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General Objectives and Features of Insolvency Procedures

General Objectives

Although the insolvency laws of countries differ in important respects, it is possible to identify two overall objectives that are generally shared by most systems.

The first overall objective is *the allocation of risk among participants in a market economy in a predictable, equitable, and transparent manner*. The achievement of this objective plays a critical role in providing confidence in the credit system and fostering economic growth for the benefit of all participants. For example, in terms of the creditor-debtor relationship, the ability of a creditor to commence insolvency proceedings against a debtor as a means of enforcing its claim reduces the risk of lending and, thereby, increases the availability of credit and the making of investment more generally. An insolvency law also serves to allocate risk among different creditors, also for the benefit of borrowers. For example, if the insolvency law affords secured creditors special treatment vis-à-vis unsecured creditors, such treatment protects the value of security, which may be particularly important for those debtors that, because of their credit risk, cannot obtain (or cannot afford) unsecured credit.

- *Predictability*. Individual countries make different policy choices as to how their insolvency laws will allocate risk among participants. Irrespective of these different choices, however, it is generally recognized that the relevant risk allocation rules should be clearly specified in the law and that they should be consistently applied by the individuals and institutions that are charged with implementing them. Experience has demonstrated that no matter what risk allocation choices countries make, participants are often able to take measures (including through price adjustment) to help manage the risk in question if the application of these rules is relatively predictable. In contrast, when the rules or their application are uncertain, such uncertainty erodes the confidence of all participants and undermines their willingness to make credit and other investment decisions.

- *Equitable Treatment*. A common feature of all insolvency proceedings is their collective nature. Unlike other laws (e.g., foreclosure laws), an insolvency law is designed to address a situation in which a debtor is no longer able to pay its debts to its creditors generally (rather than individually) and, in that context, provides a mechanism that will provide for the equitable treatment of all creditors. As will be discussed, equitable treatment does not require equal treatment. On the contrary, to the extent that different creditors have struck fundamentally different commercial bargains with the debtor (e.g., through the granting of security), differential treatment of creditors that are not similarly situated may be necessary as a matter of equity. For the benefit of all creditors, however, an insolvency law must address the problem of fraud and favoritism that often arises in the context of financial distress. Moreover, given the importance of international credit and investment, the law must ensure that there is no discrimination against foreign creditors. Finally, the collective nature of a proceeding can give reassurance to creditors that problems will be resolved in an orderly and equitable manner. A liquidator or administrator can, for example, issue statements that can calm markets effectively.

- *Transparency*. Closely related to the objectives of predictability and equity is that of transparency. During insolvency proceedings, interested participants must be given sufficient information for them to exercise their rights under the law. Thus, for example, creditors must receive adequate notice of meetings where creditor decisions are to be taken and must receive sufficient information from the debtor to ensure that their decisions are informed. When the institutions charged with implementing the law (the court and the court-appointed liquidator or administrator) make decisions, it is also important that the law provide adequate guidance as to the exercise of their discretion and, in the case of the court, require that judicial proceedings be open and that the rationale underlying the court's decision be made publicly available.

The second objective of an insolvency law is *to protect and maximize value for the benefit of all interested parties and the economy in general*. This objective is most obviously pursued during rehabilitation, where value is maximized by continuing a viable enterprise. But it is also a primary objective of procedures that liquidate enterprises that cannot be rehabilitated. The achievement of the value maximization objective is often furthered by the fulfillment of the objective of equitable risk allocation. For example, the nullification of fraudulent transactions that occurred before an insolvency proceeding ensures that creditors are treated equitably and also enhances the value of the debtor's assets. However, there can also be tension between these objectives. For example, the nullification of prior transactions also extends to nonfraudulent transactions, which can undermine the objective of predictability. Similarly, during the insolvency proceedings, many countries give the liquidator or the administrator (depending on the nature of the proceedings) the authority to interfere with the terms of a contract previously entered into between the debtor and a counterparty. While the exercise of this authority provides an important means of maximizing the value of the assets of the debtor, it also undermines the predictability of contractual relations, which is critical to making investment decisions.

