a new law (having being enacted as recently as 2000), the Mexican insolvency law has come under considerable criticism, especially for furthering the old law's practice of favouring employees in a biased manner.[19] This approach undermines the fundamental principle of secured creditors' rights and increases the insolvency risk in commercial relationships. Moreover, in actuality it does not significantly enhance the protection of workers' entitlements. Employees of insolvent, asset poor enterprises are often unable to find sufficient assets to assure payment even of the first priority employee claims in an employer's bankruptcy and must fall back on Mexico's underdeveloped social security system in a difficult labour market. This problem is compounded as owners and managers of financially distressed but viable companies operate them to the point of no return, while avoiding outside assistance for fear of being subjected to criminal sanctions for fraud.[20] In this regard, the United States has also fared poorly on workers entitlement protection in international comparisons, due to its pro-debtor stance

and relegation of certain worker entitlements to third priority status within the unsecured creditor class.[21] In the US, however, these priorities must be counterbalanced by Sections 1113 and 1114 of the US Bankruptcy Code which lay out special provisions for the treatment of collective bargaining agreements and the handling of insurance benefits for retired employees.

Model three: Bankruptcy priority–Guarantee fund approach

Most developed countries use a hybrid system that gives workers' predetermined entitlements some priority in bankruptcy, but also provides unemployment insurance in acknowledgement that the remaining assets are often insufficient to cover outstanding entitlements. For example, the Danish system gives the highest priority among unsecured creditors to claims for salaries, wages and other employee benefits (behind administrative costs), with a guarantee fund as a safety net, should the assets prove to be insufficient.[22] While this affords the employee greater security in their rights to entitlements, and grants ready access to collateral for the secured creditors, it still raises concerns. Is it equitable, or indeed desirable, to deprive other unsecured creditors (such as trade creditors who, after all, possess the same contractually based claims as employees) equal access to the remaining assets? Predictability of outcomes underpins many of the principles of commercial law and should apply to secured and unsecured creditors alike; the process of priorities in bankruptcy can seriously undermine creditor/lender confidence in a system if it is difficult to determine what percentage of remaining assets one is likely to receive. An example of a system that clouds predictability by the retention of complicated priority structures is Australia's, which delineates no less than fourteen claims that have priority over regular creditors in the unsecured creditors class.[23]

Model four: No priority–Guarantee fund approach

One of the more predicable systems for creditors is that of Germany. The German model treats all unsecured creditors, including employees, the same and accordingly allows all of them equal access to the remaining available assets of an insolvent enterprise. Worker entitlements not satisfied through bankruptcy are paid out of a national insolvency fund.[24] The only exception to this flat priority structure is the creation of a social welfare plan for those who face severe disadvantages due to their employer's insolvency. Employees under the welfare plan are then awarded first priority in insolvency, albeit with a limitation to one-third of all assets, thereby ensuring greater clarity and, consequently, greater creditor confidence in the process.

4) Strategy and policy considerations

The concept of an entitlement insurance protection scheme has been widely adopted throughout the developed world, and would appear to offer the most protection for worker entitlements while not interfering with the efficient distribution of credit in the market. What follows is a discussion of some elements to be considered in the construction of an insolvency social protection system.

Bankruptcy priority

The approach adopted should properly balance policies that promote commercial confidence with those that support social protection measures. Principle 16 of the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems addresses claims resolution in terms of the treatment of stakeholder rights and priorities.[25]

It states that insolvency and creditor rights systems, through commercial laws, should both preserve the legitimate expectations of creditors and, most importantly, encourage greater predictability in commercial relationships by upholding, to the maximum extent possible, the relative priorities of creditors established prior to insolvency.[26] The easiest way to ensure this is to have a flat hierarchy of priorities, which only consists of two levels: first, secured creditors maintain recognised priority in their collateral; second, following satisfaction of administration costs, the remaining proceeds are to be distributed equally among the remaining creditors.[27] The World Bank principles state that there should be few if any deviations from this general rule, and these rules of priority should encourage creditors to manage credit effectively.

Principle 16 of the 2001 version and Principle C.12 of the revised principles articulate a rule of best practice. It is not a straightjacket and there may be exceptional circumstances that would justify a priority. Indeed, so important is the issue, that the revised principles introduced a new sub-principle C.12.4 specifically calling for flexibility and careful consideration in the treatment of employee rights. This paper does not examine that question. Rather, it is suggested that the essence of Principle C.12. (former Principle 16) strikes a proper balance and should be the goal even in regard to employee entitlements.

Put differently, the contract governing the employment relationship should be treated the same way as other trade or service contracts. In many developing countries, where private sector growth is imperative to ensure economic and social prosperity, ready access of private enterprises to credit at reasonable terms is paramount. The more predicable and transparent the insolvency process, and the greater the chance of retrieving collateral in the advent of bankruptcy, the more willing lenders should be to lend at rates that reflect lower risk premiums. This is not to say that the repayment of employee entitlements is of less importance than payment of collateral, but rather that there may be more efficient ways of ensuring workers entitlements while still preserving a strong, predictable financing market.[28]

Insurance funds

One way to ensure the payment of employee entitlements, while maintaining market confidence, is through an insurance fund. Insurance funds can reduce the burden of the unemployed on the state for interim social protection, although they would not entirely displace the necessity of providing protection for purposes of unemployment, retraining and other needs. On an economic level, an insurance fund may provide a higher degree of reliability to the markets while at the same time affording stronger protection to employees to fulfil social objectives. Of the four models examined above, clearly the most effective are those that establish a guarantee fund as a backstop to the payment of employee claims in bankruptcy. In this author's view, however, even those models do not go far enough.

The guarantee fund models rely on a "bankruptcy payment first" concept that requires employees to wait for a period of time (in some cases, months or even years) before they can top up the shortfall in their recovery from the guarantee fund. Many employees and their families can be left destitute while they await the accrued entitlements they are owed. This hardship can be magnified if there is a lengthy delay for payment on back wages and claims. Rather than forcing employees to linger during a potentially drawn out liquidation process where assets have to be identified, realised and distributed, consideration should be given to establishing an immediate right of payment from the

insurance or guarantee fund to settle worker claims up front.[29] Upon satisfaction of the claims, the guarantee fund would be subrogated to the employee's claims against the debtor to recoup any distributions to which the workers would be entitled. For example, if an employer in Belgium is unable to pay entitlements within fifteen days of the close of the business, the Fund for Closures immediately commences payment on its behalf.[30]

Critics of insurance funds claim that they are expensive to run, punish successful companies, and benefit only certain employees.[31] However, all these accusations are difficult to substantiate empirically, as a pure entitlement insurance fund system does not appear to have been comprehensively tested as yet. Although there may be greater cost burdens for business, the burden of the risk of insolvency would appear to be better carried through an insurance fund system prior to insolvency rather than the employees (or the general creditors) afterwards. Shifting the risk to the business and taxpayers in protecting employees is more consistent with the responsibilities and obligations assumed by the debtor and the state.

There are a number of ways in which a country considering such a system can attempt to reduce the cost burden to business. The existing forms of insurance already used widely throughout the developed world (albeit usually in a hybrid system that requires some alteration to be made to the order of priority in bankruptcy) are a good example of this. Some countries may require compulsory insurance through a government-run commission, while other countries require companies to have private insurance to cover worker entitlements in the case of bankruptcy. Still others require contributions by employees, although the question remains as to whether the workers themselves are best placed to bear these costs.

Another alternative used by many countries to minimise the cost of such a scheme to business (and particularly to small business) is to limit compulsory insurance to only those companies with a predetermined minimum number of employees, *e.g.* businesses larger than 20 employees. Another option still is to limit the size of the payout either to a predetermined amount or to a percentage of entitlements owed. In Italy, for instance, an employee can only recover up to 80 percent of entitlements owing.[32] Belgium restricts compulsory insurance to the for-profit sector. However, this creates uncertainty as to the security of entitlement payouts for employees in the non-profit sector.

Another option assumed by states attempting to reduce the cost burden of entitlement payouts is to limit the types of entitlements that employees can claim. Some states expressly exclude outstanding holiday pay from priority payments, while others use a combination of included/excluded entitlements, such as commissions, outstanding sick leave, and maternity leave. The availability and level of severance pay also varies widely.

Employees should be able to expect a base level of entitlements in the event of an employer's insolvency. In Part II, Article 12, the ILO clarifies what entitlements workers should expect upon termination of employment.[33] They include a severance allowance or separation benefits based upon length of service and amount of wages to be paid by the employer directly or by an employer contribution fund, as well as unemployment insurance or social security. Part II, Article 6, stipulates that the privilege protection shall include:

- Workers' claims for wages for a period of three months or more prior to the insolvency or termination of employment;
- Workers' claims for holiday pay due as a result of work performed that year and the year before;

- Workers' claims for amounts due for other types of paid absences dating three months or more before the insolvency or termination; and
- Severance pay due to workers upon the termination of their employment.

Some countries do not have worker entitlement insurance that covers some or all of an employees unpaid wages or retirement claims. In times of crisis, the absence of such "safety nets" may create additional hurdles to recovery and may need to be supplemented with an economic stimulus package as opposed to immediate satisfaction of back claims. The absence of social safety nets or adequate programmes where claims are not likely to be covered in a bankruptcy by the available assets makes for a high wire act of rectifying the past or building for the future. Countries with more scarce resources would no doubt find little justification to follow the path to the past.

Notwithstanding the above, an ideal employee entitlement insurance system would allow for the prompt repayment of 100% of worker entitlements owing. But in the initial stages of building this fund from scratch to a point where it could withstand a major insolvency may take considerable time. To overcome this problem, one solution may be the Australian model, which consists of a temporary government fund designed to cover entitlement payouts until the newly implemented insurance system has built sufficient capital to operate in its own right.[34]

A major consideration of any insurance system is what form of corporate governance it will possess. Ideally, it would be administered entirely by the private sector, but this may be unrealistic in countries with undeveloped financial markets. If it were to be controlled by a state–and indeed in many countries, the social security administration may be best placed to operate such a fund–there would nonetheless need to be very tight controls in place to ensure that such a fund is free from corruption and accounted for individually, so profits did not simply become consolidated government revenue.

Other considerations

Although beyond the scope of this paper, another element for consideration would be the role of outstanding contributions to pension/superannuation schemes. This raises the issue of employees who are left with a savings portfolio that consists either of currently worthless stock in their former employer, or an employer-administered pension plan which is now subject to liquidation. Consequently, a country looking to implement an insurance scheme would need to consider whether such a scheme should be obliged to cover outstanding payments to pension funds, or whether this would be considered too great a cost burden.

In addition, while not addressed in detail above, many countries also provide a substantial role for worker unions in determining the most appropriate way to deal with mass redundancies and ensuing worker entitlements. There remains room for further discussion as to how a collective bargaining insolvency agreement would affect the order of creditor priority and, indeed, whether they would be necessary under an insurance scheme such as the one proposed above.

Other specific issues worthy of consideration in a law relating to employee entitlements is the place of victims of work-related injuries who, perhaps, stand to lose the most in countries without well-developed social protection systems, if the former employer becomes insolvent. Brazil[35] and, to a lesser extent, Australia[36] have made specific provisions for compensation to injured workers to be given higher priority in bankruptcy.

Section III, Article 8, of the Council of the European Communities Directive 80/987/EEC seeks to protect the rights of employees who left a business before its insolvency and had maintained rights with regard to old-age benefits in company pension schemes outside the national statutory social security schemes.[37]

5) Conclusion

Currently there does not seem to be a perfect legal scheme for handling employee entitlements in the event of employer insolvency. Some are clearly more effective than others. Each of the schemes examined in this paper are flawed in certain ways, as 100 percent of employee entitlements are never fully protected or predictability for creditors is decreased. Employees in insolvency proceedings tend be treated as neither creditors nor equity, with no vested financial stake in the bankrupt entity (outside of employee stock option plans). Yet, employees universally have the most to lose, as their families' livelihood generally depends upon the wages and benefits for work performed.

Many, maybe the majority, of families around the developing world live on the edge or hand-to-mouth, making the consequences of unemployment even more burdensome for them and the state. Additionally, employees are generally not privy to the exact financial status of their employers, so bad news may be highly unexpected and not well planned for. As perhaps the most vital part of businesses everywhere, the employee deserves to have legal protection of his/her employment claims.

The purpose of this paper has been to examine the varying legal treatments of employee entitlements in the case of employer insolvency and to encourage developing countries to develop insolvency laws which both achieve market strength and efficiency while protecting the rights of those most vulnerable in the insolvency process.

This paper does not aim to suggest that an entitlement insurance fund is a cure-all in times of large corporate redundancies. Clearly, such a system needs to be supported by active labour market programmes, such as retraining, job search assistance and public works programmes. Insurance or guarantee fund systems, however, could significantly increase the potential for employees to realise their entitlements while minimising the insolvency risks for other commercial stakeholders, and providers of credit and goods.