Some of the key policy choices to be made when designing an insolvency law relate to how the above objectives are balanced against each other. In addition, choices need to be made on who will be the beneficiaries of the value that is maximized: while some countries view rehabilitation procedures as providing a way to enhance the value of creditors' claims through the going-concern value of the enterprise, other countries also view it as a means of providing a "second chance" to the shareholders and the management of the debtor. Still others view the continuation of the enterprise as primarily benefiting the employees. The protection of employees raises the larger issue of when reliance on the insolvency law should be avoided altogether so that certain public policy objectives can be achieved. For instance, to limit unemployment or rescue enterprises that are engaged in important national activities, the authorities may prefer to address the problems of a troubled company through various measures that will involve an extensive use of public funds and give the beneficiaries a substantial advantage over their less-favored competitors.[1]

When determining how to strike the balance between the various objectives described above, it is necessary to avoid easy stereotypes. Debtors are not always fraudulent or incompetent, and creditors are

[1] Such measures can include, for example, direct subsidies, concessional loans, procurement contracts, tax rebates and deferrals, early retirement schemes, and equity participation.

not always grasping and selfish. As borne out by recent experience, although companies may fail because of incompetence, they may also fail because of economic difficulties beyond their control.

Viewed from the perspective of the economic policymaker, and in light of the above objectives, an effective insolvency law can clearly play a critical role in a number of areas. Generally, the discipline it imposes on a debtor increases the competitiveness of the enterprise sector and facilitates the provision of credit. More specifically, to the extent that the enterprise is owned by the state, subjecting the enterprise to the application of the general insolvency law sends a clear signal regarding the limitations of public financial support. In that context, the rehabilitation provisions of an insolvency law can effectively ensure that creditors contribute to the resolution of the financial problems of state-owned enterprises, thereby limiting the public cost of rehabilitation.

With respect to the financial sector, an effective insolvency law enables financial institutions to curtail the deterioration of the value of their assets by providing them with a means of enforcing their claims. In that context, it can also facilitate the development of capital markets. For example, if an insolvency law is applied with sufficient predictability, a secondary market in debt instruments can develop that, among other things, will enable financial institutions to transfer their loans to other entities that specialize in the workout process.

Finally, in the context of a financial crisis in which the entire enterprise sector is in distress, an effective insolvency law can provide a useful means of ensuring that private creditors contribute to the resolution of the crisis. For example, a rehabilitation procedure provides a way to impose a court-approved restructuring agreement over the objections of dissenting creditors. Not only does such a mechanism reduce the public cost of the crisis and relieve external financing needs, but it also strengthens the stability of the international financial system by forcing creditors to bear the costs of the risks they incur.

General Features

When designing an insolvency law, countries will need to address a common set of issues. Moreover, countries normally resolve these issues through the implementation of *liquidation procedures* and *rehabilitation procedures*.

Common Issues

Insolvency procedures generally require two elements. The first is a legal framework that sets forth the rights and obligations of participants, both substantively and procedurally. The second is an institutional framework that will implement these rights and obligations. A key question that arises in this context is the degree of discretion that the law gives to this infrastructure when it applies the law.

Legal Framework

An insolvency law must make policy choices with respect to a number of *substantive* issues, the most important of which include the following:

- It is necessary to identify the debtors that may be subject to insolvency proceedings. Will the general insolvency law apply to all debtors or will certain debtors (e.g., state-owned enterprises) be subject to special insolvency regimes or even insulated from the application of all forms of insolvency procedures?
- The law must determine when an insolvency proceeding may be commenced (upon illiquidity? upon insolvency?), who may request commencement, and whether the nature of the commencement criterion should differ depending on who is requesting commencement (i.e., the debtor or the creditor). A related question is whether the law should give the petitioner the option of requesting the initiation of either a liquidation or a rehabilitation procedure. Finally, the law must address the issue of whether the management of the debtor has a specific duty to commence proceedings when the relevant commencement condition has been met.
- To what extent should a debtor be displaced from the management and control of the enterprise once insolvency proceedings commence? In the case of rehabilitation procedures, some countries have opted for full debtor control (debtor-in-possession), while others have either given a court-appointed administrator full authority or have established some form of power-sharing arrangement between the debtor and the administrator.
- Will the "stay" that applies to the enforcement of legal remedies by creditors once insolvency proceedings commence also apply to secured creditors and, if so, what type of protection will be afforded to these creditors during the insolvency proceedings?
- To what extent will the liquidator (in the case of liquidation proceedings) or the administrator (in the case of rehabilitation) have