Notes

1. McNulty, Shiela (2002), "Enron Employees Form Coalition", *Financial Times*, 20 January 2002.
2. Korobkin, Donald R. (1996), "Employee Interests in Bankruptcy", 4 Am. Bankr. Inst. L. Rev. 5, 6
3. *Id.*
4. The World Bank (2001), *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*. The World Bank principles, as revised and updated, carry forward the same general principles in treatment, but add a principle calling for

special recognition and treatment of labour claims. Principle C.12.4 (revised) provides: "Workers are a vital part of an enterprise and careful consideration should be given to balancing the rights of employees with those of other creditors."

5. For purposes of this paper, the more detailed treatment on a country-by-country basis has been omitted.

6. International Labour Organization (1949), *C95 Protection of Wages Convention.*

7. *Id.*

8. International Labour Organization (1982), *C158 Termination of Employment Convention*.

9. The Council of the European Communities (1980), *Council Directive 80/987/EEC on the Approximation of the Laws of the Member States Relating to the Protection of Employees in the Event of the Insolvency of their Employer.*

10. "Social Policy: European Parliament Backs New Insolvency Directive", *European Report,* 15 May 2002.

11. *Id.*

12. Centre for Environmental Informatics (1998), *Employment Protection*.

13. Lee, Vicky (2000), Research and Library Services Division, Legislative Council Secretariat, *Unemployment Insurance and Assistance Systems in Mainland China*.

14. Winter-Ebmer, Rudolf (2001), "Long-term Consequences of an Innovative Redundancy-Retraining Project: the Austrian Steel Foundation", *Social Protection Discussion Paper,* No. 0103, 01/2001, the World Bank Group.

15. The World Bank, East Asia and Pacific Region Private Sector Development Unit (2000), "Bankruptcy of State Enterprises in China–A Case and Agenda for Reforming the Insolvency System", 20 September 2000.

16. *Id.* at iii. These fees have been based on a formula that applies a multiplier to an employee's current salary and takes into account length of service. In that sense, the formula and its application can be said to be generally consistently applied, even though the results may seem unequal.

17. The Chinese system, though admirable in its aims, still requires more rigorous enforcement by rule of law if the issue of protecting unviable enterprises is to be addressed and workers rights properly protected.

18. Dario U. Oscos, Coria & Oscos Abogados (2001), *The New Mexican Law on Commercial Insolvency*.

19. See Sheppard citing Ignacio Herrera *et al*., Excelsior, Mexico, 11 December 1999.

20. Rowat, Malcolm (1999), "Reforming Insolvency Systems in Latin America, Public Policy for the Private Sector", Note No. 187, June 1999, The World Bank Group.

21. Posthuma, Richard A. *et al*. (2000), "Labour and Employment Laws in Mexico and the United States: An International Comparison", *Labour Law Journal,* 20 (2000).

22. EMIRE, *Denmark: Employees' Pay Guarantee Fund*.

23. Australian Commonwealth Corporations Act 2001.

24. German Federal Parliament (1999), *Insolvenzordnung (InsO)*.

25. The World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, *supra* note 4.

26. *Id.*

27. The priority of administration costs over general unsecured creditors reflects the view that the administrator's efforts in selling assets inures mainly to the benefit of this class, and consequently should be borne evenly by allowing these expenses to be paid first. This general rule recognises exceptions where secured creditors gain a benefit from having the administrator maintain and dispose of secured assets, which might be surcharged for the activities associated with the effort to sell such assets. Other rules may also come into play, such as whether the administrator's fees are actual, reasonable and resulted in a benefit to the estate.

28. It goes without saying that the same logic applies to priorities for public debt, which can also distort expectations in commercial relationships by allocating a firm's insolvency risks to the general creditors. Notably, the United Kingdom recently moved to classify outstanding payments to the Inland Revenue Service as merely another unsecured debt. See section 251of United Kingdom Enterprise Act 2002.

29. This assumes a claims resolution process either in bankruptcy or through another administrative procedure that would be dispositive of employee claims.

30. EMIRE, *Notice, Belgium*.

31. New Zealand Ministry of Economic Development (2002), *Employee-Related Claims*.

32. EMIRE, *Wages Guarantee Fund (CIG), Italy.*

33. International Labour Organization (1992), *C173 Protection of Workers Claims (Employer's Insolvency) Convention*.

34. Australian Workplace, *General Employee Entitlements and Redundancy Scheme (GEERS)*.

35. Felsberg e Associados (2000), "Insolvency Overview: Brazil", *Global Insolvency Law Database*.

36. Section 566(f), Australian Commonwealth Corporations Act 2001.

37. The Council of the European Communities (1980), *Council Directive 80/987/EEC On the Approximation of the Laws of the Member States Relating to the Protection of Employees in the Event of the Insolvency of Their Employer.*

Annex

INSOLVENCY AND SOCIAL PROTECTION: ENTITLEMENTS IN THE EVENT OF EMPLOYER INSOLVENCY

Country	TREATMENT OF CONTRACTS			PRIORITY OF CLAIMS			SOCIAL PROTECTION	
	Automatic Termination	**Termination Requirements**	**Collective Bargaining Agreements**	**Priority**	**Allowed Amount**	**Elements Included**	**Funds**	**Amount/Claims Covered**
Argentina		Written notice of dismissal at least one month in advance.		Special priority in liquidation for certain claims. A general priority is provided for employees by granting a lien on general assets of the debtor where special priority claims are not paid. No priority over secured claims on immovable assets.	Wage arrears up to 6 months prior to filing, redundancy claims up to 3 months salary.	Special priority for wage arrears, redundancy claims, last month payment *in totum*, payment in lieu of notice, unfair discriminatory dismissal, worker injury, holiday pay and certain other compensations.	No programme.	

Country	TREATMENT OF CONTRACTS			PRIORITY OF CLAIMS			SOCIAL PROTECTION	
	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
Australia				Priority over unsecured debts and claims. Priority also over claims secured by floating charge (when assets insufficient). No priority over fixed charges.		Wages and superannuation contributions; injury compensation; industrial instrument leave of absence; and retrenchment payments.	After 09/11/01, the General Employees Entitlements and Redundancy Schemes (GEERS) applies to provide terminated employees with unpaid entitlements. In addition, employers must purchase insurance to protect employees' entitlements.	EESS: Payments to AUD 20 000 (Australian dollars), unpaid wages, annual leave and redundancy pay up to 4 weeks, pay instead of notice up to 5 weeks, long service leave up to 12 weeks. GEERS: AUD 75 200 for 01-02; AUD 81 500 for 02-03.
Belgium	No.	Employers having 20+ employees must notify the employees and the government. If contract is immediately terminated, the salary and benefit claims must be made within 15 days of the close of business.		Preferential claim for unpaid wages, social security contributions. Claims are subordinate claims secured by specific assets.	Wages up to approximately EUR 7 500 (euros), and unlimited for payment in lieu of notice; Social security contributions, including holiday pay, worker injury, social security, and payments to worker indemnity fund.	Workers comp.	Fund for closures.	
Brazil				Priority over tax and general unsecured claims. Partial priority over secured claims, which now rank ahead of tax claims.	Worker comp. Claims have highest priority; followed by wages up to 150 monthly minimum wages (*i.e.* about USD 13 000).	Compensation for work-related injuries (highest priority), labour and social security, including salaries, vacation pay, and bonuses, severance pay.	No.	

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Country	TREATMENT OF CONTRACTS			PRIORITY OF CLAIMS			SOCIAL PROTECTION	
	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
Canada	No.	Written notice or pay. If layoff is temporary or short term, advance written notice or reason for layoff is not required. However, a recall date must be provided.		4th ranking priority: preferred status over unsecured creditors (except entitlements for severance and termination pay). Secured creditors have priority (except banks holding secured claim under Bank's Act, where employee priority is senior up to 3 month.		Salaries, wages, commissions and vacation pay during the six month period prior to bankruptcy.	No specific fund, but unpaid wages, vacation or termination pay may be claimed under Canadian Employment Standards Act, but may not protect an employee if the employer has begun bankruptcy proceedings.	Directors are personally liable for up to 6 months of wages and 12 months of vacation pay under OBCA and 6 months of wages under CBCA.
China				Claims of employees are settled first for wages and insurance fees, followed by taxes, and unsecured creditors. Under the SOE insolvency law, employee claims have ranked prior to secured claims. The new draft Enterprise Bankruptcy Law maintains a partial priority over secured claims.		Wages and labour insurance fees.	Unemployment insurance. Minimum living security.	Unemployment insurance system for staff workers of state-owned enterprises will pay dismissed employees 70 to 80% of the national minimum wage for 2 years. Minimum living security ensures minimal standards of living for workers.
Denmark	No.	Estate has two weeks to decide whether to adopt employment contracts; contracts rejected in 2 weeks are preferential, while		4th Rank following secured, admin. costs and costs acquired by debtor during the suspension period.		Salaries, wages and other benefits owed to the employee, unpaid pensions, holiday pay, redundancy payments, unfair dismissal,	Employees' Guarantee Fund. Funded by employer contributions.	Covers employee claims for wages, vacation pay and severance pay earned during the 6 months before the bankruptcy

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	Automatic Termination	**Termination Requirements**	**Collective Bargaining Agreements**	**Priority**	**Allowed Amount**	**Elements Included**	**Funds**	**Amount/Claims Covered**
		others enjoy pre-preference from date of adjudication to notice.				reasonable legal costs.		proceedings up to DKK 110 000 (Danish kroner). EGF subrogates to employee preference claims.
Finland	No.				Up to FIM 90 000 (Finnish markka, in use until 1/1/02).	Wages.	Wage guarantee system funded by employers.	When the government pays out employee claims on behalf of the insolvent employers, employers are to repay the government within 10 years, unless their financial standing would render re-payment unreasonable.
France	No.			Super-preference for wages not paid in last 60 days; General preference over personal property and real estate for unpaid wages for 6 months prior to adjudication; Priority over secured claims, but not those with retention of title.	Super preference for last 60 days; general preference for last 6 months wages	Wages, paid leave, improper termination and certain dismissal allowances.	Compulsory insurance fund. Association Pour la Gestion du Régime d'Assurance des Créances des Salaries (AGS). Payments required by all *in bonis* companies.	Employees may recover when insufficient assets or recovery is expected to be protracted. Employees may collect even if employer did not contribute. By law of May 2004, compensation agreements concluded 18 months prior to filing are not covered by AGS.
Germany	No.	With proper notice.		Preference only for worker claims arising after the opening of proceedings. Pre-petition worker claims are treated as general	Up to the amount of the preference.	Can include wages, holiday pay, bonuses, comparable entitlements and pensions (so long as	Federal Employment Agency for unpaid wages up to 3 months).	Up to 3 months for wages against FEA. Unspecified for PSV. FEA and PSV both

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Country	TREATMENT OF CONTRACTS			PRIORITY OF CLAIMS			SOCIAL PROTECTION	
	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
				unsecured. Preference ranked *pari passu* with administrative claims.		post-bankruptcy).	Claims for unpaid pension obligations can be recovered from the *Pensions SicherungsVerein*.	subrogate to the employees rights against employer. In other words, for general unsecured or preferential claims.
Hong Kong, China				General priority: -Admin costs. -Fixed charges. -Preferential claims (including employee). -Floating charges. -General unsecured.	Wages, severance pay, payment for lack of termination notice, and holiday pay and annual leave.	Wages and severance pay up to HKD 8 000 (Hong Kong dollars), lack of termination notice up to HKD 2 000/1 month's pay, entire amount of holiday pay.	Employees are entitled to payments from Protection of Wages on Insolvency Fund (PWIFB).	Up to HKD 36 000 for wages, HKD 22 500 for payment in lieu of notice, HKD 50 000/50% of any claim over that amount for severance pay, nothing for lost holiday.
India				Highest priority. Accorded *pari passu* treatment with secured claims. Seem also to be ranked equally among taxes. and fiscal claims.	Wages or salaries not exceeding 4 months in prior year, accrued holiday pay, amounts owed under Employees State Insurance Act and Workmen's Compensation Act, and pension fund benefits.		Under the Companies (Second Amendment) Act 2002, enacted but not as yet notified, provides for a rehabilitation fund to be established.	Rehabilitation fund provides interim payments of workmen's dues pending rehabilitation and pursuant to section 529 of the Companies Act.

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	Automatic Termination	**Termination Requirements**	**Collective Bargaining Agreements**	**Priority**	**Allowed Amount**	**Elements Included**	**Funds**	**Amount/Claims Covered**
Ireland	No, insolvency does not create proper grounds for dismissal, either.			Preferential claims rank below admin claims and fixed charges, but ahead of floating charges and general unsecured.		Wages, holiday and sick pay, maternity leave, redundancy, wrongful dismissal, leave and benefits pay.	Social Insurance Fund.	Up to specified amounts for any claim capped at about EUR 500 per week). Preference claims not paid can still be asserted against bankrupt. Minister for Enterprise Trade and Employment subrogates to employee preference.
Italy	No.	Proper notice.	In insolvency, reduced production, or restructuring, only collective dismissal is allowed. Employers must notify their employees of these dismissals in writing and contribute to the cost of up to 9 months' availability allowance for each dismissed employee to the INPS.	General priority over movable property for matured wages, retirement indemnity claims and unfair dismissal claims. No priority over claims secured by fixed or immovable assets.		Wages, severance pay, retirement/indemnity, sickness compensation, payment in lieu of notice, holiday pay, redundancy.	Wages Insurance Fund.(*Fondo de Garanzia Inps*). CIGS for extraordinary unemployment for workers of insolvency employers.	Protects the income of employees of insolvent employers by paying up to 80% of their lost wages. CIGS allows recovery for maximum 12 months or 36 months in 5 year period.

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	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
Japan				Preferred status for employee's unpaid wage claims over other debts of employer, but not over secured debts, such as tax payments and mortgages.	Salary, severance pay and bonuses.	Salaries earned 6 months prior to bankruptcy (even if bankruptcy court decides to discharge certain debts of the debtor) 1/3 of retirement allowance.	Japan Labour Health and Welfare Organization (JLHWO) allows recovery by employees (who left an insolvent company 6 months prior to and up to 2 years after filing) of up to 80% unpaid wages and retirement allowance. The retirement allowance varies based on age.	No limit on the amount, but Civil Code states that up to 6 months of unpaid wages may be claimed.
Malaysia				Preference over unsecured claims. Priority over floating charge where assets are insufficient to meet entitlements; No priority over fixed charges.	Wages or salary; workmen's compensation, vacation leave, contributions to superannuation and provident funds for retirement benefits.		No government programme for payment of employee entitlements.	
Mexico				First priority for wages owed within 2 years prior to employer's bankruptcy.	3 months' salary/wages and seniority payment of 12 days' pay for each year of employment.		No private or government sponsored unemployment insurance schemes.	

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	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
Netherlands	No.	Trustee or administrator may terminate on maximum 6 weeks notice, and in co-operation with management.	Governmental permission is required in collective dismissals in the event of bankruptcy.	Tax and social security claims have super-preference. Employee claims have preference over general unsecured creditors' claims.	Full time employees up to 13 weeks of wages, unpaid leave entitlements, and termination pay up to 6 weeks.		Wage guarantee scheme under the Unemployment Act pays the claims from the Netherlands' social security system. Guarantee fund subrogates to preference status.	Arrears and wages up to 13 weeks of wages, termination pay up to 6 weeks. Holiday pay/allowances and pension premiums up to one year.
New Zealand	Not necessarily; the official assignee may require an employee to continue work anyway.			Preferential claim. Where assets are insufficient, partial priority over claims secured by accounts receivable and inventory (but not assets transferred or subject to purchase money security interest.	Wages, salary and related earnings, holiday pay and redundancy payments, and employee grievance claims.	4 months prior to employer's liquidation and up to NZD 15 000 (New Zealand dollars) of amounts afforded priority.	No government backed programme for employee entitlements, although the Liquidation Surplus Account has been used to settle employee entitlement claims.	
Norway	No.			Yes, claims for wages (worth up to 6 months) or pensions maintain priority in debt, second rank, following the claims for the bankruptcy proceedings costs.	Wages worth up to 6 moths (must be within 4 months of the bankruptcy filing), holiday remuneration up to 30 months' worth (must have arisen within the 24 months prior to the insolvency).	Wages, pensions, holiday remuneration.	Wage guarantee scheme administered by the government.	

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	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
OHADA				Employers may be held personally liable.	Wages must be paid within 1 year.			
Philippines		Written notice to the workers and the Dept. of Labour 1 month prior to the termination date. In addition, termination pay equal to at least 1 month's pay or 1 month's pay for every year of service, whichever is higher.		Preferential status; however, arguments in the interpretation of the law exist.				
Russian Federation				Preference for worker injury, wages and severance claims. Ranks ahead of secured creditors.	Salaries and wages, severance pay, vacation and related pay, recovery and priority hinge on type of procedure applied.		State development fund in the making to protect further employee entitlements, but no such fund currently exists.	
South Africa	Yes, insolvency terminates all employment contracts.			Limited preference against unencumbered (free) assets of the estate. No preference over secured.	First ranked are wages up to 3 months/ZAR 12 000 (South African rand); Next ranked (all paid *pari passu*) are holiday up to ZAR 4 000, paid leave up to ZAR 4 000, and severance up to ZAR 12 000.		No fund other than the general benefits of Unemployment Insurance Act.	

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	Automatic Termination	Termination Requirements	Collective Bargaining Agreements	Priority	Allowed Amount	Elements Included	Funds	Amount/Claims Covered
UK	No.			Preference payment. Ranked equally with Crown claims. Preference is after admin. costs and fixed charge claims, but ranked ahead of floating charge claims and general unsecured creditors.	Maximum of 8 weeks, up to GBP 800 (United Kingdom pounds) for unpaid wages during 4 months prior to date of insolvency. Up to 6 weeks unpaid holiday pay accrued during 12 months prior to date of insolvency. Unpaid wages and accrued holiday/sick pay. If not possible, division of profits from its remaining assets among employees.		Redundancy Payment Service. RPS gets a super-preference.	RPS pays up to GBP 270 weekly for up to 8 weeks and up to 12 months for pension contributions.
United States			WARN applies to employers with 100 or more full-time employees or part-time employees whose weekly hours amount to 4 000. Requires employers to give employees 60 days of written notice	Post-petition wages have highest priority as administrative claims. Pre-petition unpaid wages have preference over general unsecured.	Up to USD 4 650 and must arise from the period of 90 days prior to bankruptcy filing employee. Benefit plan contributions must be within 180 days from bankruptcy or termination of business.	Earned wages, salaries, commissions, vacation pay, sick leave pay, severance pay, and contributions to employee benefit plans.	Single and multi-employer pension plans are guaranteed by the Pension Benefit Guarantee Corporation (PBGC).	PBGC takes over the single employer's obligation to pay guarantee benefits up to the statutory maximum amount. PBGC then gains an unsecured claim against the debtor. With a multi-employer plan: if the entire plan becomes insolvent, PBGC pays the guaranteed benefits up to USD 6 000 per year

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	Automatic Termination	**Termination Requirements**	**Collective Bargaining Agreements**	**Priority**	**Allowed Amount**	**Elements Included**	**Funds**	**Amount/Claims Covered**
			before mass layoffs and/or close of business.					per employee.

WEAVING THE SAFETY NET FOR AN AGING WORLD: LESSONS LEARNED FROM THE PENSION AND INSOLVENCY SYSTEMS OF THE US, THE UK, AND GERMANY

by
James H.M. Sprayregen and James J. Mazza*

1) Introduction

A Chinese proverb says "respect for one's parents is the highest duty of civil life." These words carry particular significance today. As life expectancies increase and birth rates fall around the world, the global population is aging rapidly. This phenomenon already has reached a critical point in many developed nations. In 1995, there were 1.3, 2.3, 2.6, 2.7, 3.6, and 4.2 workers per retiree in Italy, Germany, Japan, the United Kingdom, Canada and the United States respectively. By the year 2050, it is predicted that there will only be 0.7, 1.2, 1.5, 2.1, 1.6 and 2.3 workers respectively per retiree in these countries.[1] Meanwhile, developing nations are also in the midst of a major demographic shift. Indeed, while nearly 60 percent of the elderly currently live in developing countries, that percentage is projected to increase to 80 percent by 2050. In developing economies such as China, Indonesia, and Korea the percentage of these countries' populations over 60 is expected to be over 30 percent by 2050. In a trend similar to that in developed countries, the ratio of workers to the elderly in China is expected to drop from 9:1 to 2.6:1 over the next 40 years.[2]

With fewer workers to support pensioners in developed countries, these nations currently have daunting agendas of pension reform, which include substantial overhauls of government supported social security systems. In addition, corporations in these countries currently offering occupational pension plans, particularly defined benefit pension plans, are finding it difficult to sustain these retirement vehicles for employees. Indeed, it is fair to say that certain developed nations, such as the US and the UK, are in the throes of a defined benefit pension crisis. Germany, which does not rely as heavily as the US and UK on funded pension systems, is also, nevertheless, experiencing certain problems in this arena. Each of these countries' respective experiences with defined benefit pension plans provide some lessons for developing countries to consider as they formulate their own occupational pension systems and their corresponding insolvency laws.

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2) The United States

The coalescence of a number of forces in recent years, including a decline in the US stock market, the lowering of interest rates, and an increase in the ratio of retirees to active workers, has saddled US employers with massively underfunded defined benefit pension plans.[3] Defined benefit plans, which set the level of benefits that an employee will receive upon retirement, place the risk of loss of pension plan assets on employers. Thus, if, for example, a defined benefit pension plan's investment returns are lower than expected, then assets in the plan may not be sufficient to pay retirees their benefits. As a result, the plan is deemed underfunded, and the employer is responsible for the difference. This is in contrast to defined contribution plans where employees make contributions to retirement accounts and bear the risk of loss in the event of a market decline.

In 2005, corporate America's unfunded pension liabilities were estimated to be USD (United States dollars) 146 billion.[4] As a result, companies in the United States with burdensome pension "legacy" costs increasingly have been turning to Chapter 11 of the United States Bankruptcy Code to eliminate the effects of these obligations on their balance sheets and remain competitive in the global marketplace.

Pension termination

The basic principles of pension plan termination in the United States' Chapter 11 context are as follows. Under the Employee Retirement Income Security Act of 1974 (ERISA), a pension plan sponsor may terminate its defined benefit pension plan if, among other things, a bankruptcy court finds that termination of that plan is necessary for the sponsor to operate outside of bankruptcy.[5] This is often referred to as "voluntary" or sponsor-initiated termination. The Pension Benefit Guaranty Corporation (PBGC), which is the quasi-governmental agency that insures and oversees the defined benefit pension system in the United States, may approve a sponsor-initiated "distress termination" of a pension plan if certain termination criteria are met.[6]

But the PBGC may not process a sponsor-initiated termination that "would violate the terms and conditions of an existing collective bargaining agreement."[7] The plan sponsor must obtain relief from its collective bargaining obligations under Section 1113 of the Bankruptcy Code, which affords special protection to these contracts. In contrast, in ERISA §4042, Congress vested in the PBGC the right to seek an "involuntary" termination of a pension plan if it determines that, among other things, the plan has not been properly funded, or the PBGC's possible long-run loss with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.[8] It is important to note that the PBGC may terminate a pension plan under ERISA §4042 notwithstanding any alleged limitations that may exist in the plan sponsor's collective bargaining agreements with its unions.[9]

For example, in the United Air Lines, Inc. Chapter 11 case, the PBGC agreed through a settlement with the company to terminate the company's defined benefit pension plans by invoking its involuntary termination power, thereby abrogating the need for the company to seek Section 1113 relief in its Chapter 11 case from its collective bargaining agreements, which had required maintenance of defined benefit pension plans. The PBGC accepted a package of consideration from United (including notes–some of which are contingent on the reorganised company satisfying certain performance metrics–and stock) in exchange for settling all pension issues with the company. Although a number of

United's unions challenged PBGC's power to enter into such an agreement with an employer, the courts have upheld United's settlement agreement with the PBGC.[10]

PBGC's role after termination

Upon an employer's termination of a defined benefit pension plan through the Chapter 11 bankruptcy process, the PBGC takes over the plan and administers it going forward by, among other things, paying pension benefits up to a guaranteed amount to plan participants. The maximum PBGC guaranty is capped at approximately USD 47 000 per year and depends on factors such as a retiree's age. However, because pension plans terminated in the bankruptcy context often do not have sufficient assets to pay plan participants' statutorily guaranteed benefits, the PBGC is now running a deficit of approximately USD 24 billion as a result of terminated, unfunded benefit plans. With some three-quarters of the companies on the S&P 500 index having defined benefit pension plans and PBGC estimating its future exposure at approximately USD 108 billion on account of future plan terminations, some believe that the defined benefit pension crisis in the US has yet to reach a crescendo.[11]

The PBGC's rights

While ERISA provides the PBGC with certain statutory lien rights to protect itself when certain events occur in connection with an underfunded pension plan (*e.g.* the sponsor ceases making minimum funding contributions), after a Chapter 11 filing is commenced, the Bankruptcy Code's automatic stay generally prevents the PBGC from attaining secured or priority status in a bankruptcy case. The PBGC has crafted many arguments over the years in an attempt to increase its recovery in bankruptcy cases, but has had little success in bankruptcy courts. The PBGC has thus lobbied diligently for a change in the Bankruptcy Code's priority scheme to protect its interests. The PBGC has also sought to change ERISA's minimum funding rules to help prevent plans from becoming too underfunded in the first place. However, it has not succeeded in these endeavours.