the general authority to interfere with the terms of contracts entered into by the debtor before the proceedings? A related issue of particular importance to financial markets is the extent to which set-off or netting rights can be suspended by the commencement of the proceeding.

- How broad will the administrator's powers be with respect to the nullification of transactions and transfers that are fraudulent or otherwise result in the interests of creditors being prejudiced?
- In the case of rehabilitation procedures, what limitations, if any, are imposed on the contents of the plan? What conditions are required for its approval and effectiveness?
- With respect to liquidation procedures, how should creditors be ranked for purposes of distributing the proceeds of a liquidation sale?
- In reorganization procedures, are the interests of the current owners and management to be given weight?

Finally, in addition to these specific issues, a more general issue that must be addressed is whether an insolvency law will effectively modify other substantive laws. For example, will the insolvency law supersede labor laws that afford employees special protection? In the context of the approval of a plan that envisages debt-for-equity conversions or the sale of the enterprise as a going concern, will it supersede provisions of the company law that would otherwise require shareholder approval?

Notwithstanding the variety of substantive issues that must be resolved, insolvency laws are highly *procedural* in nature. The design of the procedural rules plays a critical role in determining how risk is to be allocated among the various participants in the proceedings. Perhaps the most critical procedural issue relates to the identification of the decision maker. For example, in the case of liquidation proceedings, in what circumstances can the creditors replace the liquidator? In the case of a rehabilitation procedure, should the determination of whether a successful rehabilitation is potentially feasible be made by the creditors, the administrator, the court, or a combination thereof? If a rehabilitation plan is approved by the creditors, can it subsequently be rejected by the court? Conversely, can the court impose a plan that has been rejected by a requisite majority of the creditors? As discussed below, to the extent that the law confers considerable responsibility upon the institutional infrastructure to make key decisions, it is critical that this infrastructure be sufficiently developed.

Institutional Framework

An insolvency law will need to provide for an institutional framework for its implementation. Since the adjudication of disputes is a judicial function, insolvency proceedings should be conducted under the authority of a court of law where judges will, at a minimum, be required to adjudicate disputes between the parties on factual issues and, on occasion, render interpretations of the law. The judiciary will only be able to fulfill this function if it is made up of independent judges with particularly high ethical and professional standards.

Moreover, the court will also need to appoint qualified professionals (liquidators and administrators) who are designated to handle key administrative matters (recording, collection and evaluation of the assets and liabilities, management of the enterprise, etc.). The availability of an experienced cadre of such professionals with adequate commercial experience is essential to a successful implementation of the law. Among other things, safeguards will need to be in place to ensure that any conflict of interest is avoided between the designated professional and those parties that have an interest in the proceedings.

To perform their tasks, the court and the designated officials will also have to rely on specialists (accountants, appraisers, and auctioneers). They will need to have access to the debtor's books and other relevant information. For a proper discharge of their functions, laws will have to require the keeping of books and the observance of accounting standards by debtors engaged in an independent business activity. Although it is not necessary for such provisions to be contained in the insolvency law itself, they are essential to its implementation.

Exercise of Discretion

How much discretion should the law give to judges and designated officials in the exercise of their duties? Mandatory rules, when precisely formulated, give legal certainty to the parties and avoid litigation; they facilitate the proceedings and reduce their cost. Moreover, specific rules and criteria provide for the predictability that is one of the overall objectives of an insolvency law. However, most laws give the court or the designated officials at least some degree of discretion when resolving disputes during the proceedings on the grounds that it is not feasible to foresee and regulate each and every possible situation.

But to what extent should the court and the designated officials have the authority to make decisions on economic and business matters, in some cases over the objections of creditors? If a court is given such authority, it is no longer responsible solely for ensuring the legality of the proceedings; it becomes an active participant, with substantive decision-making powers on the appropriateness of certain outcomes, such as the continuation of the enterprise.

The greater the discretion that the law confers upon the court and the designated officials, the greater need there is for an adequate institutional infrastructure. Countries that give their judges such a key role in the decision-making process often find it necessary to establish a specialized court system, such as a commercial court or a bankruptcy court. The members of the court may be professional judges, preferably with special training and experience, or may be elected by the business community. In cases where the judges do not have such experience, countries often prefer to rely on qualified liquidators or administrators—or the creditors themselves—to make these decisions.

Liquidation and Rehabilitation

When a debtor is unable to discharge its liabilities as they become due, there are usually a number of competing claims on its assets, whether they be unpaid loans, invoices, rents, taxes, or salaries. To satisfy those claims, a liquidation of all of the debtor's assets and a distribution of the proceeds may be necessary. In such cases, creditors may only receive a portion of the nominal value of their claims. Sometimes, however, a complete liquidation of the debtor's assets will not be the preferred course of action, either for the debtor or its creditors. Rather, a restructuring of the debtor's operations or balance sheet may allow the creditors to be fully repaid or, at least, to receive more than they would have received through liquidation.

Although the insolvency laws of countries differ in a number of respects, almost all countries address the problems described above by including both *liquidation procedures* and *rehabilitation procedures* in their insolvency laws.

Liquidation Procedures

The need for liquidation procedures can be viewed from different perspectives. From one perspective, these procedures can be seen as addressing *intercreditor* problems. Specifically, when an insolvent debtor's assets are insufficient to meet its liabilities, an individual creditor's best strategy is to rush to take the necessary legal measures to attach and seize assets before other creditors have a chance to take similar action. Applying the prisoner's dilemma paradigm, while such behavior will appear rational from the perspective of individual creditors, such a "grab race" will not, in fact, be in the collective self-interest of creditors; not only are the legal actions taken by creditors costly, but such a disorderly piecemeal dismantling of the entity will lead to a loss in value for all creditors.

An orderly and effective liquidation procedure addresses the intercreditor problem by setting in motion a collective proceeding that seeks to achieve equitable treatment among creditors and to maximize the assets to be distributed to creditors. This is normally achieved by the imposition of a stay on the ability of creditors to enforce their rights against the debtor and the appointment of an independent liquidator whose primary duty is to maximize the value of the assets of the debtor prior to distribution to creditors.

Viewed from a broader perspective, and as discussed earlier, such liquidation procedures constitute an important disciplinary force that is an essential element of a *sustainable debtor-creditor relationship*. For example, by providing an orderly and relatively predictable mechanism by which the rights of creditors can be enforced, these procedures provide creditors with an important source of comfort when they make their lending decisions. In this way, they can be seen as promoting the interests of all participants in the economy, since they facilitate the provision of credit and the development of financial markets.

Rehabilitation Procedures

In contrast to liquidation procedures, rehabilitation procedures are designed to give an enterprise some breathing space to recover from its temporary liquidity difficulties or more permanent overindebtedness and, where necessary, provide it with an opportunity to restructure its operations and its relations with creditors. As noted above, where rehabilitation is possible, such an approach will be preferred by creditors if the value derived from the continued operation of the enterprise will enhance the value of their claims. While the benefits of rehabilitation are widely accepted, the degree to which formal rehabilitation procedures are relied upon to achieve these objectives varies considerably among countries. It is generally recognized that, in many respects, the very existence of liquidation proceedings will facilitate the restructuring of an enterprise, since it creates the necessary incentives for an out-of-court restructuring. Indeed, even in economies with sophisticated rehabilitation procedures, most rehabilitations take place "in the shadow" of insolvency proceedings. Moreover, a liquidation procedure, once activated, can also provide a basis for restructuring if it allows the enterprise to be sold as a going concern.