While the PBGC has yet to improve its own position through its lobbying efforts, PBGC's very existence has mitigated the impact of the defined benefit crisis in the US by providing retirees who lose their pension benefits with some recovery. Indeed, certain workers' earned pension benefits may not be affected at all in a bankruptcy case because PBGC's statutory guaranty will cover them.[12] The question remains whether the PBGC will be able to sustain itself over the years if it takes over responsibility for many more underfunded pension plans.

Transition to defined contribution plans

It should also be noted that the trend in the US (and other countries) is now toward employer offerings of defined contribution plans in lieu of defined benefit plans. Thus, employees will bear the market risk of a diminution in pension assets in the future. "As a general matter, worker interests in defined contribution plans are not affected by corporate reorganisations or bankruptcy."[13] This does not mean, however, that defined contribution plans are fully protected, because the funds in an employee's defined contribution account ebb and flow with the vicissitudes of the market, thereby leaving workers exposed to potential pension benefit loss. The Enron bankruptcy case in the United States highlighted this stark reality.[14] In that case, employees' defined contribution plans were heavily invested in Enron's stock, which was rendered worthless as a result of

the company's bankruptcy filing. In addition, under US pension law, Enron's rapid stock decline prevented employees from unloading the Enron stock in their defined contribution accounts. Thus, with Enron employees chained to a rapidly declining stock, their defined contribution plans suffered significant diminutions in value.

3) The United Kingdom

The US is not alone in its pension crisis. A number of British businesses face similar issues, including British Airways and Corus, which operate respectively in the airline and steel industries. Both have been protagonists in the US defined benefit pension crisis.[15] Pension liabilities have also struck the British retail industry by derailing takeover bids at Marks & Spencer and WH Smith.[16] Approximately 60 000 people have lost part or all of their pension benefits in the United Kingdom as a result of recent pension terminations there.[17]

The Pensions Act of 2004

The British government recently passed legislation (the Pensions Act of 2004) to stem the tide on the country's pension problem. The act has introduced the Pension Protection Fund (PPF), which is modelled after the United States' PBGC, to pay compensation to members of defined benefit pension plans when an employer becomes insolvent or when there are insufficient assets to cover guaranteed levels of PPF pension compensation.[18] Like the PBGC, the PPF is not supported by the government. Rather, it is funded by compulsory premiums charged to employers with pension plans covered by the PPF's programme. In addition, benefits are capped at approximately GBP (United Kingdom pounds) 25 000 per year. Finally, the Pensions Act has effectively increased employer's pension funding requirements by adding in a risk based premium, which is calibrated to the risk of a particular plan's termination (including its underfunded status). To avoid this risk premium, some British companies have been using creative means to remedy their plans' underfunded status. For example, Marks & Spencer used capital raised from a debt issuance to improve its plan's funding status.[19]

Powers of the pension regulator

Where a British pension scheme is underfunded and the principal employer of the scheme is subject to an event (for example a takeover, sale of assets, or payment of dividend) the Pensions Regulator (TPR–an ombudsman created by the Pensions Act), may seek to secure extra financial support for the pension scheme by issuing a financial support direction (FSD) or contribution notice (CN). These demands may be issued against the principal employer or a group company, which directly or indirectly holds more than 30% of the principal employer's share capital ("associates" and "connectees").

An FSD can only be issued where the principal employer is a service company (*i.e.* the only income of the principal employer is from supplying services to the group), or the value of the assets of the principal employer and its associates/connectees is less than 50% of the scheme when valued on a buyout basis (the cost of purchasing annuities to provide all the benefits that the scheme promises). Meanwhile, a CN may only be issued where the employer has acted with a purpose so as to avoid pension liabilities–the valuation basis for any liability being calculated on a buyout basis.

It should be noted that for either an FSD or a CN to be issued, the pension scheme must be underfunded on an FRS17 basis–the pension valuation accounting standard used

by UK companies–and an event must have occurred. Additionally, a CN can be issued against a natural or legal person whereas an FSD can only be issued against a corporation. An FSD can be issued up to a year after an event, and a CN can be issued up to six years after an event.

4) Germany

Germany, in contrast, does not rely heavily on funded pension plans. The German system is based on a three-tier system of pensions. The first tier is the state-run mandatory pension system (Rentenversicherung),[20] which covers all employees and certain other beneficiaries. The second tier is made up of company-sponsored occupational pension schemes (Betriebliche Altersvorsorge), while the third tier consists of private pension planning. Companies are not required to offer pensions at all, but if they offer pensions they need to abide by mandatory law (Gesetz zur Verbesserung der Betrieblichen Altersversorgung)[21] which prescribes, *inter alia*, how pensions fare in a restructuring or an insolvency of the company.[22]

In contrast to the US and the UK, the second tier company sponsored pension plans usually do not need to be "funded" and they are backed by the general assets of a company (as opposed to a specific asset pool set aside for the beneficiaries).[23] The liabilities are recorded as general unsecured liabilities of a company. Accordingly, there are no "underfunded" pension plans–as long as the corporation is solvent, the pension obligation is deemed to be covered. If the company commences a formal insolvency proceeding, a collective insurance scheme (the Pensionsicherungsverein, or PSV) takes over.

The PSV is funded through contributions of those companies that have non-funded pension plans.[24] In an insolvency, the PSV assumes the pension liabilities and is subrogated (as a general unsecured creditor) to the claims of the beneficiaries.[25] Because of the historically low return to unsecured creditors in German insolvencies, the PSV usually has to shoulder the burden of an insolvency, and there is an increasing trend by distressed investors in Germany to strategically use insolvency proceedings to shed burdensome pension liabilities.[26] The PSV has already raised concerns as to its financial health based on demographic trends in Germany (particularly, an aging populace) and waning contributions to the PSV as a result of German corporations' transition to pension plans not covered by the PSV.[27] It will be interesting to see how Germany deals with its upcoming pension problem and whether there will be an increasing trend towards "funded" pension plans.

5) Lessons learned

While the recent experience in developed countries is no doubt unique–particularly in the US where employer defined benefit plans have been battered by a "perfect storm" as the US stock market has declined and America's so-called "baby-boomer" generation has reached retirement age–developing countries may still glean some important lessons. As occupational pension plans became more generous in developed economies, particularly in the United States, they became less sustainable for businesses operating in a competitive global marketplace. With more businesses turning to insolvency, and the respective institutional pension backstops in the US, UK, and Germany likely to be facing their own financial problems in upcoming years, consideration will be given to providing these key players with more protection in insolvency proceedings. After all, without such

backstops, many pensioners would be even worse off. Any additional protections afforded to pension insurers would have to considered cautiously, however, as overbroad rights for these parties could stifle reorganisation proceedings designed to maximise the value of corporations by maintaining their healthy core operations. Other approaches, such as higher pension premiums to increase revenues of pension insurance funds, might also be considered.

With corporations' transitioning toward defined contribution systems, new challenges lie ahead, as evidenced by the Enron experience in the United States. Provided that employees are given control over their investments, employees will have the opportunity to manage their own retirement responsibly, and the situation that occurred in Enron could be avoided. While corporations in developing countries, which are also in the midst of profound demographic change, embark on implementing new occupational pension plans to attract and retain talented employees, they would be well advised to monitor the state of occupational pension plans in developed countries. While developed countries attained their economic prosperity before their populations became too old, developing countries are getting old before they ultimately get rich. Thus, while developing countries can assess with hindsight the occupational pension mistakes made in developed countries, their situation is somewhat precarious as an aging population will need support for years to come from economies that have yet to hit their stride.

Notes

1. Congressional Testimony by James B. Lockhart III, Deputy Commissioner, Social Security Administration (18 May 2004).
2. Trinh, Tamara (2006), "China's Pension System: Caught Between Mounting Legacies and Unfavourable Demographics", Deutsche Bank Research.
3. The Economist (2005),"Corporate America's Legacy Costs: Now for the Reckoning", 13 October 2005.
4. Levitt, Harry (2006), 22 No. 2 Journal of Compensation & Benefits.
5. See 29 USC. §1341.
6. Id.
7. See 29 USC. §1341(a)(3).
8. See 29 USC. §1342(a).
9. See 29 USC. §1341(a)(3).
10. In re UAL Corp., 428 F.3d 677 (7th Cir. 2005) (Circuit Court ruling affirming lower courts' approval of United-PBGC settlement agreement).
11. Indeed, the US Congressional Budget Office estimates that PBGC's shortfall will expand to USD 86.7 billion by 2015.

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12. In contrast, other employee losses (such as wage or job loss) suffered by employees in US bankruptcy cases are provided fewer protections. For example, the US Bankruptcy Code only allows workers unsecured, priority claims against their employer of up to USD 10 000 for unpaid wages earned up to 180 days prior to the company's bankruptcy filing. 11 USC. §507(a)(4). If the employer ultimately fails to emerge from bankruptcy, then the employee may not be paid for lost wages because his or her claim will only be paid after claims of higher priority (e.g. secured or other priority creditors) are paid in full. As one commentator sees it, the US system relies on market forces to correct temporary setbacks such as job or wage loss, rather than an institutional backstop such as the PBGC. See Willborn, Steven L. (2004), "Workers in Troubled Firms: When Are (Should) They Be Protected?", U. Pa. J. Lab. & Empl. L. 35. An employee that loses his or her job can simply look for another job at another company. On the other hand, loss of a benefit such as pension compensation, which has taken considerable time to earn, requires some sort of social safety net, because an employee cannot simply turn to the marketplace to recoup their loss.

13. Willborn, Steven L. (2004), "Workers in Troubled Firms: When Are (Should) They Be Protected?", U. Pa. J. Lab. & Empl. L. 35.

14. Id.

15. The Economist, supra note 3.

16. Id.

17. Hewitt Associates (October 2004), UK Pension Rules (Part I).

18. Risk Based Levy Update, Comp. Law. 2006, 27(1), 22 (2006).

19. See Hewitt Assocs., supra note 17.

20. See Schaub ArbR-Hdb. §80 et seq. for a detailed description of Rentenversicherung.

21. Gesetz zur Verbesserung der Betrieblichen Altersversorgung (BetrAVG) vom 19.12.1974, BGBl. I, S. 3610.

22. See §7-15 BetrAVG.

23. ee Mercer Human Resource Consulting (2005), Pension Funding in Germany, June 2005, for a more detailed overview.

24. See §10 BetrAVG

25. See §7(1) and (2) BetrAVG

26. In certain defined circumstances the PSV can also take over pension obligations in an out-of-court restructuring (see §7(1)(2) BetrAVG). However, the instances where the PSV has consented to such an out-of-court restructuring are rare as the PSV usually wants to avoid creating a precedent, thus incentivising companies to offload their pension liabilities in an out-of-court restructuring.

27. Companies can opt out of the PSV or significantly lower their contributions to the PSV by converting to "funded" models or by transferring their pension liabilities to a third party such as a pension insurance fund or life insurance company. Alternatively, the companies can opt to segregate an asset pool (Pensionsfonds) and back pension obligations with external investments as is the case in other countries such as the United States and United Kingdom (see "German Pensions Insolvency Protection Fund Proposes Move to a Full-Funding Model", European Pensions and Investment News, May 2005, for more details).

FUTURE DEVELOPMENTS IN CROSS-BORDER INSOLVENCY LAW

by
Christoph G. Paulus*

1) What has been achieved so far

For centuries, jurisdictions followed the so called territoriality principle; *i.e.* they closed their doors to foreign administrators (and creditors as well) and did not allow their law to reach out beyond the borders of their respective jurisdictions.

In the nineties, the UNCITRAL model law on trans-border insolvency was proposed. At present, it has been adopted by ten jurisdictions. A number of other jurisdictions plan to do adopt it in the future, or draft their own cross-border law based on the model. These jurisdictions represent both common law and civil law countries. Thus, it is a proper starting point for any jurisdiction to have its own cross-border insolvency law be identical to or modelled after the UNCITRAL proposal.

2) Deficiencies and ambiguities

However, it does not come as a surprise that developments in this field did not stop with the model law. The more this law and its principles are used in practice, the more it will become obvious that there are deficiencies and ambiguities that need to be addressed.

At this point, it is worth pointing out a phenomenon that proved to be quite influential in the development of cross-border insolvency law, namely, a certain regionalisation. Starting as early as the end of the 19th century, some Latin American countries entered into treaties dealing with cross-border issues. The first was the Montevideo Treaty, which was specified some decades later by the second Montevideo Treaty. In between these dates, a number of other Latin American and Caribbean countries developed still another treaty, commonly known as the Bustamante Code.

Other regions followed, admittedly, a considerable time later. Thus, the member states of the European Union developed the European Insolvency Regulation in the late nineties. At about the same time, some 16 states in central Africa formed a group of common law jurisdictions called OHADA and, finally, the members of NAFTA developed the ALI project which brings both common law and civil law jurisdictions under one roof.

These regional undertakings go further than the UNCITRAL model law. This is no surprise as these regions share closer ties among members than they do with the rest of the world. Therefore, the mutual trust in each others' systems is greater. It might, therefore,

* World Bank.

appear that regionalisation would be a driving force in cross-border insolvency law. However, the achievements of these regional efforts, increasingly, appear to have deficiencies.

3) Consequences

What can be learned from the development of cross-border insolvency law as described so far? The least one can say is that regionalisation is a recognised way of developing cross-border insolvency law, and that some regions seem to have sufficient economic, political and cultural commonalities to set up treaties through which they may proceed on their own path.

Thus, if some countries in Asia (if not all) can find commonalities that justify the development of their own regional cross-border insolvency law, much can be learned from the deficiencies of existing model laws and regional treaties.

Almost paradigmatic is one of the most intricate problems in cross-border insolvency law, namely, the insolvency of groups. It is "solved" as of today by means of the term "centre of main interests" (*cf.* Model Law, EIR, and, to a certain degree, the OHADA legislation). There is, nevertheless, a far-reaching consensus that this solution is far from satisfying, and the European Court of Justice has just (2 May 2006) decided accordingly.

Therefore, what needs to be found is a more precise determination of where a main proceeding is to be opened. One possibility would be to request a determination from group companies themselves at the time when the group is formed through obligatory registration. For those to whom this appears an unwelcome invitation to forum shop, one could look for other more objective criteria that might determine the place where a group insolvency proceeding should be handled.

A further problem is the splitting of one main proceeding into several secondary proceedings. As a compensation for the loss of efficiency, the present rules provide for co-operation duties. However, what appears to be an attractive solution proves, in practice, to be a stumbling block. The problem of co-operation increases to the degree to which it is possible to open secondary proceedings. As a result of a political compromise, the present rules in the said treaties have quite a low threshold for such opening, namely, an establishment as a combination of an asset plus human means.

Possible solutions that could be tested in a new regional treaty are, for example, to heighten this threshold by increasing the requirements that need to be met in order to open a secondary proceeding, or providing an exclusive right to file a petition to open a secondary proceeding to the debtor and the administrator of the main proceeding, or to require this administrator's consent to a petition of a creditor.

One final example of the said deficiencies is that the highly influential European regulation is designed exclusively for its member states. All third countries outside the territory (as covered by the member states) are excluded and ignored. One might thus say that this legislative piece adheres to a territoriality principle on a higher level. The consequence thereof is that each member state has its own cross-border insolvency law with regard to third countries–the German one, *e.g.* modelled after the rules of the regulation, and the English one modelled after the UNCITRAL model law.

Looking at this example, it would be advisable to avoid a "closed-shop approach" and to provide an opening opportunity for the rest of the world or, at least, interested new members of the regional neighbourhood right from the outset.

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4) Outlook

In this way, the regions of the world can add their experience, knowledge and imagination to the further development of cross-border insolvency law. As each region has its own historical, economic and legal background, such multilateral approaches will ensure that the future cross-border law will enjoy general acceptance and application.

THE BANKRUPTCY CRITERIA AND PRIORITY OF CLAIMS: AN INTERNATIONAL COMPARISON OF INSOLVENCY LAWS

by
Wang Huaiyu*

Comparatively speaking, the criteria used for deeming an enterprise bankrupt and the priority of labour creditors are two core problems in insolvency law. The former is the precondition for the execution of insolvency law. The latter influences the execution of insolvency law; it establishes creditors' rights and interests, and develops an effective economic order. The Chinese Insolvency Law is about to be revised. The new one will be geared to international standards in accordance with conditions extant in China. This text summarises pertinent regulations in 42 different countries.

1) On bankruptcy criteria

Bankruptcy criteria describe the conditions under which an enterprise can turn to bankruptcy procedures. When certain conditions are met, an enterprise can apply for voluntary bankruptcy, or it can be forced into a bankruptcy procedure under a creditor's application. We have roughly classified the regulations of 42 countries with respect to bankruptcy conditions. They are as follows:

a) The inability to pay off debts

   i) The inability to pay off expired debts is a bankruptcy condition in: Australia; Canada; Chile; Estonia; France; Germany; Hong Kong, China; Hungary; Indonesia; Italy (except for companies that can rapidly improve their economic condition); New Zealand; Scotland; Singapore; Slovakia; the US; Venezuela; and Viet Nam.

   ii) Some limits or specific conditions are added to the inability to pay off debts as a basic bankruptcy condition. For example, Belgium, Bermuda, Colombia, England and Wales (the inability to offset its debts with its assets is one of the causes of the inability to pay off its debts), Malaysia, Romania, Russia, South Africa, Switzerland, and Thailand, (debts greater than 5% of gross debts).

   iii) The permanent inability to pay off debts. Not many countries have this as a condition for bankruptcy. Finland is an example.

b) The inability to pay off its expired debts or the inability to offset its debts with assets. An enterprise can turn to a bankruptcy procedure provided it meets one of the situations. For example, Austria, the Czech Republic, Israel, Japan, Latvia,

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Mexico (the debtor's assets cannot offset more than 80% of its debt), Poland and other countries.

c) The inability to pay off the expired debts and also the inability to offset its debts with its assets. For example, Norway and Spain.

d) No specific bankruptcy condition is specified; the creditor can prove that the enterprise is bankrupt in any way. This kind of bankruptcy is not strictly limited. It leaves judges wide room to decide whether a company qualifies for bankruptcy. This kind of regulation exists in Sweden.

Some countries use the period of sustained losses, business stops or the attempt of management to flee the country etc. as conditions for bankruptcy. In Viet Nam, employees with three consecutive months' of unpaid wages can apply for the bankruptcy of their employer.

As a whole, most countries make the inability to pay off debts the basic condition for bankruptcy.

2) The relationship between employee, creditor, and secured creditor rights

A debtor-secured creditor relationship usually exists between banks and enterprises. It is very important for enterprises to maintain their banking relationships as a source of financing. But, employees are necessary to actually run an enterprise. So when an enterprise falls into bankruptcy, the question of how to deal with the interests of its two most important creditors becomes important. The following describes international approaches:

a) Give the employees absolute priority protection, *i.e.* employee rights come prior to secured creditors' rights. Countries with such regulations are Brazil (this section is being modified in a new law), Chile, Columbia, Indonesia (specified in the New Labour Law in 2003), and Mexico.

b) Provide absolute priority to employee creditors with certain restrictions. For example, employee creditors meeting certain requirements have priority over secured creditors within a certain period. Countries using this approach are the Czech Republic (Secured creditor's can only can be repaid preferentially from 70% of the value of the security, the remaining 30% is to be added to the bankrupt's assets. Employees are paid preferentially with 30% of the bankrupt's assets. Unpaid employees and secured creditors are repaid as common creditors from the remaining 70%), Russia (employee creditors come prior to fixed security after it expires), Spain (within the last 30 days).

c) Secured creditor's come prior to employee creditors while employee creditors come prior to floating security creditors. Examples are Australia; Bermuda; England; Hong Kong, China; Israel; Romania; Scotland; Singapore; Slovakia; and Wales.

d) All secured creditors' rights are prior to employee creditors' rights while employee creditor rights are prior to common creditors' rights. See Austria, Canada, Hungary, Japan, Malaysia, Norway, South Africa, Sweden, Switzerland, Thailand, Venezuela, Viet Nam, the US, and so on.

Among the above, generally speaking, there are certain restrictions on employee creditors' rights in items c) and d), including restrictions on time and amount.

e) Employee creditors do not enjoy any priority. They are repaid together with common creditors. Estonia, Germany and other countries have such regulations.

We can see from the above that countries have different regulations on the priority of labour and secured creditors. The International Labour Organization put forward its Protecting Labour Creditor's Rights (Enterprise Bankruptcy) Convention in 1992. The convention came into effect in 1995. It stipulates that employee creditors' rights shall be protected preferentially, but the relationship between it and secured creditor's rights are to be determined by each country according to their own national circumstances. Nor does the EU Convention on Insolvency Proceedings, which came into effect on 31 May 2002, directly address the relationship between labour and secured creditors' rights. It leaves it to each country to decide. The relationship between these two kinds of creditor's rights is thus entirely determined by each country's domestic law. It has nothing to do with whether a country has a market economy or not.

Most countries do not equate labour creditor rights with common creditors' rights. Instead they always confer a certain priority. This is because of the importance of labour in market development. At the same time, labour is in a vulnerable position in the employment relationship, since it is unable to ask employers to provide guarantees for payment when signing employment contracts. This puts labour in an unfavourable situation compared with other creditors. In order to establish and perfect an efficient labour market and to defend principles of fairness and equitable treatment, most countries give labour creditors certain priority rights. But this kind of priority differs depending on the country. Some countries specify that labour comes before most other creditors (including secured creditors); some countries specify that labour creditors come before most other creditors (except secured creditors); and some countries put them on a level with common creditors. Regardless of the priority, labour creditor rights have certain restrictions on time and amount in most countries (refer to Table 3). Such restrictions can enhance labour's realisation of market risk and make talent move to better enterprises.

Although no single standard or approach applies to the priority of labour creditors, most countries give priority to secured creditors over labour creditors (refer to Table 2). This choice is related to the development of the capital market. With the development of a country's market, the need for capital will increase rapidly, so the guarantees provided to financial institutions are important to maintaining a sound system of credit.

On the whole, when dealing with the relationship between labour creditors and secured creditors, both fairness and efficiency are taken into account. Balancing the interests of each, and the constitution of supporting institutions depend upon the state of market development of the national market.

Annex

Table 1: Schedule of liquidation order under insolvency proceedings

Liquidation Order	1	2	3	4	Note
Country					
Australia	Dead securities	Clearing charges	Unpaid wages, pension and other employee creditor right	Floating security	
Austria	Secured creditors	Costs of insolvency proceedings	Employee wages and termination costs for service after the beginning of the insolvency proceeding	Others	Creditor's rights to real property after the beginning of insolvency proceeding will be superior to secured creditors' rights
Belgium	Costs of insolvency proceedings	Secured creditors	Others		No priority regulation for labour creditors
Bermuda	Dead securities	Labour creditors (including wages, pension and compensation payments)	Governmental creditors (such as taxes)	Floating security	
Brazil	Industrial injury and labour creditors, social security creditors	Tax	Maintenance and creditor's right of insolvent assets	Secured creditors	
Canada	Secured creditors	Costs of insolvency proceedings	Unpaid wages up to a certain amount	Others	
Chile	Costs of insolvency proceedings, labour creditors	Secured creditors	General creditors		
Colombia	Support creditors judicial cost and labour creditors, etc.	Freight charges and secured creditor's right	Others		

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Czech Republic	70% of secured assets to secured creditors	30% of secured assets are added to the bankrupt's assets, of which 30% is used to pay back labour creditors, and pension and alimony from three years before the insolvency	The remaining 70% of assets are used to pay back creditors, including labour creditors, who have not been completely paid off		
Estonia	Costs of insolvency proceedings	Secured creditors	General creditors		No mention of labour creditors
Finland	Dead securities	Floating security	Others		No priority regulation for labour creditors
France	Labour creditors	Costs of insolvency proceedings	Secured creditors	Unsecured creditors	
Germany	Secured creditors	Common creditors			
Hong Kong, China	Costs of insolvency proceedings	Dead securities	Labour creditors (wages and salaries of four months before the issuance, not to exceed CNY 8 000 (Chinese Yuan renminbi), due labour compensation in accordance with the "labour compensation ordinance", one month wage due to dismissal of employees or a salary of CNY 2 000 (when the monthly salary is less than CNY 2 000, holiday subsidies	Floating security	
Hungary	Clearing charges	Secured creditors	Labour, life annuity, alimony etc.	Compensation for injuries	No reference to wages
Indonesia	Tax and employee creditors	Secured creditors	Free of guarantee creditors		
Ireland		Labour creditors have priority. The order between labour and secured creditors is unclear. Labour, life annuity, and alimony.			
Israel	Dead securities	Clearing charges	Wages and taxes over a certain period and of a certain amount	Floating security	
Italy	Secured creditor are superior to labour creditors				

Japan	Secured creditors	Taxes and the unpaid wages	Common benefit right		
Latvia	Costs of insolvency proceedings	Salaries, remuneration, annual compensation and dismissal pay etc. in the most recent three months of the 12 months before the insolvency	Payments for agricultural products	Taxation one year prior to the insolvency	
Malaysia	Secured creditors	Clearing charges	Wages or salaries not exceeding MYR 1 500 (Malaysian ringgits), compensation, holiday or death subsidies to workers, and pensions due or retirement plans 12 months before the insolvency	Federal taxes	
Mexico	Insolvency management expenses	Labour creditors	Tax	Secured creditors	
New Zealand	Wages of the bankruptcy trustee	Insolvency application expenses	Tax and social security expenses	Employee wages and pensions	Not very clear about the relationship between secured and labour creditors in accordance with the existing materials
Norway	Secured creditors	Labour creditors	Tax, etc.		
Poland	Secured creditors	Tax and social security	Costs for insolvency proceedings and labour creditors		
Romania	Secured creditors	Tax and social security	Wages within 6 months before the insolvency		
Russia	Personal injury and relative right of claim	Labour creditor and copyright	Others (including compulsory payments and secured creditors)		If the dead securities are set before the due date of the formal two creditor's rights, it shall be superior to the formal two
Scotland	Dead securities	Labour creditors up to a certain amount	Floating security	Clearing charges	

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Singapore	Dead securities	Costs for insolvency proceedings	Back pay not exceeding SGD 7 500 (Singapore dollars)/person, dismissal payment, compensation due, pension and holiday subsidies not exceeding the same amount	Tax	
South Africa	Secured creditors	Clearing charges	Labour creditors (Salary, holiday subsidies, dismissal payments and others. The preferential scope is between ZAR 4 000 (rand) to ZAR 12 000.)	Taxes, etc.	
Spain	Taxes, wages 30 days before the insolvency	Secured creditors			
Sweden	Creditors after the insolvency	Priority of maritime liens	Secured creditors	Labour creditors	
Switzerland	Secured creditors	Labour creditors of 6 months before the insolvency			
Thailand	Secured creditors	Costs for insolvency proceedings	Labour creditors		
UK (England and Wales)	Dead securities	Costs of insolvency proceedings	Labour creditors (wages, salaries, medical and labour protection costs) not more than GBP 800 (United Kingdom pounds) in total	Floating security	
USA	Secured creditors	Costs of insolvency proceedings	Labour creditors (wages, salaries and commissions 90 days prior to the production stop or insolvency declaration, including holidays, illness, and welfare within 180 days not to exceed USD 4 295 (United States dollars) in total	Others	

Notes: The EU Convention on Insolvency Proceedings and the convention of the International Labour Organization make no explicit recommendations with respect to the priority of labour and secured creditors, leaving it to be specified in domestic law.