Notwithstanding the above considerations, there are a number of reasons why formal rehabilitation procedures can provide a mechanism for enterprise rehabilitation that serves the interests of all participants in the economy.

First, out-of-court rehabilitation requires unanimity of creditors. With the growth of capital markets and the resulting increase in the number and diversity of creditors, both the debtor and those creditors that wish to restructure may need to rely on the formal rehabilitation provisions that exist in a number of countries, which enable the debtor and the majority of its creditors to impose a plan upon a dissenting minority of creditors. Indeed, this feature of rehabilitation proceedings further facilitates out-of-court restructuring insofar as it reduces the leverage of a "hold-out" creditor during such out-of-court negotiations.

Second, in the modern economy, the degree to which an enterprise's value can be maximized through liquidation of its assets has been significantly reduced. In circumstances where the value of a company is increasingly based on technical know-how and goodwill rather than on its physical assets, preservation of the enterprise's human resources and business relations may be critical for creditors wishing to maximize the value of their claims.

Third, rehabilitation procedures may be viewed as economically beneficial in the long run, since they encourage debtors to restructure before their financial difficulties become too severe. Moreover, some countries view such procedures as serving a broader societal interest, by giving debtors a second chance and, thereby, encouraging the growth of the private sector and an entrepreneurial class.

Finally, and perhaps most important, as in the design of most other economic laws, economic efficiency is not the only consideration when designing insolvency laws. There are social and political factors that are served by the existence of formal rehabilitation provisions and, in particular, the protection of employees of a troubled enterprise. These considerations explain why the design of rehabilitation provisions varies from country to country. When countries evaluate and reform their insolvency laws, the key question will often be how to find the appropriate balance between a variety of social, political, and economic interests that will induce all actors in the economy to participate in the system.

While it is generally recognized that rehabilitation procedures are necessary, statistics show that, at least in a number of countries, up to 90 percent of insolvency proceedings end up in liquidation. Yet, statistics may be misleading. They often fail to capture the fact that larger companies (which have a greater impact on the economy) are more likely to be rehabilitated. Moreover, the failure of rehabilitation in these circumstances may often be due to the inadequate design or application of the rehabilitation procedure, and the conversion of rehabilitation into liquidation may reflect the fact that an enterprise with no chance of rehabilitation has used the rehabilitation procedure solely as a means of forestalling liquidation.

Pre-Insolvency Procedures

Some countries have adopted what can be described as "pre-insolvency" procedures that are, in effect, a hybrid of out-of-court rehabilitation and formal rehabilitation procedures. For example, in the United States, regulations have been issued that allow for the court to approve a reorganization plan under the rehabilitation chapter (Chapter 11) of the insolvency law even though the support required from creditors as a condition for court approval under this chapter was obtained through a vote that occurred before the actual commencement of the formal rehabilitation proceedings. Such "prepackaged bankruptcy" regulations are designed to minimize the cost and delay associated with formal rehabilitation procedures while providing a means by which a rehabilitation plan can be approved absent unanimous support of the creditors.

Under French law, to facilitate the conclusion of an amicable settlement with its creditors, a debtor may ask the court to appoint a "conciliator." The conciliator has no particular powers but may request the court to impose a stay of execution against all creditors if, in his or her judgment, a stay would facilitate the conclusion of a settlement agreement. During the stay, the debtor may not make any payments to discharge prior claims (except salaries) or dispose of any assets other than in the regular course of business. The procedure ends when agreement is reached either with all creditors or (subject to court approval) with the main creditors; in the latter case, the court may continue the stay against nonparticipating creditors by providing a grace period of up to two years to the debtor.