Most developed countries have established special foundations or insurance organisations to ensure employee creditors' rights. In case insolvency proceedings do not result in complete payment of creditors, these special organisations will usually be at hand to solve their problems.

This table is based mainly on the highlights of the revision of the Chinese Insolvency Law, specifically the priority given to labour and secured creditors. The table focuses on the order of these two creditor rights in a number of countries but does not completely reflect the relations between all the creditors.

Table 2: The relationship between labour and secured creditors in different countries

Nations where secured creditors come before labour creditors	Nations where labour creditors come between dead securities and floating security	Nations where labour creditors have complete superiority over secured creditors	Nations where labour creditors (with certain limitations) are superior to guaranteed creditors
Austria, Belgium, Canada, Estonia, Finland, Germany, Hungary, Japan, Malaysia, Norway, Poland, Romania, South Africa, Sweden, Switzerland, Thailand, USA (17)	Australia; Bermuda; Hong Kong, China; Israel; Scotland; Singapore; Slovakia; Romania; UK (9)	Brazil,* Chile, Colombia, Indonesia, Mexico (5)	Czech Republic, France, Russia, Spain (4)

* The new insolvency law of Brazil specifies that the prior labour creditor's right takes the 150-month lowest wage as its limitation. For its long time limit, this right actually takes priority of the labour creditor's right.

Table 3: Limitations to the priority of labour creditors

Limitations to the Priority of Labour Creditors	One Month	Three Months	Four Months	Six Months	One Year or More	Limit on the Fixed Amount
Country	Spain	Latin America USA*	Hong Kong, China*	Japan, Romania Switzerland,	Brazil, Czech Republic	Canada; Hong Kong, China; Israel;* Malaysia; Singapore; South Africa; UK, USA

* Nations with limitations on both time and amount of labour creditors' rights.

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OPPORTUNITIES AND PITFALLS IN EMERGING MARKET RESTRUCTURINGS: A STRATEGIC PERSPECTIVE

by
Steven T. Kargman*

In many emerging market debt restructurings involving corporate debtors, creditors often find themselves at a distinct disadvantage vis-à-vis the debtors and their controlling shareholders. Indeed, in certain cases, creditors may believe that they face seemingly insurmountable obstacles in negotiating such restructurings. In some cases, foreign creditors, perhaps even more so than domestic creditors, may believe or come to realize over time that they are especially disadvantaged in such restructurings.

Creditors may be handicapped in such emerging market restructurings by several factors. In the first place, the insolvency law in certain local jurisdictions may be very unfavorable to creditors either because of the terms of the insolvency law itself or, equally important, by how the law is applied in practice by local courts. Second, in certain jurisdictions, creditors may have serious concerns regarding the fairness and independence of the local judiciary.

Third, in certain cases, the creditors may be pitted against powerful controlling shareholders of the -debtor company, and such individuals or family interests may have considerable influence in the local society. As a result, in such cases, the controlling shareholders may appear to have a limited incentive to reach a timely and/or fair and reasonable restructuring with their creditors. Moreover, such controlling shareholders may be disinclined to agree to any changes in the corporate governance structure that would mean a loss of power or control for them.[1]

Certain foreign creditors, including at times major international financial players, may not always be fully aware of or focused on the extent to which they which they are seriously disadvantaged by the foregoing factors in negotiating emerging market restructurings. Some foreign creditors may believe that they can approach an emerging market restructuring in roughly the same way that they would approach a restructuring in a more developed jurisdiction. However, foreign creditors proceeding on that basis may ultimately discover to their considerable dismay and frustration that many emerging market restructurings unfold according to a very different dynamic compared with restructurings in their home jurisdictions.

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Once creditors, particularly foreign creditors, realize that they are not playing on a level playing field vis-à-vis the debtor and its controlling shareholders, the question becomes: What should or can the creditors do? Specifically, what steps can they take to at least try to neutralize any inherent advantages that may be enjoyed by the debtor and its controlling shareholders? To begin with, creditors need to understand that there are not necessarily any easy or uniform answers. Instead, the optimal creditor response may vary from restructuring to restructuring depending, for example, on the local legal framework in which the restructuring is taking place.

Nevertheless, as an overarching goal, the creditors would be well advised to adopt a strategic perspective and outlook for addressing difficult and challenging emerging market restructurings. Specifically, creditors should be prepared to seize and take advantage of any opportunities that may arise in the course of the restructuring that could give the creditors additional leverage vis-à-vis the debtor and its controlling shareholders. While such opportunities may arise only from time to time and indeed may not even be readily apparent to the casual observer, the creditors should be prepared to act when they do arise. Conversely, creditors should be alert to, and take actions to avoid, pitfalls in the restructuring process that could have the effect of enhancing any existing advantages and leverage enjoyed by the debtor and its controlling shareholders.

This article presents an overview of such potential opportunities and pitfalls. It is not meant to be an exhaustive listing of such opportunities and pitfalls. Rather, it is designed to highlight certain types of selected opportunities and pitfalls that may arise in emerging market restructurings as well as some of the associated underlying strategic considerations. (It should be noted that while the article focuses on debtors that may not necessarily be models of cooperation in the restructuring process, it recognizes that there are other emerging market debtors that are more cooperative and committed to closing restructurings.)

Potential Opportunities

During the course of a restructuring, the creditors may be faced with various situations and developments that effectively represent potential opportunities for the creditors to strengthen their hand in the restructuring process. But the creditors should not assume that such potential opportunities are presented to them on a silver platter. Instead, the creditors may need to show some savvy and initiative in recognizing and capitalizing on such potential opportunities.

Invitation to Negotiate

In a number of emerging market restructurings, it can be a fairly long period of time before the parties actually sit down and begin to have substantive discussions and negotiations regarding a restructuring deal. For months prior to that moment, the parties may be engaged in various preliminary matters, such as negotiating the parameters of a due diligence investigation, and such preliminary matters may themselves involve a fair amount of negotiating and even skirmishing between the parties. In fact, certain debtors may use these preliminary matters as a means of delaying the commencement of restructuring negotiations.

Nonetheless, at a certain point in the process, the debtor may eventually indicate that it is ready to begin negotiations with the creditors. What will prompt a decision by the debtor to extend an invitation for negotiations may vary from restructuring to

restructuring. Such a decision may, for example, be prompted by a public perception that the debtor is dragging its feet, by a strong recommendation from the debtor's financial adviser, or by other similar factors. Especially if the preliminary maneuvering has gone on for an extended period of time, the creditors may be relieved that they can finally put those matters behind them and can begin to focus on what they consider to be the more substantive aspects of the restructuring. Thus, if the debtor extends to the creditors an invitation to negotiate, the creditors may be inclined to enter into the negotiating process without any hesitation and, more importantly, without any preconditions.

On the face of it, accepting an offer to negotiate without preconditions may, from a certain perspective, seem like an entirely logical and sensible approach on the part of the creditors. The creditors may be anxious to proceed in that manner, particularly if the debtor has thus far been keeping the creditors at arm's length and the creditors have begun to lose their patience for any further delay and/or obstruction on the part of the debtor. Yet if the creditors opt for such an approach, it is possible that they may be squandering a valuable opportunity to insist, for instance, upon certain protections for creditors during the course of the restructuring process itself.

Emerging market restructurings can remain unresolved for several years, and during this period, the creditors may wish to ensure that their interests are protected or at least not further disadvantaged. For example, the creditors may believe that it is important to institute a system of cash monitoring of the debtor's operations and cash flows during the restructuring process.[2] The creditors may be concerned that there will be a dissipation of debtor assets by the debtor and its controlling shareholders during the restructuring process, and the creditors may believe that a system of cash monitoring could prevent or minimize such developments.

However, the creditors may have a difficult time convincing the debtor to institute a cash monitoring system. If the creditors try to convince the debtor to do so in the opening phase of the restructuring process when preliminary matters are being addressed (i.e., prior to the commencement of actual negotiations), they may run into strong resistance. As a general matter, some debtors may object to the creditors having such oversight powers, and in particular they may view cash monitoring as an unnecessary intrusion on their business and financial affairs. For the controlling shareholders, cash monitoring may tie into their overarching fear concerning "loss of control" of the company.

Nonetheless, if for whatever reason the debtor and its controlling shareholders are prepared to begin negotiations with the creditors, the creditors may have some leverage to insist upon some form of cash monitoring being implemented. Yet even under such circumstances, it may not be easy to convince the debtor of the need for, or the merits of, cash monitoring. Assuming, however, that the debtor does finally agree to the concept of cash monitoring, there may then ensue a lengthy discussion and negotiation between the creditors and debtor regarding the precise contours of any cash monitoring system.

For instance, will the creditors have a right to review expenditures pre-disbursement or only post-disbursement, and what will be the monetary threshold or types of transactions that trigger such review? Obviously, the more rigorous a cash monitoring system that the creditors insist upon, the more resistance they are likely to encounter from the debtor. In certain cases, however, the creditors may believe that only a robust cash monitoring system will adequately protect their interests.

In short, an invitation by the debtor to negotiate may present the creditors with certain opportunities and leverage that they might not otherwise have. The creditors might try to

condition their acceptance of such an invitation on certain key demands or requirements, such as implementation of a meaningful cash monitoring system. There is obviously no guarantee that by doing so the creditors will be able to achieve what they want (which itself will be a product of negotiation), but it is possible that they may have a greater likelihood of success on such issues than if they raise such issues in a vacuum.

Changes in Local Law

As a general matter, the creditors may believe in particular restructurings that the local insolvency law and the local legal system place them at a potentially serious disadvantage *vis-`a-vis* the debtor and its controlling shareholders. In its shorthand version, the creditors may refer to lack of a "level playing field." But the local legal framework will not necessarily remain static during the course of a restructuring, especially if the restructuring process extends over a period of several years. During this time, there may be important changes in the local insolvency law or in other laws (*e.g.*, securities/corporate laws, etc.) that could also have an impact on a restructuring in progress. (Generally, any time creditors, particularly foreign creditors, are considering these types of issues, they should consult closely with local counsel in the relevant jurisdiction since it is local counsel that will be most attuned to and familiar with the details, nuances, and implications of any changes in local law.)

Changes in law may be significant to creditors in different ways. First, the new law may introduce a new insolvency process that on its face offers more of a time-bound procedure than under the prior law, which as a practical matter may have allowed insolvency cases to drag on for many years. By way of example, the insolvency law in Mexico underwent a major reform in May 2000 when the old law, the suspension of payments law enacted in 1943, was replaced with a new law, the *Concursos Mercantiles* law.[3] (It should be noted that the new law was not made retroactive to cases that were then pending under the suspension of payments law, of which there were a few major cases.)

Under the suspension of payments law, it was not unheard of for cases to remain unresolved for a number of years, even for ten or more years in certain cases. During the period that a debtor remained in suspension of payments, no debt service was paid, interest ceased to accrue on the outstanding debt, and foreign currency debt was converted to Mexican pesos for purposes of the suspension of payments proceeding.

Under the new *Concursos Mercantiles* law in Mexico, cases are supposed to be resolved within a maximum period of twelve months after a court declares that a debtor is subject to reorganization. (If a reorganization agreement has not been achieved by the end of such twelve-month period, the court is supposed to order the liquidation of the debtor.) Thus, the new law is meant to reverse the situation that existed under the suspension of payments law where as a practical matter the debtor could effectively make a suspension of payments proceeding last for years at a time. But given that the *Concursos Mercantiles* law is still a relatively new law, creditors and their advisers are still monitoring how the new law is applied in practice.