Still another method is the "London Approach." It is based on nonbinding guidelines issued by the Bank of England to commercial banks. Under this approach, banks are urged to take a supportive attitude toward their debtors that are in financial difficulties; decisions about the debtor's longer-term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties to a work-out. Interim financing is facilitated by a standstill and subordination agreement, and banks work together with other creditors to reach a collective view on whether and on what terms a company should be given a financial lifeline.

Drawing on the success of the London Approach, a number of countries that have recently experienced international financial crises have put in place nonbinding principles or guidelines that are designed to promote out-of-court restructuring of enterprises through negotiations with their domestic and foreign creditors (e.g., the Jakarta Initiative). Such guidelines establish a collective framework for negotiations and provide for the availability of interim financing to enterprises by creditors and the provision of information by these enterprises so that their restructuring proposals can be effectively evaluated by creditors. The government generally plays the important but limited role of facilitating negotiations. Although this approach is designed to minimize recourse to the insolvency law, the effective application of the law is critical to the success of these informal procedures since it provides the necessary incentives for meaningful negotiations.

Relationship Between Liquidation Procedures and Rehabilitation Procedures

Although liquidation and rehabilitation procedures are often viewed as relatively distinct from each other, there are, in fact, considerable overlap and linkages between them, both as a matter of procedure and in terms of the substantive issues they address.

Given the different objectives of these procedures, the determination of whether the enterprise is viable should, at least in theory, also determine which procedure should be used. As a matter of practice, however, when either of these procedures is initiated with respect to a debtor, it is often impossible to tell, at the time of commencement, whether the debtor should be liquidated or rehabilitated. In many countries, therefore, the party initiating the proceedings is given the choice between liquidation and rehabilitation procedures. However, when a creditor initiates a liquidation proceeding against a debtor, the law will often establish some mechanism that enables the proceedings to be converted into a rehabilitation proceeding. Conversely, in circumstances where a debtor seeks protection by commencing a rehabilitation proceeding, the law will often provide a means by which the proceedings can be converted into liquidation proceedings if it is determined that a successful rehabilitation is not likely (as discussed above, a key issue is the identity of the decision maker). As a general principle, therefore, although these are presented as "two-track" procedures, they are normally utilized sequentially; that is, a liquidation procedure will only run its course if rehabilitation efforts (whether formal or informal) have failed.

With respect to the substantive issues that these procedures must address, there is also considerable overlap. This is due (at least in part) to the fact that the distinction between a "liquidation" and a "rehabilitation" is somewhat blurred. How does one classify the sale of an enterprise as a going concern? From one perspective, it can be viewed as a rehabilitation, because the enterprise continues its activities and employment is preserved. From another perspective, it can be viewed as a liquidation of the debtor's assets because the company that owns the enterprise is liquidated and the enterprise (as an economic unit) is now under new ownership. If, as in most cases, the sale of an enterprise as a going concern is considered a possible outcome of a liquidation proceeding, the continuation of the enterprise becomes just as critical as under a rehabilitation procedure, so similar safeguards regarding the stay on creditor actions and the treatment of contracts may be required.

A number of countries reflect the above linkages in the design of their laws. For example, in some countries, liquidation procedures normally may be commenced only if all attempts to rehabilitate have failed. In effect, the law presumes that a company should be rehabilitated. The rehabilitation stage will only be skipped where there is clearly no hope for the enterprise (e.g., it is already out of business).

Following a different approach, some countries that have recently revised their bankruptcy laws have introduced "unitary" proceedings as an alternative to separate, self-contained proceedings. For example, under the revised law of Germany, all insolvencies are conducted initially under the same rules and, for an initial period of up to three months, there is no presumption as to whether the enterprise will be rehabilitated or liquidated. The proceedings only separate into liquidation proceedings and rehabilitation proceedings once a determination has been made as to whether rehabilitation is, in fact, possible. The procedural simplicity of such an approach may have advantages, particularly where the capacity of the institutional infrastructure is limited. However, this trend toward "unitary" proceedings is a recent one and is still not reflected in the structure of the insolvency laws of many countries. For this reason, the structure of this report follows the twin procedure model that still prevails, identifying the linkages and differences between these proceedings as they arise.