Second, the local insolvency law may change in a way that gives the creditors greater options. For instance, an existing insolvency law may be changed in such as way as to introduce the concept of a so-called "involuntary" insolvency filing whereby the creditors, not just the debtor, can put the debtor into insolvency, whether reorganization or liquidation. Such a change may stand in contrast to the pre-existing law where only the debtor could initiate an insolvency proceeding.

However, even if creditors are able to successfully make an involuntary filing against the debtor under a new law, the debtor may find other ways to frustrate implementation of, say, an involuntary reorganization. These risks should be weighed carefully by the creditors before taking legal action against the debtor.

Third, elements of an insolvency law may change, perhaps even in very technical ways, which may make an insolvency proceeding less daunting and adverse to creditors. For instance, Brazil has recently reformed its insolvency law in a number of major respects, including, among other changes, revising the order of priority enjoyed by various classes of creditor claims.[4] Under the pre-existing law, tax claims ranked ahead of secured claims, but under the new law, the order of priority has been reversed so that secured claims rank ahead of tax claims. As one observer has noted with respect to this change in order of priority, "This represents a significant improvement in the chances of credit recovery, since tax debts are generally the bulk of the debts of a distressed company in Brazil."[5] Furthermore, whereas the old law gave labor claims an absolute priority, the new law effectively provides that the absolute priority of labor claims will be capped.[6]

Changes in local insolvency law, therefore, can perhaps change the playing field between creditors and the debtor. Such changes may give creditors new options— and potentially new leverage—that they did not enjoy under the prior law. However, new laws do not always work out as intended or as written, and thus creditors should exercise considerable caution before relying upon new provisions of law, especially if the new law is relatively untested. Again, creditors should consult with local counsel when developing a legal strategy based on local law.[7] Nonetheless, if there are changes in the local insolvency law, creditors should consider whether such changes may have the potential to alter the negotiating dynamic between themselves on the one hand and the debtor and its controlling shareholders on the other hand.

Emergence of a Strategic Investor

The creditors may have initially approached the restructuring process by pursuing (or attempting to pursue) bilateral negotiations with the debtor based on the premise that the restructuring would be a so-called "stand-alone" restructuring—*i.e.*, a restructuring of the debtor "as is" without the involvement of a third party. However, in certain cases, such bilateral negotiations based on a standalone restructuring model may not necessarily yield the results that the creditors are seeking. In some situations, it may be difficult for the creditors to have successful or meaningful negotiations with the debtor if they are the only ones across the negotiating table from the debtor. Furthermore, a stand-alone restructuring based essentially on a reallocation of the debtor's existing available resources may not necessarily provide the creditors with the most attractive economic package as part of a restructuring.

The creditors may welcome the emergence of a strategic investor for several reasons.[8] First, the strategic investor might bring valuable management skills to the debtor, and it may have been the lack of such skills that contributed to the debtor's then current financial travails. Second, the strategic investor may be willing to make a significant infusion of capital to the debtor, and this may be of critical importance to the debtor, particularly if it is seriously overleveraged. Third, the strategic investor's other operations may have potential synergies with the debtor, and the creditors may believe that such synergies could help improve the longer-term profitability of the debtor's operations.

Nonetheless, a proposal for a strategic investor cannot simply be imposed on a recalcitrant debtor. But certain debtors and their controlling shareholders may be receptive to the notion of a strategic investor for their own reasons. Among other things, the debtor's controlling shareholders may believe that only a strategic investor would have the necessary resources to be able to offer them the right "exit price" in order to give up any further involvement with the company. Or, in certain cases, the controlling shareholders may believe that they can work out a deal with the strategic investor so that they can continue to play some management role in the restructured company.

Yet, even if the debtor is ultimately willing to entertain the notion of bringing in a strategic investor, the creditors will have to consider how to protect their interests in the process. A strategic investor may be able to bring considerable economic and other value to the debtor company, but the creditors cannot simply assume that their interests will be safeguarded. The creditors may need to consider how much involvement they will want to have at different stages of the process.

To begin with, the creditors may wish to consider whether the process for identifying a strategic investor is designed to attract the most attractive bids for the company. For example, is the bidding process simply an ad hoc process organized by the debtor or is it a more formal auction process overseen perhaps by a recognized financial firm? Furthermore, the creditors will have to consider whether the length of any exclusivity period granted to a potential strategic investor is reasonable or whether it is merely another means for the debtor to prolong the restructuring process.

In addition, the creditors will have to decide whether they will allow the debtor and strategic investor to work out the terms of the strategic investment strictly by themselves or whether the creditors, too, should be able to provide their input. The creditors could have a crucial stake in a number of the issues discussed by the debtor and the strategic investor. For example, the creditors will consider it important to know whether the controlling shareholders will have any continuing management role in the restructured company and how much equity the controlling shareholders will hold post-restructuring and post-strategic investment. Furthermore, the creditors will want to know whether the strategic investment is premised on any specific debt restructuring parameters, such as any proposed forgiveness of debt by the creditors.

In sum, the emergence of a strategic investor may in certain cases ultimately prove to be beneficial to the creditors and, depending on the circumstances, may yield the creditors a more favorable result than would otherwise be the case under a stand-alone restructuring. However, if the creditors want to protect their interests, they may not be able to simply sit on the sidelines and allow the debtor and its controlling shareholders to control the process vis-à-vis potential strategic investors without any involvement or participation by the creditors. Instead, the creditors may have to figure out ways to insert themselves (or at least their views) into the process involving a strategic investor.

Change in Market Conditions

During the course of the restructuring, the market conditions facing the debtor may fluctuate, sometimes for the better and other times for the worse. For instance, when the restructuring process started, the price for the debtor's products may have been in a trough. Indeed, that may have been what precipitated or contributed to a default or imminent default or other financial distress experienced by the debtor. This underlying economic reality of low or depressed prices for the debtor's products could severely constrain the options available to both the debtor and creditors in any restructuring plan.

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(The debtor's economics could be adversely affected by other factors, such as rising prices for inputs to its production.) Obviously, the less cash flow the debtor is generating, the less "sustainable debt" it is likely to be able to service going forward.

Where prices for the debtor's products are low, the debtor may be less likely to want to close a restructuring deal in the near term. The debtor and its controlling shareholders may be concerned that if they do close deal based on what may turn out to be somewhat optimistic assumptions, they may be setting themselves up for another payment default. As part of the restructuring plan, the creditors may be insisting upon serious consequences in the case of a subsequent default, such as a change of control of the debtor that would put the creditors in charge of the company. The controlling shareholders in particular may want to avoid putting themselves—and any continued control of the debtor company—at the mercy of market conditions when faced with such possible consequences.

Conversely, if market conditions break in the debtor's favor, the debtor and its controlling shareholders may show a greater willingness to close a restructuring deal. For instance, if the price for the debtor's products recover or even reach new highs, the debtor and its controlling shareholders may have less concern about experiencing a subsequent default. They may take additional comfort if they consider the restructuring plan's underlying economic assumptions to be realistic or conservative (*i.e.*, targets that they can meet comfortably).

In such a rising market, the debtor may be in a better position to give the creditors a more attractive restructuring package. For one thing, at a very fundamental level, the debtor may ultimately agree that it is in a position to consider less of its debt in the restructuring plan as "unsustainable debt" and more as "sustainable debt." That result would obviously please the creditors as they seek to maximize their recovery in any given restructuring.

Moreover, a rising market may also pique the interest of strategic investors in the debtor company. Potential strategic investors may consider the debtor company a more valuable asset where, for example, the prices for the debtor's products are on the rebound. As discussed above, depending on the circumstances, the emergence of a strategic investor may in certain cases ultimately redound to the benefit of the creditors.

Thus, the dynamics of the restructuring process can be significantly affected by fluctuations in market conditions. If and when the market conditions break in a favorable way, the creditors should be prepared to try to reinvigorate the restructuring process to the extent that the process is stalled or otherwise not moving forward in a timely manner. Unlike other situations, the debtor in such circumstances may actually be receptive to moving the restructuring forward. Indeed, a rising market may in certain cases have a positive impact on the overall psychology of the restructuring process and its key participants.

Potential Pitfalls

Restructurings can present myriad potential pitfalls for creditors. The debtor and its controlling shareholders may utilize various tactics and strategies to outmaneuver or otherwise disadvantage creditors.[9] And, in some cases, the creditors may even create their own problems

Death by a Thousand Cuts

The longer the restructuring process drags on, the more anxious the creditors may become to close a deal as soon as possible. And the debtor and its controlling shareholders may be aware of this growing anxiety on the part of the creditors. Under such circumstances, the debtor may try to extract advantage from the creditors. Thus, the debtor may present its position on a given issue as being non-negotiable or even suggest that the issue is a so-called "deal breaker." The debtor may bring or threaten to bring the negotiations to a halt unless the creditors agree with its stated position.

Faced with such a situation, the creditors will have to weigh whether the cost of making a concession on a given issue is outweighed by the benefit of possibly reaching closure on the outstanding issues. The creditors may not like to make the particular concession in issue because it may affect, for example, the underlying economics or other fundamental aspects of the overall restructuring package. However, the creditors may feel that, as a practical matter, they have very little choice if they ever want to close a restructuring deal with this particular debtor. They may believe that if they stand their ground, they may put the restructuring deal in jeopardy because they may believe that the debtor will not budge from its position.

Nonetheless, this may simply be the beginning of a slippery slope.[10] The debtor may later come back to the creditors with other issues that the debtor announces or otherwise seems to indicate are also of a "make-or-break" nature. And the creditors will be faced with the recurring dilemma of whether to stand their ground or to make further concessions supposedly in the interest of advancing the process with the ostensible aim of ultimately closing a deal. However, to the extent that the creditors have conceded on several of these types of issues, they may in effect be encouraging the debtor to continue with a pattern of trying to extract further concessions from the creditors.

Any one of the concessions made by the creditors may or may not be especially significant in its own right, although obviously some concessions may be more significant than others. However, the cumulative effect over time of a series of such concessions may be a fundamental modification or weakening of the restructuring deal that the creditors thought that they had earlier negotiated for themselves. The debtor may be prepared to wear the creditors down, and they may be counting on the creditors to offer up concessions in the interest of "saving" the deal.

In some cases, the creditors may exacerbate this problem with their own actions. At certain points in the process, the negotiations may be at an impasse, and the creditors may try to anticipate what types of concessions they could offer to the debtor in order to set the negotiations back on track. But a possible danger is that the creditors may offer concessions that even go beyond what the debtor is seeking. The risk for the creditors, therefore, is that they may end up negotiating against themselves. This would only compound the problem of the debtor seeking concessions from the creditors on a piecemeal basis, or what might be referred to as "death by a thousand cuts."

Illusion of Progress

At various times, the debtor and its controlling shareholders may be taking various steps that appear to be designed to moving the restructuring process forward. For example, among other things, the debtor may have its representatives sitting with the creditors' representatives for negotiations with respect to a term sheet. In addition, the debtor's financial adviser may be discussing and reviewing financial models with the

financial adviser for the creditors, which may be viewed as an important step given that certain financial and economic assumptions are likely to play a key part in affecting or shaping the parameters of any restructuring plan. Furthermore, the debtor may be producing certain information in response to the creditors' due diligence requests. And the debtor may have even agreed with the creditors upon a detailed timeline for taking a broad range of other miscellaneous actions by specific dates.

In connection with these various activities, the debtor may be incurring considerable expenses. The debtor's outside counsel and financial adviser, each potentially with large teams of professionals and staff members devoted to the matter, may be spending a great deal of time working on the restructuring. Given the volume of work involved as well as the number of individuals that the outside advisers may have working on the restructuring, the outside advisers may in turn be submitting large invoices for fees and expenses to the debtor. In addition, in certain restructurings, the debtor may also be responsible for paying the fees and expenses of some of the creditors' legal and financial advisers, and again these bills could potentially be quite significant. (Of course, any expenditure by the debtor for the fees and expenses of outside advisers, while potentially substantial, will probably pale in comparison to the aggregate amount of money that the debtor is "saving" in debt service payments resulting from any debt standstill that may be in place.)

In short, the debtor may be taking various actions whose ostensible purpose is to advance the restructuring. And yet the restructuring process may essentially be stalled or at best advancing only in fits and starts. For a period of time, the creditors may not want to believe the worst— i.e, the debtor is deliberately holding up progress on the restructuring. The creditors may be willing to give the debtor the benefit of the doubt, especially if the debtor appears to be taking various steps such as those outlined above. In addition, the debtor may create confusion with its actions, particularly if its negotiating tactics essentially follow a pattern of "one step forward and two steps back." For example, this may be the case where the debtor appears to agree with the creditors on the resolution of a major outstanding issue and then suddenly raises a series of new issues or revisits issues that had previously been resolved. Initially, the creditors may focus on the "one step forward" and not necessarily on the "two steps back."

Nonetheless, after a certain period of time, the creditors may become frustrated if they do not see some signs of tangible progress in the restructuring. For instance, if the debtor and creditors have been negotiating a term sheet for a number of months and yet there has been no closure reached on some of the major issues to be addressed in the term sheet, then the creditors in certain cases may justifiably begin to question whether the negotiations are leading anywhere. Or if the debtor invites the creditors' financial adviser to conduct due diligence and yet provides

the financial adviser only with limited information or otherwise creates roadblocks to obtaining information about the debtor, then the creditors may question the value of the debtor's cooperation in the due diligence process.

Some debtors may wish, as a deliberate strategy, to create the illusion of progress without delivering any substantive results. Such debtors can then argue in the court of public opinion and elsewhere that they are working hard to move the restructuring forward, whereas in reality they may at best simply be going through the motions. Even though the debtor may be incurring substantial expenses as a result of its various activities, this may be a small price for the debtor to pay if it serves the debtor's broader objective of forestalling a restructuring solution and if in the meantime during a debt

standstill the debtor is relieved from the burden of paying debt service. However, this approach on the part of the debtor could leave the creditors in an awkward position: they may try to argue that the debtor is impeding progress in the restructuring, but to an outside observer this may not be readily apparent since the debtor may appear to be taking various actions related to the restructuring.

And yet, for their part, the creditors need to periodically apply a reality check to the restructuring process and ask themselves the following: Is genuine progress being made in the restructuring or is there simply the illusion of progress created by the debtor? If it is the latter, the creditors may need to re-evaluate their options. At the very least, the creditors under such circumstances may need to voice their concerns directly and forcefully to the debtor and its controlling shareholders. In any event, the creditors should not assume that simply because the debtor is or appears to be taking various actions related to the restructuring, that somehow represents a firm commitment on the part of the debtor to move the restructuring forward, much less close a restructuring deal.

Self-Inflicted Wounds

Often creditors may complain about the delaying and obstructionist tactics of the debtor and its controlling shareholders. But sometimes the creditors may, unwittingly or not, create problems of their own that could contribute to a lack of progress and closure in emerging market restructurings. Specifically, the creditors may create an unwieldy steering committee structure that could make it difficult to conduct effective discussions and negotiations with the debtor, or the creditors may be so riven by inter-creditor disputes that they cannot properly focus their attention on resolving issues with the debtor.

In some cases, creditors may create a steering committee that is too large to be genuinely effective.[11] There are both internal and external dimensions to this issue. From an internal perspective, the existence of a steering committee with too many members may make it difficult for the creditors to have meaningful communication and coordination among themselves regarding the broad range of issues that typically arise in a restructuring. Issues of coordination can become particularly acute where the creditor community is spread across several continents and multiple time zones—such as where creditors are from North America, Europe, and Asia—which is not uncommon in large, complex international restructuring situations. Moreover, it may be very difficult for a steering committee to reach a consensus on important issues if there are too many creditor institutions participating in discussions and meetings.

From an external perspective, an unwieldy steering committee structure may make it more complicated for the creditors to interact effectively with the debtor and its controlling shareholders. It may be difficult for the steering committee to have productive and frank discussions with the debtor and its controlling if the steering committee, together with a possible phalanx of legal and financial advisers, can only be accommodated, for example, in a large hotel meeting room. Notwithstanding any confidentiality agreements that may exist, the debtor may be reluctant to share highly sensitive business and financial information with a steering committee that it considers to be too large. Moreover, the existence of an outsized steering committee, unless it appoints a smaller working group to represent it, may make the process of negotiation with the debtor messy and inefficient.

Another way in which creditors can do very serious, if not virtually irreparable, damage to themselves is through inter-creditor disputes that are not properly handled.[12] In most creditor bodies, there will be various competing creditor interests, such as secured versus unsecured creditors, holding company creditors versus operating company creditors, original lenders versus creditors who purchased their debt in the secondary market, and so forth.[13] However, if these inter-creditor disputes become the central focus and preoccupation of the creditors, it is possible that the creditors as a whole may make limited progress in their negotiations with the debtor. Indeed, the debtor and its controlling shareholders may even be counting on this very dynamic—*i.e.*, the creditors tearing themselves apart over inter-creditor issues so that the debtor and its controlling shareholder do not have to worry too much about reaching a restructuring deal.[14]

In short, left to their own devices, creditors can do considerable damage to themselves in ways that could impede the restructuring process. Creditors, as a general matter, may be tempted to blame the debtor and its controlling shareholders for any lack of progress in the restructuring process. However, unless creditors properly handle and address internal matters, such as forming a well-func-tioning steering committee and managing the process for resolving inter-creditor disputes, they may be creating their own serious obstacles to advancing the restructuring process.

Term Sheet Deal versus Completed Deal

It may take a long time—sometimes even a couple of years after the beginning of the restructuring process— for the creditors to have in hand a completed term sheet with the debtor and its controlling shareholders. Prior to that, there may have been seemingly endless wrangling and delays concerning a wide range of matters. For instance, the parties may have had protracted debates regarding the proper scope of any due diligence investigation to be conducted by a financial adviser on behalf of the creditors. And then the parties may have had sharp differences as to whether the creditors are being afforded proper access to the debtor's business in order to conduct a meaningful due diligence investigation. Furthermore, even while the parties are negotiating a term sheet itself, the creditors may find themselves frustrated by what they perceive as the debtor's unwillingness to resolve issues in a timely and forthright manner.

In light of such possible frustration, the creditors may believe they have reached a major milestone when a term sheet is finally completed and signed. They may believe that this signals that a closing of the restructuring is in the offing. The creditors may believe that the documentation process (*i.e.*, converting the term sheet deal into the relevant restructuring agreements and related documents) will be relatively straightforward and that counsel for the respective parties should be able to draft and finalize documents in a reasonable period of time. In other words, the creditors may express considerable relief when a term sheet is finalized with the debtor—they may see this as the "beginning of the end" of the restructuring process.

However, in reality, the signing of a term sheet may simply represent the "end of the beginning," if that. The creditors may believe that the term sheet resolved all of the major business issues and that the documentation process should be a relatively mechanical, if somewhat time-con-suming, exercise of translating the agreed upon terms into final deal documentation. (Of course, in so many transactions, even where the parties are working relatively cooperatively toward the same goal of closing the deal, the documentation process is rarely without its own challenges and even hiccups.) But in some cases the

debtor and its controlling shareholders may view the documentation process as an opportunity to introduce new issues or revisit old issues that were already addressed in the term sheet.

Inevitably, to be sure, a term sheet may have certain gaps that need to be addressed in the documentation process. Yet the debtor may be seeking to make more than mere interstitial changes to the terms set forth in the term sheet. The debtor may look upon the documentation process as an opportunity to further delay and obstruct the overall restructuring process. If and when the debtor pursues such an approach, the documentation process may proceed at best in a desultory fashion and at worst may grind to a halt completely.

The creditors, therefore, must not be lulled into a fall sense of complacency simply because they have concluded a term sheet with the debtor. For one thing, it may be a very long and tortuous road between the signing of a term sheet and the closing of a deal. For another, the fact that the debtor has executed a term sheet may not represent a firm commitment at all on the part of the debtor that it intends to close a restructuring. Simply stated, creditors should not assume that a signed term sheet with the debtor will necessarily lead to a timely closing or perhaps any closing at all of the restructuring.

Conclusion

Emerging market restructurings may pose many unique challenges for creditors, particularly foreign creditors. In order to increase their chances of concluding a satisfactory restructuring or otherwise protecting their interests, creditors should be prepared to seize opportunities that may give them additional leverage in the process. At the same time, creditors should carefully avoid the many pitfalls that they may find in their way. In pursuing such an overall strategy, creditors may find that the playing field for the restructuring, which may tend to favor the debtor and its controlling shareholders, at a minimum becomes somewhat less daunting.

Notes

1. See, *e.g.*, Asian Development Bank, Law and Development at the Asian Development Bank (1999 edition)—Special Report: Insolvency Law Reform in the Asian and Pacific Region, p. 16 (noting that a "principal factor that concerns 'owners' of financially troubled corporations in many of the . . . economies is the fear of loss of control of the corporation. This produces an aversion to anything that might put the corporation in a position where others might dictate its immediate and long-term future."). See also Samuel J. Tobing, formerly chief operating officer of the Jakarta Initiative Task Force, "The Need for a Workable Corporate Insolvency Framework for Emerging Economies," speech to APEC conference "The Second APEC Symposium on Strengthening Economic Legal Infrastructure," July 2002 (on file with author) (noting that "in certain emerging economies, corporate assets are concentrated in the hands of a small number of well-connected individuals or families. When faced with loss of ownership, these groups may seek to exert their influence to frustrate the operation of the insolvency system.").

2. For a further discussion of cash monitoring and related issues, see Steven T. Kargman, "Tackling Restructuring in Emerging Markets (Part III), International Financial Law Review, August 2003, pp. 44-45.

3. For a discussion of some of the main features of the new law, see, *e.g.*, Eduardo Martinez R, "Mexico," in Insolvency & Restructuring 2005, pp. 240-245, (Law Business Research, October 2004). For a Spanish-language version of the law, see www.shcp.gob.mx/servs/normativ/leyes/l_cm.html. See also generally United States-Mexico Law Journal, Vol. 10, Spring 2002, pp. 43-60 and pp. 85-94, as well as the website of the Instituto Federal de Especialistas de Concursos Mercantiles (known as IFECOM) at www.ifecom.cjf.gob.mx.

4. For a discussion of the changes to the Brazilian law, see generally Felsberg e Associados, "Final Text of the New Brazilian Bankruptcy Law Approved in the House of Representatives," Restructuring Alert, December 2004 (on file with author) and Tozzini, Freire, Teixera e Silva, "Brazil: New Bankruptcy and Restructuring Law,"TFTS News, February 2005 (on file with author).

5. See Felsberg e Associados supra.

6. Id. (". . . the absolute priority currently enjoyed by labor claims in bankruptcy proceedings will be limited to a cap of 150 minimum monthly wages. . .") and Tozzini supra.

7. For a further discussion of litigation-related options available to creditors and the need for careful weighing of the pros and cons of pursuing legal action, see Steven T. Kargman, "Tackling Restructurings in Emerging Markets (Part III)," International Financial Law Review, August 2003, pp. 45-46.

8. For a fuller discussion of the role of strategic investors in restructurings, see Steven T. Kargman, "Tackling Restructuring in Emerging Markets (Part III)," International Financial Law Review, August 2003, pp. 43-44.

9. Some of the tactics employed by debtors and their controlling shareholders are discussed in Steven T. Kargman, "Negotiating Emerging Market Debt Restructurings: Recognizing the Warning Signs of a Non-Cooperative Debtor," The Journal of Private Equity, Summer 2004, pp. 80-86.

10. For a discussion of what the authors refer to as the "negotiating two-step" employed by emerging market debtors, see Timothy B. DeSieno and Helder P. Pereira, "Emerging Market Debt Restructurings: Lessons for the Future," New York Law Journal, August 25, 2003.

11. For a discussion of issues relating to the formation of steering committees in emerging market restructurings, see Steven T. Kargman, "Restructuring: A How-To Guide," The International Economy, November-December 2001, pp. 47-48, and Steven T. Kargman, "How to Tackle Debt Restructuring in Emerging Markets," International Financial Law Review, December 2002, pp. 41-43. For a discussion of issues relating specifically to the formation of bondholder steering committees, see, *e.g.*, Don S. De Amicis, "Bondholder Workouts In and Outside of Bankruptcy," Journal of Bankruptcy Law and Practice, Vol. 12, No. 6 (2003), pp. 39-42.

12. For a discussion of inter-creditor issues that may arise in emerging market restructurings, see Steven T. Kargman, "Tackling Restructuring in Emerging Markets (Part II)," International Financial Law Review, July 2003, pp. 57-59.

13. For an overview of key participants in the restructuring process, including various creditor interests, see Peter Darrow, "Restructuring Corporate Debt in Latin America," International Financial Law Review, September 2003, pp. 28-29. For a discussion of creditor constituencies in the context of project finance restructurings (as to which there may be certain parallels with how creditor constituencies approach corporate debt restructurings), see Richard Cooper and Gesine Albrecht, "How to Approach the Restructuring of Problem Project Financings with Multi-Sourced Lending Arrangements," Project Finance International, May 19, 1999, pp. 55-56.

14. For a discussion of "divide-and-conquer" tactics that debtors may employ to take advantage of inter-creditor divisions, see Steven T. Kargman, "Negotiating Emerging Market Debt Restructurings: Recognizing the Warning Signs of a Non-Cooperative Debtor," The Journal of Private Equity, Summer 2004, pp. 85-86.

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Asian Insolvency Systems

CLOSING THE IMPLEMENTATION GAP

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